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5 Legal Protections for Investors in Early-Stage Tech Investments

by **Lester Sosa-Villatoro**

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Investing in early-stage technology companies can be rewarding, but it also poses significant risks. To mitigate these risks, investors should ensure that their investment documents contain legal protections that safeguard their interests.

Here are five legal protections to consider when investing in early-stage tech companies.

1. Liquidation Preference

Liquidation preference clauses determine the order in which investors are paid back in the event of a liquidation event, such as a sale or dissolution of the company. This provision ensures that early-stage investors receive their investment back before other shareholders.

A common provision is a "1x liquidation preference", which means investors will get their initial investment back before any proceeds are distributed to other shareholders. This protection can significantly reduce the risk of loss in situations where investee companies are failing.

2. Anti-Dilution Protection

Anti-dilution protection is crucial for investors in early-stage companies, especially if the company raises additional funding at a lower valuation. This clause protects investors from having their ownership percentage diluted in subsequent funding rounds.

There are two main types of anti-dilution provisions: full ratchet and weighted average.

- Full ratchet adjusts the conversion price of preferred shares to the lower price of the new shares issued.
- Weighted average takes into account the number of shares issued at the new price.

Both mechanisms help maintain the value of the investor's stake.

3. Board Representation and Voting Rights

Investors should always seek to secure board representation and/or observer rights as part of their investment. Having a seat on the board or the right to attend board meetings enables investors to stay informed about the company's strategic direction and decision-making processes.

Additionally, negotiating specific voting rights can give investors a say in significant corporate actions, such as new funding rounds, acquisitions, or changes in management.

This level of involvement can provide critical oversight and influence over the company's trajectory. Investors will frequently also have certain actions of the investee company and/or its founders subject to the consent of the investor. Such actions may include the allotment of shares by the company or the transfer of shares by the founders.

4. Information Rights

Information rights provisions grant investors the right to receive regular updates and access to key financial and operational documents. This can include quarterly financial statements, budgets, and annual reports.

By having access to this information, investors can monitor the company's performance and make informed decisions about their investment. This transparency is vital for assessing risks and identifying potential issues at an early stage.

5. Pre-Emption Rights and Tag-Along Rights

Pre-emption rights give investors the opportunity to purchase any new shares issued by the company before the company offers them to other parties, including existing shareholders. They are a critical investor protection as they allow investors to maintain or increase their ownership stake in the company as it grows.

Tag-along rights, on the other hand, allow investors to sell their shares alongside founders or other major shareholders if they decide to sell their shares to a third party, ensuring that the investor has a chance to capitalise on liquidity events.

Negotiate

Legal protections in investment documents are essential for safeguarding investors' interests in early-stage tech companies. By negotiating key provisions investors can mitigate risks and keep a close eye on the investee company's progress. Understanding, and seeking expert advice on these legal protections is crucial for making informed investment decisions and protecting investments in a dynamic and often unpredictable tech landscape.

For further information and advice on investing in early-stage technology companies please, contact Lester Sosa-Villatoro or Jonathan Braden.

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