



Start-ups: It's all about the rights

SHAHRAM SAFAI, PARTNER AT AFRIDI & ANGELL LEGAL CONSULTANTS IN DUBAI, EXPLAINS THE RIGHTS INVOLVED IN VENTURE CAPITALIST INVESTMENTS.

Dubai has evolved into the entrepreneurial epicentre of the Middle East due to its advanced infrastructure, open business climate, and accessibility to the global marketplace.

It is home to the region's most innovative start-ups and attracts regional talent with its promise of success. But start-up operations and innovation are not the only ingredients for success. Legal know-how is key, and it's all about the rights.

Venture capitalists (including VC funds) and other major investors commonly request

convertible preferred shares in return for their investments in a start-up. The rights normally associated with such shares are as follows:

- A liquidation preference that entitles the preferred shareholder to receive a certain fixed amount (expressed as a multiple of the shareholder's original purchase price, plus any declared and unpaid dividends) before any assets are distributed to the common shareholders in a liquidation.
- A dividend preference that entitles the holder to a dividend (which may be non-cumulative and discretionary or cumulative) prior to any dividend being paid to the common shareholders.
- Redemption rights that enable the investor to compel the company to purchase its shares on or after a certain date (and in some cases at a premium over the initial purchase price of the shares).
- Anti-dilution rights that protect an investor from dilution resulting from subsequent share issuances at a lower price than the investor

originally paid by adjusting the conversion price applicable to the investor's preferred shares.

- Voting rights that generally allow the preferred shareholders to:
 - Vote with common shareholders (as though the shares had been fully converted);
 - Elect one or more of the company's directors;
 - Approve certain types of corporate actions (for example, amendments to constitutional documents, proposed mergers, issuance of a new series of preferred shares).
- A pre-emption right that enables the preferred shareholders to participate in any future issuance of securities by the company (up to its percentage shareholding as of the date of the issuance).
- A right of first refusal that enables a preferred shareholder to purchase shares that another shareholder wishes to transfer (up to preferred shareholder's percentage shareholding as of the date of the transfer notice) on the same terms offered to a third party.
- Co-sale/tag-along rights that discourage the founders from selling their interest in the investee company by permitting the preferred shareholders to participate in such sale.
- Drag-along rights that prevent common shareholders from objecting to a sale or liquidation of the company that has been approved by the preferred shareholders.
- Vesting of founder's shares, that discourages founders from leaving the company by giving the company the right (which lapses with time) to repurchase some or all of a founder's unvested shares in the event the founder terminates his employment.
- Investors taking a minority interest in the target company typically seek tag-along rights that, in the event of a proposed sale of the shares held by certain shareholders, would compel



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such selling shareholders to sell the minority shares on the same terms and conditions applicable to their shares. In many cases, this right would be triggered if a majority shareholder (or group of shareholders holding a majority of the outstanding shares) initiated a sale; however, investors may seek the tag-along right in any proposed sale involving a founder, which may involve a certain shareholding threshold for the offer (eg, 20 percent).

- Representation on the company's board of directors as a condition of the investment. Venture capitalists in the UAE typically prefer to take an active role in the management of early stage companies.
- Inspection and information

rights. Specifically, the shareholder may examine the books and records of the company and inspect its facilities, and the company will be required to provide the shareholder with periodic financial reports.

The demand for venture capital funding in the Middle East is on the rise as successful start-ups emerge from their cocoon and desire increasing amounts of sophisticated capital to succeed. As a result, the demand and the opportunity for start-ups and the venture capital industry in the Middle East is quickly expanding. More than ever, start-ups and venture capitalists need to understand and focus on their investment rights. Afridi & Angell is the market leader in the Middle East in cutting edge legal advice to the venture capital industry.

About the Author:

Shahram Safair practices venture capital law and represents venture capitalists, investors and entrepreneurs. Shahram is also a professional engineer and has previously worked in the Silicon Valley in California practicing venture capital law, mergers, and acquisitions. He is a partner at the law firm of Afridi & Angell.