Startup terms glossary

There are a lot of buzzwords and lingo in the startup and VC ecosystem. Here we provide a guide to the most commonly used terms, so that you can reference them as you navigate venture financings for the first time.

Click on a term in the list below to read its definition.

Terms

Pre-Emptive Rights | Pre-Money Valuation | Pro-Rata Rights | Prospectus Exemptions | Protective Provisions
Qualified IPO | Redeemable Preferred Shares | Registration Rights | Representation and Warranty
Reverse Vesting (in respect of restricted shares) | Right of First Notice | Right of First Refusal | SAFE
Secondary Sale of Shares | SR&ED | Unanimous Shareholders Agreement | Up-Round | Valuation Cap
Vesting (in respect of options)

Acceleration (Employee Options and Restricted Shares)

Acceleration refers to the treatment of unvested options or shares upon the occurrence of certain events, most often in change of control or exit scenarios. It can take many forms, including most commonly single trigger acceleration or double trigger acceleration. It is common for founders' shares and options to be subject to double trigger acceleration while advisors are often subject to single trigger acceleration. Typically, the majority of "non-founder" employees are not subject to any acceleration provisions.

See also: Reverse Vesting (in respect of restricted shares)

Acceleration, Double Trigger

Double trigger acceleration refers to acceleration of unvested options or shares that is contingent upon both (i) a change in control of the company (i.e. a merger or sale of the company), and (ii) the termination of the employee post change of control. In order for the unvested options or shares to be accelerated (i.e. automatically vested), both events need to occur.

See also: Vesting (in respect of options)

Acceleration, Single Trigger

Single trigger acceleration refers to the acceleration of unvested options when there is a change in control of the company, i.e. a merger or sale of the company. In order for the unvested options or shares to be accelerated (i.e. automatically vested), only the occurrence of a change of control transaction is required.

Accredited Investor

An accredited investor is someone legally authorized to invest in private companies, based on certain attributes of the investor. The most common attributes that qualify investors as accredited investors are their net income or net worth.

See also: Prospectus Exemptions

Acquihire

An acquihire is a situation where a company is acquired primarily to recruit its employees as opposed to acquiring the company's product or service. In most acquihires, the buyer does not plan to run the target business as a going concern, but rather, plans to redeploy the target's employees to work on the buyer's own products/services.

Anti-Dilution Protection

Anti-dilution protection refers to clauses (usually in a company's share terms) which protect investors from losing value in their share ownership in the event of a down-round of financing. This is also referred to as "price-based anti-dilution", and is triggered when new equity is issued at a lower valuation than when the existing investor(s) purchased their shares. Anti-dilution protection does not (and is not intended to) protect an investor's ownership percentage through successive rounds of financing.

Rather than issuing new shares to existing investors to account for the down-round, anti-dilution protection works by adjusting the conversion rate of the investors' shares (typically preferred shares) into common shares. In the event of a successful exit transaction, existing investors will receive a greater portion of the proceeds, as their preferred shares will convert into a greater number of common shares after the anti-dilution adjustment.

See also: Anti-Dilution Protection, Broad Based Weighted Average, Anti-Dilution Protection, Full Rachet, Anti-Dilution Protection, Narrow-Based Weighted Average

Anti-Dilution Protection, Broad Based Weighted Average

Broad Based Weighted Average is a method of calculating Anti-Dilution Protection in the event of a down-round using a weighted average (in proportion to the amount of new equity issued) rate which mitigates the losses of dilution. It is called "broad" because the weighted average calculation includes convertible securities like employee options, which are excluded from the calculation under the Narrow-Based Weighted Average method. Broad-Based Weighted Average anti-dilution provides less protection to the investor than a Full Ratchet or Narrow-Based Weighted Average and is therefore the most favourable from a founder's perspective. It is the most common type of price-based anti-dilution protection found in venture capital transactions.

Anti-Dilution Protection, Full Ratchet

Full Ratchet is a method of calculating anti-dilution protection in the event of a down-round, which adjusts the conversion price of the existing investors' preferred shares into common shares to the same price at which shares are issued to new investors in the down-round. It is the strongest form of price-based anti-dilution protection for investors, and therefore the least favourable from a founder's perspective.

See also: Anti-Dilution Protection, Narrow-Based Weighted Average

Anti-Dilution Protection, Narrow-Based Weighted Average

Narrow-Based Weighted Average is a method of calculating anti-dilution protection in the event of a down-round using a weighted average (in proportion to the amount of new equity issued) rate which mitigates the losses of dilution. It is called "narrow" because the weighted average calculation excludes convertible securities like employee options, which are included from the calculation under the broad based weighted average method. Narrow-Based Weighted Average anti-dilution provides less protection to the investor than a full rachet, but more protection than Broad-Based Weighted Average.

Authorized Share Capital

The Authorized Share Capital of a company is the maximum number of a class of shares that the company is able to issue pursuant to its constating documents.

Basic Capitalization

Basic capitalization refers to the shares issued and outstanding on a company's capitalization table, not including any securities that are convertible or exercisable for shares (such as employee options or warrants).

See also: Fully Diluted Capitalization

Board Observer

A Board Observer is a representative of an investor who is authorized to attend meetings of a company's board of directors or receive the minutes of a board meeting, but who is not permitted to participate in votes of the board of directors. The right to designate a board observer is a contractual right granted to certain investors as a result of their significant investment amount or their ability to provide strategic advice to the company. As the right is contractual, and not based in statute, the company and investor are free to negotiate the parameters of the board observer's rights. For example, they may be entitled to receive materials distributed to the board in advance of a meeting, or they may be excluded from certain portions of a board meeting where commercially sensitive information is being discussed.

Bridge Financing

Bridge financing refers to short term financing which bridges the gap between when a company would run out of money and a future larger financing. It can take the form of debt or equity, but is commonly completed using convertible instruments (such as convertible note or SAFEs). Bridge rounds of financing can often be completed much faster than full financing rounds, allowing a company to extend its runway with minimal distraction from the business. Bridge financing can also provide a company with the time and resources it needs to reach an upcoming milestone that is expected to increase the company's valuation, such that the later larger financing can be completed on better terms than might otherwise be available today.

Canadian Controlled Private Corporation

A Canadian Controlled Private Corporation (CCPC) is a corporation that meets certain ownership and control requirements defined under the Canadian Income Tax Act. In general, a CCPC must be a private corporation (i.e. not publicly traded) and must not be controlled directly or indirectly by one or more non-resident Canadians. For an early-stage company, being a CCPC has many tax advantages, including certain capital gains exemptions and expanded access to tax credits.

Closing Date

In the venture financing context, a closing date is the date the financing is officially consummated, meaning the shares or other securities issued in the financing are actually issued. The closing date may be different from the date the investors sign the financing paperwork or the date they wire their investment funds. A financing may also have more than one closing date. In that instance, the first closing date (typically including the lead investor) is referred to as the "initial closing" and the remaining closing dates are referred to as "subsequent closings". The documentation for a financing transaction will often specify the last date that can be a closing date, which sets the outer limit for the duration of the financing.

Conversion Rate

The meaning of the term "Conversion Rate" in venture financings depends on the context in which it is used. In convertible note financings, for example, the conversion rate is the rate (often expressed as a price per share) at which a convertible note can be converted into shares in the company. In preferred share financings, on the other hand, the conversion rate is the rate at which preferred shares can be converted into common shares. In this context, the conversion rate may be adjusted pursuant to the anti-dilution mechanics set out in the share terms.

See also: Convertible Note, SAFE, Antidiultion Protection

Convertible Note

A Convertible Note is a loan given to a startup company that converts into equity in a future financing, often at a discount to the price paid by investors in the future financing. The conversion rate of the loan into equity can also be subject to a valuation cap. Because convertible notes are structured as debt until they convert to equity, they have a maturity date and bear interest. Convertible notes are one of the most popular forms of financing for early stage startup companies.

See also: Conversion Rate

Co-Sale Rights

A right of co-sale is a provision commonly found in venture financing agreements which permit investors to participate in a significant shareholder's (often the founders) proposed sale of shares to a third party on the same terms as the proposed sale. The right protects minority investors who may not have as much leverage in getting a deal to sell their shares and protects liquidity in a market with relatively few buyers.

See also: Drag-along Rights

Convenants

A covenant is an umbrella term referring to promises to do or to refrain from certain activities. They are demands of either investors or the company and can take many forms depending on the nature of a deal. Common covenants in venture financing transactions include voting limitations, salary/bonus limitations, meeting performance goals and capital spending limitations.

Disclosure Schedule

The disclosure schedule is a companion document to a share purchase agreement or subscription agreement in a venture financing. The share purchase or subscription agreement contains a number of representation and warranty about the company, and the disclosure schedule provides the company with the opportunity to disclose information that might otherwise make the representation or warranty untrue. For example, the subscription agreement might say the company has no outstanding litigation, and the disclosure schedule might then list an ongoing lawsuit involving the company. The representations and warranties may also require the company to list certain information in a disclosure schedule, including material agreements and open source software used in a company's technology. In this way, the disclosure schedule also supplements the investors' own due diligence efforts. It is important the founders and company executives carefully review the company's representations and warranties and the accompanying disclosure schedule in a venture financing, as any errors therein could result in liability for the company.

Discount

A Discount is an optional feature of both convertible notes and SAFEs which refers to the amount by which the conversion rate of the note or SAFE is discounted relative to the price per share paid by new investors in the next round of equity financing. For example, if investors in the next round of equity financing pay $1/share, and the note or SAFE has a 20% discount, then the note or SAFE will convert into shares at $0.80/share. This is the benefit received by the note or SAFE investor for having invested earlier, when the investment was riskier. The larger the discount, the more investor friendly the note or SAFE will be. If a note or SAFE also includes a valuation cap, then the investor is entitled to the better of the conversion rate calculated using the discount and that calculated using the valuation cap.

Dividends

A dividend is a distribution of some or all of the company's assets (typically cash) to its shareholders. Early stage startups rarely pay dividends, as any cash available to be distributed is usually reinvested in the business to continue growing. Nonetheless, sometimes investors with preferred shares have the right to receive dividends at a prescribed rate, if the company were to also pay dividends to the holders of common shares (i.e. founders). Such dividends can be Cumulative or Non-cumulative.

Dividends: Cumulative

Cumulative dividends refers to Dividends that accrue whether or not the company declares a dividend, and are paid out if/when the company eventually does declare a dividend, in priority to payments on other classes of shares (e.g. common shares). In other words, cumulative dividends entitle the investor to receive any missed dividends in the future.

See also: Dividends: Non-Cumulative

Dividends: Non-Cumulative

Non-cumulative dividends refers to Dividends that do not accrue if the company does not actually declare a dividend in a particular period. In other words, non-cumulative dividends do not entitle the investor to receive any missed dividends in the future.

See also: Dividends: Cumulative

Down-Round

A down-round refers to a round of financing for a startup in which the valuation of the company is lower than the valuation at the time of the company's prior round of financing. The valuation can be expressed on either a Pre-Money basis or a Post-Money basis. A down-round of financing may trigger Anti-Dilution Protection.

See also: Up-Round

Drag-along Rights

Drag-along rights allow majority shareholders to force a minority shareholder to agree to a sale of the company at the same terms the majority has agreed to. This is particularly useful when a company has a significant number of smaller shareholders (e.g. employees who exercised options) and it would be administratively cumbersome to seek consent from each shareholder to sell their shares. Drag-along rights may also be exercised when the sale price of the company is close to the aggregate liquidation preference, leaving little value left for common holders. In this instance, minority common shareholders may have little incentive to support the sale transaction, but can be "dragged along" by the remaining shareholders.

Employment Offer Letter

An employment offer letter is a short form version of an employment agreement that lays out the contractual relationship between the company and its employees. When the employee signs and returns the offer letter, an employment relationship is established. The offer letter includes details on the position, compensation, benefits (if any) and other terms of employment. In a startup context, this document will also specify any equity the employee will receive under the company's equity incentive plan (often in the form of options) and how that equity will vesting over time. Most jurisdictions in North American have their own employment standards legislation, so attention must be paid to ensure the employment offer letter complies with the applicable statute, and that they work together.

Equity Incentive Plan / Stock Option Plan / Option Pool

An Equity Incentive Plan is a document which details equity awards that may be given to employees. The equity awards may take the form of options, restricted shares, restricted share units, deferred share units, performance share units or share appreciation rights, though options are by far the most common form of equity award in a start-up company. The Equity Incentive Plan will discuss the number and types of awards that may be granted, how the awards will vesting, what happens to the awards upon cessation of the employee or service provider's services to the company and how the plan is to be administered.

Fully-Diluted Capitalization

The fully-diluted capitalization of a company refers to the total number of shares in a company, based not only on shares that have been issued, but also on the equity that has been set aside to be issued, such as employee options, convertible notes or warrants.

Information Rights

Information rights are rights provided to investors (sometimes only a subset of investors who meet a threshold of ownership, often referred to as a “Major Investor”) which require the company to provide the investor with certain information about the company. The list of information to be provided is negotiable, but often includes financial statements, budgets and capitalization tables, as well as the right to inspection the company's records or visit the company's facilities. The agreement providing the information rights will usually specify a timeframe during which the information needs to be provided (e.g. within 90 days of financial statements being prepared).

See also: Major Investor

Invention Assignment Agreement

An invention assignment agreement is a contract which allows one party to receive ownership of intellectual property that the other party creates, usually in the course of employment. For example, a software engineer can assign their claims to ownership over the intellectual property of the code they write to their employer. In startup companies, it is common for every employee to sign an invention assignment agreement alongside their employment offer letter, whether or not they are directly involved in creating the company's product or service.

Key Holder

A key holder is a designation given to certain shareholders (typically founders who hold common shares) in the agreements between the founders and investors. Under those agreements, certain provisions may apply specifically to Key Holders. For example, the right of first refusal may apply only to transfers of common shares held by Key Holders.

Limitations on Class Voting

Certain corporate statutes permit companies to prohibit shareholders from voting as a separate class with respect to certain fundamental matters. These matters are typically related to (i) increasing or decreasing the maximum number of authorized shares of the applicable class or series of shares; (ii) effecting an exchange, reclassification or cancellation of all or part of the applicable class or series of shares; and (iii) creating a new class or series of shares.

Liquidation Preference Overhang

The liquidation preference overhang can refer to one of two scenarios, both of which have to do with the liquidation preference attached to a company's preferred shares.

(1) The first results from a situation where the financial return from a liquidity event (i.e. exit transaction) is received entirely by preferred shareholders as a result of their liquidation preference, leaving no proceeds left to be distributed to common shareholders. The overhang itself is the amount by which the aggregate liquidation preference of all preferred shareholders exceeds the proceeds from the liquidity event.

(2) The second results from a situation where an investor who holds a convertible note receives the exact same type of share as investors who are investing new money in the subsequent round of financing in which the notes convert to equity. The overhang arises because the new shares typically carry a 1X liquidation preference, but the convertible note holders did not pay the full $1X since they received a discount to the share price at conversion. Therefore, upon a liquidation event, the aggregate liquidation preference will exceed the cash received by the company for the preferred shares, making the effective liquidation preference greater than 1X. This is often solved by specifying in the convertible note documentation that convertible note investors will receive a class or series of shares that is identical to that received by new investors in the equity financing, other than when it comes to the liquidation preference, which will reflect the price actually paid by convertible note investors.

Liquidation Preference ("Waterfall")

A Liquidation Preference is a right attached to some preferred shares which grants the investor priority for their returns in a liquidation event over other shareholders that are lower down in the preference chain (typically common shareholders). Liquidation preferences are usually expressed as a multiple of dollars invested. For example, a 1X liquidation preference means that for each $1 put into the company, an investor will receive $1 in preference to all investors that are lower down the preference chain. The share terms may also contain extra benefits to the investor, such as requiring multiples of the return (e.g. 2X or 3X), or some level of participation in the returns to common shareholders after the preference is paid out (known as participating preferred shares). When participating preferred shares are used, the amount of participation may be subject to a cap. In the absence of participating preferred shares, investors with a liquidation preference must decide at the time of a liquidation event whether they are better off keeping their preferred shares and receiving their liquidation preference or converting to common shares and participating in the residual proceeds. The amount of money received by each investor in a liquidity event is known as the "waterfall". This can get fairly complicated as additional classes or series of preferred shares are created, each with their own liquidation preference and/or priority.

See also: Liquidation Preference Overhang

Liquidation Preference: Pari Passu Liquidation Preference

A pari passu liquidation preference refers to a liquidation preference in which the investor's right to receive proceeds of the liquidation is on par with some or all of the other investors holding preferred shares. In other words, each class or series of preferred shares that are pari passu rank equally in respect of liquidation entitlements with all other classes or series of preferred shares that are also pari passu. Where 3 or more classes/series of preferred shares are issued, it is possible for some of them to be pari passu with each other, while others may have a different priority.

See also: Liquidation Preference Overhang, Liquidation Preference: Senior Liquidation Preference

Liquidation Preference: Senior Liquidation Preference

A senior liquidation preference refers to a Liquidation Preference in which the investor's right to receive proceeds of the liquidation ranks higher than some or all of the other investors holding preferred shares. In other words, when proceeds of a liquidation are distributed to shareholders, investors holdings preferred shares with a senior liquidation preference will be entitled to receive their liquidation preference in priority to any other investors ranking junior to such investor. Where 3 or more classes/series of preferred shares are issued, it is possible for them each to have their own priority (e.g. 1st, 2nd and 3rd) or for some of them to be Pari Passu with each other (e.g. 1st, 2nd and 2nd).

See also: Liquidation Preference (aka "waterfall"), Liquidation Preference Overhang

Major Investor

Major Investor is a designation given to a subset of investors in a company's shareholders agreements who meet a threshold of ownership. Major Investors are typically entitled to special rights above and beyond the rights granted to non-Major Investors, including information rights, pre-emptive rights and right of first refusal. These rights are reserved for Major Investors in recognition of their significant financial support for the company and to reduce the burden on the company of providing such rights to all investors. The threshold of ownership at which Major Investor rights kick in is negotiable, and may change between rounds of financing.

Management Rights Letter

A management rights letter is a contract between a venture capital firm and a company giving certain management rights, like the ability to attend board meetings, access to financial documents and the ability to advise the company, to the investor. It is common for U.S. investors that are subject to the Employee Retirement Income Security Act of 1974 (ERISA) to request a management rights letter to permit such investor to rely on the "venture capital operating company" exemption under ERISA.

Market Stand-Off/Lock-up

A market stand-off or lock-up is a provision commonly included in the shareholder agreements for startup companies that restrict shareholders from selling shares immediately after an IPO, usually for 180 days, to prevent rapid fluctuations of share price. Such restrictions are often required by underwriters in connection with an IPO, so the provisions are typically included in shareholder agreements to ensure that each shareholder has committed to the restrictions and won't be able to cause any issues at the time of an IPO.

Most Favoured Nation

A most favoured nation clause is a provision in a contract that allows the recipient of the right to benefit from any better terms subsequently offered to third parties. In the venture financing context, most favoured nation provisions are sometimes seen in convertible notes and SAFEs, where the company agrees to give the investor the benefit of any subsequently negotiated better terms (e.g. higher interest, better discount or lower valuation cap) offered to future investors.

Non-Competition

Non-competition clauses are a type of restrictive covenant that prevent the restricted party (typically a founder or employee) from competing with the start-up company within a specified geographical area both during their employment and for a specified time period after their departure from the company. The enforceability of non-competition clauses in the employment context, and restrictive covenants in general, depends on the jurisdiction, so careful attention must be paid to local laws to ensure that the covenant as drafted will withstand legal scrutiny. It is often preferable to focus the scope of the non-competitive covenant, both in geography and time period, to increase the likelihood of its enforceability.

See also: Non-Solicitation

Non-Disclosure Agreement, Mutual

A mutual non-disclosure agreement prevents both parties to the agreement from disclosing the confidential information of the other party. Mutual NDAs are used when both parties are expected to disclose and receive confidential information. If only one party is disclosing confidential information to the other, a unilateral NDA should be used instead. Non disclosure agreements are critical for early stage startups whose technology is still in development and highly proprietary.

Non-Disclosure Agreement, Unilateral

A unilateral non-disclosure agreement prevents the party receiving confidential information from disclosing that information to third parties. Under a unilateral NDA, only one party is expected to disclose confidential information to the other party. If both parties to the agreement are expected to disclosure confidential information to each other, a mutual NDA should be used instead. Non disclosure agreements are critical for early stage startups whose technology is still in development and highly proprietary.

Non-Participating Preferred Shares

Non-Participating Preferred Shares are preferred shares that contain a right whereby on liquidation of the company, the holder of Non-Participating Preferred Shares receives up to a fixed value for their shares and does not “participate” in the residual value of the company. Holders of Non-Participating Preferred Shares typically have a right to receive capital in preference to holders of common shares.

No-Shop

A no-shop clause is a provision in a financing term sheet that prevents founders from further “shopping around” for investors for a specified period of time after the term sheet has been signed. Investors want to know that the founders will be focusing their time and attention on closing the transaction with the investors, and aren't using the first investors to solicit a better offer from other investors.

Non-Solicitation

Non-solicitation clauses are a type of restrictive covenant that prevent the restricted party (typically a founder or employee) from soliciting a company's employees and customers.

See also: Non-Competition

Options, "In the Money"

Stock options are considered to be "in the money" when the fair market value of the shares underlying the options is greater than the strike price of the options (i.e. the price required to be paid by the holder to exercise the options and receive the shares).

See also: Options: "Out of the Money" Options

Options, "Out of the Money"

Stock options are considered to be "out of the money"when the fair market value of the shares underlying the options is less than the strike price of the options (i.e. the price required to be paid by the holder to exercise the options and receive the shares). In this instance, there is little incentive to exercise the options, as the holder would receive a share that is worth less than they paid to acquire it.

See also: Options: "In the Money" Options

Options, 409A valuation report

A 409A valuation report is an independent determination by a professional appraiser of the fair market value of a startup's common shares. The report is so named because it satisfies the valuation requirements under section 409A of the U.S. Internal Revenue Code, barring evidence to the contrary. 409A valuations are regularly used in the U.S. to determine the exercise/strike price of options granted to employees/service providers, in order to ensure optimal tax treatment. While originally a U.S. concept, 409As are also widely used in Canada for the same purpose, even though they are not strictly required under Canadian tax legislation.

Options, Option Pool

See also: Equity Incentive Plan

Participating Preferred Share

Participating preferred shares are a type of preferred share sometimes used in venture financing transactions, which allow the investor to both receive their liquidation preference as well as participate in the residual value alongside the common shareholders. Participating preferred shares are not as common as standard preferred shares, in part because they can be viewed by founders as the investors trying to "double dip" in an exit transaction. Where participating preferred shares are used, they may be subject to a Participation Cap.

Participating Preferred Shares, Participation Cap v. Uncapped

The participation cap refers to the maximum amount an investor can receive through their liquidation preference when participating preferred shares are used. The capped amount is expressed as a multiple of the original investment (e.g. 3X of 4X). A lower participation cap, is more founder friendly, whereas a higher cap is more investor friendly. In contrast, if the participation feature on a preferred share is “uncapped”, no limit is placed on the participation rights of the investor, such that in addition to their liquidation preference, the investor will get to fully participate in the residual value of the company (with no limits imposed).

Pay-to-play

In the venture financing context, pay-to-play refers to a provision included in a company’s financing documents that requires investors to participate in a future round of financing on a pro-rata basis, or risk losing some of their rights as investors. For example, the provision might say that investors who do not participate in the financing will lose Anti-Dilution Protection, their Liquidation Preference, voting rights, or other rights customarily provided to preferred shareholders. Alternatively, in the “strongman” formulation of pay-to-play provisions, it might say that investors who do not participate in the financing have their preferred shares automatically converted to common shares. In some formulations, the pay-to-play only kicks in for a Down-Round financing.

Post-Money Valuation

Post-money valuation refers to the equity value of the company after taking into account any new money invested by investors in a round of financing. In most (simple) financings, the post-money valuation is equal to the pre-money valuation plus the amount of money raised in the financing.

Pre-Emptive Rights

Pre-emptive rights (sometimes called pro rata rights) give investors the right to purchase up to their pro rata portion of shares in a start-up’s future rounds of financing, to maintain their equity stake in the company. The rights may be granted to all investors, or to a limited subset of investors (such as major investors). These rights apply to all newly issued shares, subject to certain common exemptions, such as shares issued to employees in the form of options. While the existence of these rights is very common in venture financings, they are rarely formally complied with. Instead, companies often seek a waiver of these rights, allowing them to issue shares to new investors and bypass the timing and procedural requirements set out in the formal pre-emptive right provisions.

See also: Anti-Dilution Protection

Pre-Money Valuation

Pre-money valuation refers to the equity value of the company before taking into account any new money to be invested in a round of financing. In most (simple) financings, the pre-money valuation is equal to the post-money valuation less the amount of money raised in the financing.

Pro-Rata Rights

See Pre-Emptive Rights.

Prospectus Exemptions

In Canada, all securities (including shares) issued or sold by a company must be issued or sold pursuant to a prospectus that complies with applicable securities laws, unless an exemption from the prospectus requirements is available. As preparing and filing a prospectus is expensive and time consuming, almost all venture financings are completed pursuant to an exemption from the prospectus requirements. The most common prospectus exemptions include the Accredited Investor exemption, the Private Issuer exemption, and the Friends, Family and Business Associates exemption. Depending on the exemption relied upon, a filing may be required with the applicable regulatory body, and the investor may be required to complete a questionnaire demonstrating their qualification to rely on the applicable exemption.

Protective Provisions

Protective provisions give investors the right to veto certain decisions or actions of the startup company. Such decisions tend to be more fundamental rather than operational in nature, and may include changes to the terms of the investors' shares, winding up the company, or taking on debt beyond a specified amount. Decisions/actions within the scope of the protective provisions may still be made by the company, but only with consent of the investors. The protective provisions will typically specify the threshold of investors required to approve any such decisions or actions (often a simple majority) to prevent the company from having to seek the consent of every investor individually. The provision may also name specific investors whose consent is required, even if the threshold number of investors is otherwise reached.

Qualified IPO

A Qualified IPO is an event whereby all of a class or series of preferred shares automatically converts into common stock. A Qualified IPO is typically defined as a firmly underwritten public offering of common shares of the company at a price per share significantly greater than the original issue price of the preferred shares and for a minimum total offering size. The purpose of this provision is to compel all of the shareholders of a class or series of preferred shares to agree in advance to convert their shares into common shares upon a sizeable public offering.

Redeemable Preferred Shares

Redeemable Preferred Shares are preferred shares that contain a redemption right. This redemption right is typically at the investors' option and provides holders of redeemable preferred shares with the right to compel the company to redeem all such shares. The redemption price is typically the original purchase price of the shares plus any declared and unpaid dividends.

Registration Rights

Registration rights give an investor the right to have the company register their shares with the applicable securities regulators to permit the investor to sell their shares on the capital markets. There are two types of registration rights: demand and piggyback. When demand rights are exercised, investors may compel the start-up to register their shares, forcing a public offering. By contrast, piggyback rights give investors the right to include their shares in an ongoing registration by the company. While registration rights are unlikely to be exercised by an investor in the very early stages of a company's life cycle, they are often included in venture financings in anticipation of the company maturing to a level where the rights become more relevant.

Representation and Warranty

A representation is an assertion made by one party for the benefit of another party. A warranty is a promise to indemnify the beneficiary of the representation if the assertion turns out to be false. In the start-up context, companies regularly give representations and warranties to investors regarding the state of their business, typically in the subscription/purchase agreement for the investor's shares. The representations may be fairly basic (e.g. the company has been properly incorporated) or may be much more detailed (e.g. the company does not include any copy-left open source code in its own software, other than the libraries identified on a schedule). Since founders know much more about the business than investors, it is common for investors to seek a robust set of representations to get comfortable with the risk of their investment.

Reverse Vesting (in respect of restricted shares)

Reverse vesting refers to the right of a start-up to buy back the shares held by a shareholder (typically founders) if they leave the company. The longer the shareholder remains with the company, the greater the proportion of their shares that are vested, and therefore no longer subject to the repurchase right. It is called “reverse” vesting because, unlike with options, the shares that are subject to reverse vesting are all owned by the shareholder upfront, and are released from the repurchase right over time. With options, on the other hand, the recipient does not receive any shares upfront, but rather receives the shares as they are vested and the options are exercised. The provisions setting out the reverse vesting conditions are typically located in a Restricted Stock Purchase Agreement.

Right of First Notice

A right of first notice is a right granted to an investor to receive notice from a start-up if the company receives an offer from a potential buyer for an acquisition, or if the company decides to put the itself up for sale. As the right is contractual, there are many variations, including in the amount of information required to be delivered to the investor in the notice. At one end of the spectrum, the right of first notice might only require that the notice state the fact that the company has received an offer. At the other end of the spectrum, the right of first notice might also require that the notice include the identity of the offeror, the form of consideration, the value of consideration and any other material terms of the offer.

Right of First Refusal

A right of first refusal refers to the right of the start-up and/or its investors to purchase shares from a key holder (typically a founder) in the event the Key Holder wishes to sell some or all of their shares, before the Key Holder can sell any shares to a third party. In standard venture financing agreements, the right first refusal is first given to the company, and only if the company elects not to purchase all of the shares being offered, does the right then pass to the investors in proportion to their equity interest. Sometimes the right of first refusal is granted to major investors only.

SAFE

SAFE stands for Simple Agreement for Future Equity and is a common instrument used to finance early stage start-ups. SAFEs were originally developed by YCombinator. Like convertible notes, SAFEs ultimately convert into shares, however unlike convertible notes, SAFEs do not have a maturity date (i.e. there is no fixed date for the investment amount to be returned to the investor) and do not bear interest. For that reason, a SAFE is generally not considered to be debt. Similar to convertible notes, SAFEs may have a discount, a valuation cap, or both. SAFEs convert into shares of the start-up in a future round of financing. SAFEs have become very popular in recent years, due in part to their simplicity (which translates into speed and low transaction costs) and in part to their ability to defer discussions on valuation until a subsequent round of financing.

Secondary Sale of Shares

A secondary sale of shares is the sale of pre-existing shares by current shareholders (typically founders and early round investors) to another party. In a secondary sale, the price paid by the buyer goes to the seller of the shares, rather than to the company. By contrast, a primary sale of shares is where shares are newly issued and the subscription price goes to the start-up directly. Secondary sales are commonly seen alongside later stage financings, as a means of providing liquidity to founders and early investors.

SR&ED

The Scientific Research and Experimental Development (SR&ED) program refers to a federal and provincial tax credit policy which aims to encourage research and development efforts. SR&ED tax credits come in both refundable and non-refundable varieties, and can be a significant source of non-dilutive funding for a Canadian start-up.

Unanimous Shareholders Agreement

A unanimous shareholders agreement (USA) is an agreement among all shareholders and the company that governs the relationship between the shareholders vis-à-vis each other and between the shareholders and the company. Under Canadian corporate statutes, unanimous shareholder agreements are given special treatment that enhances their enforceability. USAs can provide for any number of matters, but typically include provisions regarding the structure of the board of directors, drag-along rights, rights of first refusal, pre-emptive rights and information rights. In the venture financing context, the aforementioned rights are often split up into three separate agreements, in order to mirror the style of financing agreements commonly used in the United States.

Up-Round

An up-round refers to a round of financing for a startup in which the valuation of the company is higher than the valuation at the time of the company's prior round of financing. The valuation can be expressed on either a Pre-Money basis or a Post-Money basis. Unlike a Down-Round, an up-round does not trigger Anti-Dilution Protection.

Valuation Cap

A Valuation cap is an optional feature of both convertible notes and SAFEs which refers to the maximum valuation of the company that can be used to determine the conversion rate of the note or SAFE into shares. If a convertible note or SAFE has a valuation cap (but no discount), the conversion rate is based on the lower of the valuation cap and the valuation of the company at the time of conversion. That way, if the valuation of the company exceeds the valuation cap at the time of conversion, the note or SAFE holder gets the benefit of the valuation cap for the purposes of determining the number of shares they will receive on conversion. A valuation cap is therefore an investor-friendly feature, and is more investor-friendly the lower the cap is set. If a note or SAFE also includes a discount, then the investor is entitled to the better of the conversion rate calculated using the discount and that calculated using the valuation cap.

Vesting (in respect of options)

“When a company issues options to employees or service providers, the recipient of those options is typically restricted from exercising the options and receiving the underlying shares immediately upon grant. Rather, the options are usually subject to vesting, meaning that a set portion of the options are released from their restrictions over time, until eventually all of the options are released (aka 'fully vested'). The number and timing of release of the restrictions on the options is known as the 'vesting schedule'. The most common vesting schedule for employee options is 25% vesting on the 1 year anniversary of the grant, and the remaining 75% vesting in monthly or quarterly installments over the following 3 years, often referred to as 'four year vesting with a one year cliff'.

At any point in time, an employee can exercise their vested options by paying the applicable exercise price and receiving the corresponding shares. The options continue to vest according to the vesting schedule so long as the employee continues to provide services to the company. If the employee leaves the company, their unvested options will typically be cancelled, and they may have a limited period of time to exercise their vested options. The purpose of the one year 'cliff' in the vesting schedule is to provide sufficient time for the company and employee to get to know enough other and determine whether the relationship is a good fit. If the employee and company part ways within one year, the employee doesn’t receive any equity.”