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Startup vocabulary 101

Every beginner startup founder will at one point or another come into contact with different industry terms which seem to be well-known for everybody except for the newcomer. Here is a little cheat sheet for some of the terms used in startup scene.

/1/ ANTI-DILUTION RIGHTS

This is a contractual clause to protect investors in a situation where, in a future equity investment round, shares of the company are sold for a lower price than was paid by the investor that is protected by the anti-dilution right. Accordingly, this clause is essentially used in a situation where the valuation of the company in a new investment round is lower compared valuation based in which the investor had made its investment. In such case, the anti-dilution right grants the investor a certain amount additional equity based on a pre-agreed formula.

Example: Company sells to the investor a share with the nominal value of 500 Euros for 2 Million Euros and grants to the investor anti-dilution protection. In the second equity round, the company sells a share with the nominal value of 500 Euros for 1 Million Euros – i.e. a price two times lower than in the first financing round. Under anti-dilution clause, the company has to compensate the investor the fact that the price per share (i.e. the company valuation) has dropped by giving the initial investor a new share based on the pre-agreed formula.

/2/ BAD LEAVER OR GOOD LEAVER

The term describes the circumstances under which some or all of the shares owned by a leaving founder transfer to the company.

A founder becomes a “Bad Leaver” if during the vesting period they resign voluntarily, their professional relationship is terminated, or they fail to perform their responsibilities. If the founder becomes a Bad Leaver, the company may request the Founder to transfer all his shares back to the company against payment of the nominal value of such shares or for free.

Example: Founder A committed fraud, so they become a Bad Leaver and they have to sell their shares back to the company for nominal value.
A founder becomes a “Good Leaver” if his professional relationship is terminated during the vesting period in circumstances where he is not a Bad Leaver. If the founder becomes a Good Leaver, the company may request the founder to transfer his vested shares back against payment of fair value for such shares.

Example: Founder B fell seriously ill, so they become a Good Leaver, their vested shares are bought back for their fair value and unvested shares for the nominal value.

/3/ CAP TABLE

A cap or capitalization table is a table showing the equity ownership capitalization for a company.

/4/ CLIFF

A cliff refers to the percentage of shares vested after a certain period of time, usually one year.

Example: 25% of founder B shares vest after 1 year.

/5/ CONVERTIBLE NOTE

An agreement which sets forth the amount of the investment and the conditions of the conversion/repayment. Includes representations and warranties and may sometimes provide veto rights to the investor (see "Veto right"). The process is usually faster compared to an equity investment.

/6/ COMPETITION CLAUSE

The obligation not to compete with the company's business in the territory defined by the agreement for a set period of time.

Example: Founder A cannot, directly or indirectly, to carry on or be engaged in any business competing with the company's business in the territory of the EU while he is a shareholder and for a period of one year after he ceases to be a shareholder.

/7/ DRAG ALONG RIGHT

A provision that enables a majority shareholder to force a minority shareholder to join in the sale of a company. The majority owner doing the dragging must give the minority shareholder the same price, terms, and conditions as any other seller.

Example: Founder A and B owning 70% of shares in the company have the right to require founder C to sell their shares to the buyer.

/8/ EXIT HORIZON

A clause referring to the obligation of start-up founders to work towards selling their ownership in a company after expiry of a certain period (usually between 5 to 7 years).

Example: The founders did not manage an exit within expiration of the Exit Horizon, so the investors installed more motivated directors to effectuate the exit take point in the sales process.

/9/ FOUNDERS AGREEMENT

An agreement which governs the founders' relations vis-à-vis each other and the company. It is one of the first agreements to be signed by the founders and it regulates, among other things, the role and responsibilities of each founder, the matters that require prior approval by the founders, the required majority to adopt founders' decisions and the conditions under which the founders may transfer their shares to other persons. It also determines what happens to founder's shares if a founder leaves the company during an agreed period (see "Bad Leaver or Good Leaver") and includes founders' obligation not to compete with the company (see "Competition clause").

/10/ FOUNDERS LOCK-UP

A lock-up agreement is a contractual provision preventing founders of a company from selling their shares for a specified period of time. They are commonly used as part of the initial public offering (IPO) process.

Example: Founder A, B and C cannot sell their shares two years after the investment.

/11/ FOUNDERS REVERSE VESTING

Under reverse vesting agreements, founders essentially do not have full control of the shares they own if they leave the company before the reverse vesting period ends—typically four years. Reverse vesting agreements give the company repurchase rights to those shares not yet mature for a nominal fee or in many cases, for no cost at all.

Example: The vesting period for founder's shares shall be 4 years from signing the founder's agreement. 25% of founders Shares shall vest on the first anniversary of the agreement. The remaining 75% shall vest quarterly in equal instalments over the following years.

/12/ LIQUIDATION PREFERENCE

Liquidation preference refers to the right of an investor to recoup the money invested in the start-up over other shareholders, mainly founders and employee shareholders but in some cases, preference will be given to some investors over others as well. Essentially, liquidation preference determines the order of payments in case of a sale, liquidation or transfer of all assets of a company.

Example: The investor invested 5 million euros in the company and received 10% of the shareholding. The other 90% belongs to the founders and the proceeds of the liquidation event were 20 million euros.

Multiple
If the liquidation preference is set at 1x, the investor receives 5 million euros and the founders 15 million euros of the proceeds. However, if the liquidation preference was set at 4x, the investor would receive all the 20 million euros and the founders will be left empty-handed.

Participating/non-participating
In case of non-participating liquidation preference, the investor has the right to receive the invested amount, i.e. 5 million euros. In case of participating liquidation preference, the investor has the right to receive their invested amount 5 million euros AND, on top of that, share in the remaining proceeds with the common shareholders on a pro rata basis (also called double dip).

/13/ MFN

A most favored nation clause, referred to as a MFN clause, is a term that allows the party to elect to inherit any more favorable terms that are offered to any subsequent investors following the original investor's investment and prior to a next equity round.

Example: Subsequent investors were given higher interest rates, so the initial investor applying the MFN clause has the right to receive the same rate.

/14/ OPTION AGREEMENT

A written agreement which grants the employee of a company an opportunity to benefit from increases in the company's share value by granting the right to buy shares at a future point in time at a price equal to the fair market value of such shares at the time of the grant. The option agreement dictates all the terms of the offer -- including vesting schedule, time limits for exercise once vested, and any other special conditions.

/15/ SAFE

SAFE or simple agreement for future equity is an agreement between an investor and a company that provides rights to the investor for future equity in the company similar to a warrant, except without determining a specific price per share at the time of the initial investment. Includes limited representations and warranties and does not include a maturity date nor interest rate.

/16/ SHAREHOLDERS AGREEMENT

An agreement setting forth the between the founders and the investors and regulates the corporate management of the company (veto rights, share transfers, vesting, IP transfer, non-compete, confidentiality, etc).

/18/ TERM SHEET

An agreement establishing the key conditions under which the investment is to be made. As a rule, a term sheet is non-binding, except for the clauses regulating confidentiality, exclusivity, and dispute resolution or applicable law. Regardless, if you sign a term sheet then it is later difficult do deviate from it in the investment agreement or shareholders agreement.

/17/ TAG-ALONG RIGHT

Tag-along rights also referred to as "co-sale rights," are contractual obligations used to protect a minority shareholder. If a majority shareholder sells his stake, it gives the minority shareholder the right to sell a proportion of their shares in the company on the same terms. Tag-alongs effectively oblige the majority shareholder to include the holdings of the minority holder in the negotiations so that the tag-along right is exercised.

Example: Founder A sells 90% of the company's shares and founder B owning 10% has the right to sell a portion of his shares on the same conditions.