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# Terms of Priced Startup Rounds

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## What is a priced startup round?

A priced startup round is a funding event where investors buy equity at a set valuation. This determines the company's worth before investment, allowing investors to know their ownership percentage. The round involves negotiating terms like share price and investor rights. Priced rounds differ from convertible notes or SAFE agreements, which don't set a valuation upfront. They are essential for startups to raise capital while establishing a clear ownership structure.

## What type of equity do investors buy in a priced round?

In a priced round, investors typically buy preferred equity. This type of equity gives investors priority over common shareholders in terms of dividends and liquidation rights. Preferred shares often come with additional rights, such as anti-dilution provisions and the ability to convert to common shares. The specific terms can vary based on negotiations between the startup and investors.

## What is a liquidation preference?

A liquidation preference is a term in startup financing that dictates how investors are paid back during a liquidation event, like a sale or bankruptcy. It specifies the order and amount investors receive before common shareholders. For instance, with a 1x liquidation preference, investors get back their investment first. This term protects investors by ensuring they recoup their investment before others receive any proceeds.

## Describe the conversion feature in a priced equity round.

The conversion feature in a priced equity round allows investors to convert their preferred shares into common shares at a predetermined rate. This typically occurs during a future financing round or an exit event, like an acquisition or IPO. The conversion rate is often set to ensure that investors benefit from the company's growth. It protects investors by giving them the option to participate in the company's success while also providing a clear valuation at the time of investment.

## Describe how dividends work in a priced equity round.

In a priced equity round, dividends are payments made to shareholders from a company's profits. They can be either cash or additional shares. Typically, preferred shareholders receive dividends before common shareholders. The dividend rate is often set in the investment terms. If the company does well, dividends can provide a return on investment. However, many startups reinvest profits instead of paying dividends to fuel growth.

## It is common for terms to call for a cash dividend or do they usually accrue to be paid upon liquidation or exit?

In startup funding rounds, cash dividends are uncommon. Typically, dividends accrue and are paid upon liquidation or exit. This means investors receive their returns only when the company is sold or goes public, rather than receiving regular cash payments. This structure aligns investor interests with the company's growth and exit strategy. Always review specific terms in the investment agreement, as they can vary.

## Explain preemptive rights.

Preemptive rights allow existing shareholders to maintain their ownership percentage during new funding rounds. When a startup issues new shares, shareholders with these rights can buy additional shares

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before new investors. This prevents dilution of their ownership stake and protects their investment value. Preemptive rights are typically included in the company's bylaws or shareholder agreements and can vary in execution and duration.

### **What is a ratchet in terms of anti-dilution provisions?**

A ratchet is an anti-dilution provision that protects investors from losing value in their shares during future funding rounds. If a startup raises money at a lower valuation than previous rounds, a ratchet adjusts the price of earlier investors' shares to maintain their ownership percentage. This mechanism helps early investors by reducing the risk of dilution, ensuring their investment retains value even if the company's valuation decreases in subsequent rounds.

### **Explain protective provisions.**

Protective provisions are clauses in investment agreements that safeguard investors' interests. They require the startup to obtain investor approval before making significant decisions, such as issuing new shares or selling the company. These provisions ensure that investors have a say in critical matters that could affect their investment. They help prevent actions that could dilute the value of their shares or negatively impact the company's future.

### **Explain drag-along rights.**

Drag-along rights are provisions in investment agreements that allow majority shareholders to force minority shareholders to sell their shares if a third party wants to acquire the company. This ensures that potential buyers can purchase 100% of the company without being blocked by minority stakeholders. It helps streamline the sale process and can make the company more attractive to buyers. Typically, these rights are included to protect the interests of investors and facilitate smoother exits.

### **Explain tag-along rights.**

Tag-along rights are provisions that protect minority investors in a startup. If majority shareholders sell their shares, tag-along rights allow minority investors to join the sale and sell their shares on the same terms. This ensures that minority investors can exit alongside larger shareholders, preventing them from being left behind in a sale. These rights are important for maintaining equity and ensuring that all investors have the opportunity to benefit from a liquidity event.

### **Do preferred shareholders vote prior to conversion?**

Yes, preferred shareholders typically have voting rights before conversion, depending on the terms outlined in the company's charter or the preferred stock agreement. They may vote on significant matters, such as mergers or changes to the stock structure. However, the specifics can vary by company, so it's essential to review the governing documents for exact details.

### **How big are startup boards?**

Startup boards typically consist of 3 to 7 members. Early-stage startups often have smaller boards for agility, usually including founders, key investors, and advisors. As companies grow, boards may expand to include more independent directors for diverse perspectives. The size can vary based on the startup's stage, industry, and funding rounds. Generally, a smaller board is more effective for decision-making, while larger boards can provide broader expertise.

### **Explain no-shop provisions.**

No-shop provisions are clauses in investment agreements that prevent a startup from seeking offers from other investors for a specified time. This allows the current investor to conduct due diligence and finalize the deal without competition. Breaching this clause can lead to penalties or loss of the offer. These

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provisions create commitment and security for the investor but limit the startup's options during negotiations.

### **Explain pay-to-play provisions.**

Pay-to-play provisions require existing investors to participate in future funding rounds to maintain their ownership percentage. If they choose not to invest, they may lose certain rights, like anti-dilution protections. This encourages continued investment and commitment from current investors. It can also protect the startup from dilution by ensuring that only active investors remain involved. Overall, it aligns the interests of investors and the company's growth.

### **Explain conditions precedent.**

Conditions precedent are specific requirements that must be fulfilled before a startup receives funding in a priced round. These can include legal approvals or financial audits. Investors set these conditions to ensure the startup is ready for investment. If conditions aren't met, funding may be delayed or canceled. Understanding these conditions is crucial for both startups and investors to ensure a smooth transaction.

### **Explain information rights.**

Information rights are the rights of investors in a startup to receive specific financial and operational information. This includes access to regular financial statements and updates on business performance. These rights allow investors to monitor their investment and make informed decisions. They can vary based on the investment agreement but typically include quarterly reports. This transparency fosters trust between the startup and its investors.

### **How long does it typically take to close a round after the term sheet is signed?**

Typically, it takes about 4 to 6 weeks to close a funding round after the term sheet is signed. This timeframe allows for due diligence, finalizing legal documents, and transferring funds. However, it can vary based on the complexity of the deal and the responsiveness of both parties. In some cases, it may take longer if there are negotiations or issues that arise.

### **Who usually pays for the costs of documentation and due diligence?**

Typically, the startup pays for the costs of documentation and due diligence during funding rounds. However, these costs can sometimes be negotiated, and investors may cover some expenses, especially if they are leading the round. It's important for startups to clarify these terms in the investment agreement. Always review the terms carefully to understand who is responsible for what costs.