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RIGHTS OF A VENTURE CAPITAL INVESTOR

Every entrepreneur requires funds to convert his idea into reality and turn it into a scalable. business. Depending on the type of business as well as the size of its operations, the sources of such funding differ.

The conventional stages of funding in a business include:

1. *Seed Round*: This is the initial round of capital that is invested in the idea that the entrepreneur has in order for it to move into product development. In this round, the capital is often either invested by the entrepreneur himself or through funds of friends and family. In this stage, the capital is mostly in the form of a loan and the entrepreneur remains the sole owner of the startup.

2. *Angel Funding*: After utilizing the initial round of capital, the entrepreneur approaches an angel investor for further funding and has to convince the potential investor regarding the feasibility of the idea/product. The entrepreneur needs to approach the angel investor at the right, such that the investor recognizes the potential of the idea/product. Angel investors are also often friends and family, but may also include high net worth individuals.

3. *Venture Capital*: An entrepreneur should approach a venture capitalist only after figuring out all aspects of product development, the size of the market, the scalability of the business, or a proof of concept. There may be multiple rounds of funding and the valuation of each round shall be dependent on the success of the previous round. It is important during this stage that the entrepreneur safeguards his stake in the business and doesn't part with the major chunk of his equity. As the entrepreneur starts seeking multiple rounds of funding, he has to weigh the benefit of the new funding over giving up the business' equity.

4. *Growth Equity*: Growth equity funds invest in fast-growing businesses, which have moved beyond the start-up stage in exchange for a minority equity stake. In such funding, strategic and operational control is often retained by the promoters, and in order to achieve the full potential of a growth equity funding, trust based partnership between the investors, existing owners and management is required.

In addition to the above, entrepreneurs may also seek to raise funds in the following manner:

5. *Bridge Funding*: During the interim period when the business is considering the prospect of raising funds from the public, it may take up short term loans to cover short term expenses. This is usually a high interest loan and is preferred by businesses preparing to raise funds from the public. It is often structured in a manner so that it may be repaid from the proceeds of the public offering.

6. *Initial Public Offering (IPO)*: At this stage the business has grown exponentially and has reached a stage where it is beneficial

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to spread the risk of ownership among a large group of shareholders. This is the stage where the venture capitalists or other private equity investors are able to monetize their investments, exit, and receive a return on their investments.

Rights of a Venture Capitalist

From some of the most popular brands in the world today such as Google and Facebook to huge multinational companies, venture capital (VC) has funded and nurtured some of the most influential companies in today's global economy.

At any stage of funding, an investor seeks certain rights in the target company in order to ensure that its rights are protected. Such rights may be divided into economic terms and control rights over the target company. The rights granted in an early stage venture capital funding often set the ground rules for future fundraising, and therefore need to be carefully reviewed both from the perspective of the venture capitalist as well as the entrepreneur.

A venture capitalist usually focuses on the return on the investment he would receive from the company in future fundraising rounds and/or when the company going public. Investing in the equity of a new company entails a long-standing relationship with the founders. The relationship is often cemented by a shareholders' or investor rights agreement that acts as the key binding agreement and lays out the carefully negotiated rights of the investor.

Economic rights set out the share pricing, valuation, investment amount and the rights and obligations of the preference shares being invested in by the VC. Some of the key economic rights that are negotiated include:

1. Share Price and Valuation: The offer made by the VC, including the pre-money and post-money valuations of the target company is a fairly subjective process. Any target's current operations, future projections as well as the strength of its business model, the experience of its team and the market-size are all included when assessing the valuation and consequently the share price of a VC's investment. The expected number of future fundraisings also impact valuation as they will dilute not only the founder but also the existing VC investor. Any investor rights agreement will clearly define the nature of the instrument a VC is investing in, which is often the preference share capital of the target.

2. Liquidation Preference: Liquidation Preference gives preference shareholders preference over ay distributions received in case of a defined liquidity event, such as acquisition by a strategic investor, merger, an IPO or liquidation of the company such as a winding up or a bankruptcy. It is standard for the VC to seek liquidation preference, i.e. preferred return of their invested capital and a specific internal rate of return over and above it. If the VC has invested in "participating preference shares", the balance of exit proceeds after the liquidation preference has been satisfied is shared by the preference shareholders *pro rata* with equity shareholders, on an as-converted basis.

3. Anti-Dilution Rights: The VC at the time of investing also has to ring fence itself from future funding rounds to safeguard the valuation at which he invested in the company. Accordingly, in the event that the new shares are valued lower than the valuation at which the VC invested; the anti-dilution protection applies, i.e. the shareholders who invested at a higher valuation in earlier rounds will receive additional shares to maintain their ownership stake in the company and avoid dilution. Equity shareholders do not get anti-dilution protection and are diluted in future fundraising rounds. Anti-dilution provisions come with

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varied degrees of severity. There are broadly two methods of anti-dilution:

a. *Full Ratchet*: This is an extremely harsh form of anti-dilution and is usually not accepted by the founder. In this method, in case the subsequent round is at a price lower than per share paid by the VC, the price per share of the VC will be revised to the new lower price by either issuing additional shares or the conversion price would be revised.

b. *Broad Based Weighted Average*: As compared to full ratchet method, broad based weighted average method uses a formula which considers the number of shares issued in a subsequent round of investment and the number of shares held by the existing VC and is, therefore, a well-rounded method and is adopted more freely in VC investments.

4. Conversion Rights: Preference shareholders often negotiate the right to convert their preference shares to equity shares of the target, at their discretion, upon the occurrence of pre-agreed trigger events, typically just prior to a sale or a merger. In the case of IPO, the conversion is mandated under law in most jurisdictions including India. The conversion rate is usually 1:1 and is pre-agreed in the shareholders' or investor rights agreement executed with the VC.

VCs typically negotiate some control rights to monitor the development of the target and influence important decisions. Some of the key control terms negotiated by VCs are set out below:

1. Board Representation: Despite being minority shareholders, VCs often negotiate 1 or more Board seats with voting rights (depending on the amount invested in the target). A single VC may be able to negotiate more in its favour, whereas in the case of a more sought after company having multiple VC investors may be able to negotiate lesser representation as a condition of investment.

2. Protective Provisions: VC investors usually receive voting rights on an "as-converted" basis equal to that of equity shareholders, unless restricted by applicable laws. In addition, a number of items are covered under reserved matters, i.e. the VCs have the ability to veto a decision on the pre-agreed list of matters at the Board as well as shareholders level. Founders often negotiate the reserved matters list heavily to ensure that there are no operational impediments on account of any of the matters. VCs usually focus on seeking reserved matters rights over *inter alia* actions which would alter the constitutional documents of the target, which would adversely change the rights attached to the preference shares held by them, approval of any sale, divestment, merger, business transfer, future fundraising rounds, ESOPs and appointment or removal of senior management.

3. Restrictive Covenants on the Founders: The VC invests into the company due to the vision of the founder, therefore it is critical to the VC that the founder remains a part of the company and grow the company and consequently the profits that the VC will derive from the company. One of the most common restrictions imposed on the founder is a lock-in period, i.e. the founder is not permitted to sell or transfer its stake to any third party during the lock in period without the consent of the VC.

4. Restrictions on Transfer of Shares: Most VCs will have a right of first refusal (ROFR) on the sale of shares by the founders or other existing shareholders. The ROFR is an opportunity for the VC to purchase the stake of the founder in

case it has received an offer from any third party. The founder may sell its stake to the third party only if the VC refuses to match the price offered by the third party.

5. Drag-Along / Tag-Along Rights: A drag-along provision gives the VC the right to force other shareholders to sell their shares in a third-party transaction. This provision enables the VC to sell out and achieve a clean exit. A tag-along provision provides the VC the right to sell their shares in conjunction with the sale by founders or other shareholders in a third-party transaction, usually on a pro rata basis.

6. Pre-emptive Rights: At the time of investing in a company, the VC seeks to secure its future growth and prevent the dilution of its stake in the company. In order to achieve this, the VC places conditions on the future issuance of further securities of the company. In the event of further issuance, the VC has a pro-rata right to purchase such securities in order to maintain his or her percentage ownership of the company.

7. Information Rights: As venture capital investors are purely financial investors, not involved in the operations of a company, they seek information rights which clearly outline which operational and financial information must be provided to them and when, in order to keep themselves up-to-date with the operations and financial conditions of the target. The requested information usually includes monthly unaudited and annual audited financial statements.

Conclusions

VC funds are minority investors putting their money on the future growth of early-stage companies – often pre-profit, pre-revenue, and in some cases even pre-products. Despite the lack of a controlling stake, venture capitalists often negotiate economic terms and control rights in a manner that enables them to guide the target through early years of development and obtain the best possible return on their investment. A venture capital investment may be instrumental in the growth of the company; however, the success of the company is largely dependent on finding the correct venture capitalist and negotiating the terms of the investment.

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