EA EVOLUTION ADVISORS

Dictionary of Terms related to Equity for Private Companies

- Stock / Equity – The right to certain economic interests and control rights in the company. When used generically, the term Stock includes all Classes of Stock, such as Common Stock and Preferred Stock (see below).

    - Equity's economic interests are subordinate to the interests of creditors.

    - Therefore, in any liquidating distribution of Company assets, all loans, vendors claims, customer claims, lawsuits, etc., must be paid before the equity gets anything.

    - Control rights are, without the addition of contracts, typically limited to (i) the election of the Board of Directors (not the executives), (ii) certain corporate transactions such as mergers and sales of the Company or its assets, and (iii) changes to the Company's Charter (see below) that adversely impact a particular Class or Series of Stock.

- Share – In some states this is synonymous with Stock (e.g., "Shareholders", not "Stockholders"). In most cases, the "share" also means the counting unit of Stock (e.g., "John owns 3 shares of Common Stock").

- Class of Stock – Groupings of shares that bear similar rights, preferences and obligations. Usually, shares are divided into Common Stock and Preferred Stock.

- Series of Stock – Describes features of a group of shares <u>within a Class</u> that bear similar rights, preferences and obligations. In almost all cases, Series only will apply to Preferred Stock and will be denoted in alphabetic order based upon the date of issuances (i.e., the first series issued will be Series A Preferred Stock, followed by Series B Preferred Stock, etc.).

- Common Stock – Equity that is entitled to 100% of the assets of the company upon its liquidation after paying ALL creditors and senior equity (such as Preferred Stock).

- Preferred Stock – Equity that receives a senior (that is, "preferred) return, prior to the payment of the Common Stock, on (i) dividends, and (ii) liquidation. In this context, Liquidation means both a traditional liquidation of the company's assets in a "down-side" sell off scenario, but also a sale or merger of the Company, regardless of whether there is little or enormous profit.

    - In the public market, preferred stock is often a junior debt like instrument that bears a fixed dividend coupon and has few if any rights.

    - In the private company market, preferred stock often has (i) additional corporate control features (e.g., right to approve certain transactions etc.), (ii) bears accruing but unpaid cash dividends (typically 6-10%), (iii) has the right to convert into Common Stock, and (iv) bears the (hypothetical) right to be repurchased (i.e., redeemed) by the Company, usually 5 years from issuance, and, carries a Liquidation Preference, typically equal to its initial purchase price (or some multiple thereof), plus accrued but unpaid dividends.

- Immediately following the bubble, some Preferred Stock was issued with up to 10X liquidation preferences! That means an investment of $1m would entitle the investors to take the first $10m of liquidation proceeds!

- Priority / Senior & Junior / Subordinate – Words that describe the order in which assets would be distributed by the Company. If a Class of Equity is “Senior” or “Prior” it will receive assets before any assets can be distributed to a “Junior” or “Subordinated” Class of Equity.

    - Ex. Debt is senior to Equity.

    - Ex. Preferred Stock is typically senior to Common Stock.

    - Ex. Series A Preferred Stock is often subordinate to Series B Preferred Stock. The usual rule is “last money in, first money out”.

- Pari Passu – A Class of Equity that receives assets at the same time as another Class of Equity.

    - Ex. If Series A and Series B Preferred were Pari Passu, each share of Series A and Series B would be entitled to the assets being distributed at the rate of 1 Share of Series A (or B) / All Shares of Series A + All Shares of Series B.

- Pro Rata – Allocated in accordance with the percentage ownership. If Series A is paid $100 and John owns 10% of the shares, John would receive $10 on a pro rata distribution.

- Participating Preferred Stock – Preferred Stock that entitles holders to BOTH a Liquidation Preference and the right to then convert into Common Stock and participate, pro rata, in the distribution of the remaining company assets.

- Waterfall – A spreadsheet calculation or provisions in a Charter showing the distribution of assets in accordance with their priority rights.

- Charter / Certificate of Incorporation / Articles of Incorporation (“Charter” is used by most practitioners as the shorthand, regardless of the technical name in the jurisdiction of the Corporation) – The legal document that describes certain fundamental characteristics of the corporation and the filing of which gives the corporation separate legal existence (and that all important limited legal liability). A Charter is filed with a particular state (the “jurisdiction of incorporation”) whose laws will substantially govern all matters related to shareholders.

- Authorized Stock – The maximum number, Classes and Series of shares the Company might be hypothetically divided into – very limited practical effect – mostly regarding franchise tax calculation. This will typically appear in representations that the Company makes regarding its structure and on the face of all stock certificates.

- Outstanding Stock – The shares of stock actually issued (and not repurchased) by the Company. Typically, this is the number of shares that is used to discuss VOTING INTEREST.

    - Ex. If there was only one class of stock (and in the absence of any contractual changes), ownership interest and voting interest would be calculated as:

        - A holder’s shares / all outstanding shares.

  - Ex. If John owns 10 shares, out of 100 issued, John owns 10% of the outstanding shares of the Company. In any vote or distribution of assets, John would get 10%.

- Reserved Stock – Stock that has been authorized, but reserved for issuance typically for issuance upon the exercise or conversion of Convertible Securities, including Employee Stock Options.

- Convertible Securities – Contractual rights to acquire shares of equity, which the Company will authorize and reserve against the exercise of such rights. Examples are stock options, warrants and convertible debt. If Preferred Stock is convertible (mandatorily or voluntarily) into shares of Common Stock, the Preferred Stock is a form of Convertible Equity.

  - Vested – A convertible security that has a present right by the holder to acquire equity. The exercise of such a security may be conditioned upon the payment of money, or the fulfillment of some other condition such as current employment at the time of exercise.

  - Unvested - A convertible security that has a future (usually conditional) right by the holder to acquire equity.

  - Exercise – The act of using the rights under an Option or Warrant to acquire Equity. It usually implies the payment of the Exercise Price and the delivery of any associated paperwork.

  - Conversion / Exchange - The act of using the rights under a Convertible Security to acquire Stock. It usually implies the delivery of any associated paperwork.

  - Conversion Price / Conversion Ratio – The rate at which Preferred Stock or another Convertible Security converts into Common Stock.

    - If expressed as a Conversion Price, the Conversion Ratio is usually achieved by dividing the initial price of the security by the then effective Conversion Price.

    - Various events (Down-rounds, Splits, etc.) can adjust the Conversion Price upwards or downwards.

    - Conversion Ratios are typically, but not always, set initially at 1:1 (i.e., the Initial Price and Conversion Price are the same).

- Options – In the private company context, usually Convertible Securities issued to Employees and Directors entitling them to purchase Stock upon the payment of an amount called the "Exercise Price."

  - The Exercise Price is the fair market value of the Stock on the day of the issuance of the Option.

  - Options may be vested or unvested, typically based upon length of employment with the Company and/or certain performance metrics. Except for performance based vesting, these options typically vest 25 or 20% after 1 year of service with the remaining vesting (monthly or quarterly) over another 3-4 years.

- Typically, Options are exercisable, once vested, for 5-10 years from the date of issuance.

- Typically, once employment is terminated, Options may be exercised for a limited period of time, often based upon whether the termination was voluntary or involuntary.

• Warrants - In the private company context, these are typically Convertible Securities issued to vendors, lenders or other strategic partners. The Exercise Price may or may not be the Fair Market Value of the Stock on the date of issuance, although accounting issues arise if it is not.

• Convertible Debt – The principal, and usually the accrued interest, on a debt which may, under certain conditions and at the option of the lender, be converted into Stock at some ratio.

  - Many angel investors use this as a tool to invest without a fixed valuation – setting the ratio as a function (typically 80-90%) of the value of the Company in a later venture capital transaction.

• In-the-Money – a Convertible Security with an Exercise Price less than the current fair market value of the underlying Stock.

  - Ex. John has an Option with an Exercise Price of $.10/sh, where the Stock issuable upon the exercise of the Option is worth $2.00/sh.

• Out-of-the-Money – a Convertible Security with an Exercise Price equal to or greater than the current fair market value of the underlying Stock.

  - Ex. John has an Option with an Exercise Price of $1.00/sh, where the Stock issuable upon the exercise of the Option is worth $0.50/sh.

• Fully Diluted Equity (sometimes abbreviated "FDE") is a calculation of the total division of positive Equity interests in a Company, i.e., typically used to calculate a holder's ECONOMIC INTEREST.

  Fully Diluted Equity is calculated as:

  - All outstanding shares of Common Stock +
  - Common Stock issuable upon conversion of all Preferred Stock +
  - Common Stock issuable upon exercise of in-the-money Convertible Securities.

  In some cases, Fully Diluted Equity will also include:

  - Common Stock issuable upon exercise of out-of-the-money Convertible Securities, and/or
  - Common Stock reserved for issuance under an approved Employee Stock Option Plan.

• Pre-Money Valuation – The Fair Market Value of the whole of the Company issuing equity to investors, before accounting for the influx of the new cash. Usually determined by a private negotiation between the Company and investors.

- Pre-Money Valuation per Share – The Pre-Money Valuation divided by the number of Fully Diluted Shares (usually including the shares issuable pursuant to a current or proposed Stock Option Plan).

- Post-Money Valuation – The Pre-Money Valuation plus the gross amount of invested cash (there is typically no deduction for the deal expenses in thinking about this number).

- Up-Round – A financing in which the Pre-Money Valuation per Share is larger than in the previous financing round.

- Down-Round – A financing in which the Pre-Money Valuation per Share is less than in the previous financing round.

- Flat-Round – A financing in which the Pre-Money Valuation per Share is the same as in the previous financing round. Note that if additional Convertible Securities have been issued in the interim between the two rounds, the same Pre-Money Valuation in those two deals will lead to different Pre-Money Valuations per Share.

- Stock Split – A legal mechanism whereby each single share of stock becomes some other number of shares. In the private company context, a stock split tends to have NO economic effect. It is akin to taking pie slices and re-slicing them into smaller increments. It does not change who owns what.

    - In the public company context it can often have impact upon the ability of a company to stay listed on an Exchange that has minimum per share price rules.

    - A split of the Common Stock typically has a proportionate change to the price and quantity of any common Stock issuable under any Convertible Securities, so that there remains parity among all of the stockholders.

- Securities Laws – Laws that govern the issuance and trading of Equity, Convertible Equity, and in some cases Debt. Securities Laws are issued by all 50 states, the Federal Government and foreign jurisdictions.