Seed Financing: Key Considerations

A Practical Guidance® Practice Note by
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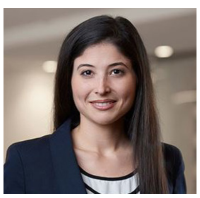

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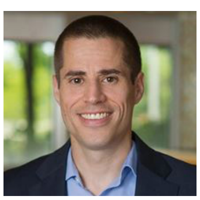

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This practice note focuses on the various ways early stage startups raise capital through the issuance of equity or convertible instruments, as well as the benefits and pitfalls of each approach.

Following a company's formation, especially fast-growing technology-based companies, the founder(s) will often look at different ways to infuse cash into the business. The content of this practice note is appropriate for startup companies that want to be venture-backed, high growth companies, and may not be appropriate for other types of businesses.

For additional context on venture capital financing, see Venture Financing Overview, Venture Capital Financing: Conducting the Transaction, Preparing for a Pre-Seed Financing Round, and Pre-seed and Seed Stage Equity Investment Transactions.

Traditional Debt vs. Capital Raising

When a company is looking for money, the two general options available are (1) to incur traditional indebtedness (e.g., term loan facility, line of credit, etc.) or (2) to issue convertible instruments or equity to investors. This practice note focuses on a company's decision to forego incurring traditional debt and to pursue raising money through convertible instruments or through an equity financing.

Convertible Instruments

Convertible Notes

A convertible note is a debt instrument through which an investor lends money to a company. The amount lent by the investor will incur interest during the life of said convertible note (most often anywhere between 12 and 24 months), and upon maturity, the note is repayable by the company. Note that often these convertible notes have a mechanism for conversion into common shares of the company, as well upon maturity. There is no standard form of convertible note in the venture-backed community. As a result, the terms of any given note, most importantly the conversion mechanics by which the instrument is converted into equity of a given company, are all a matter of negotiation between the business parties. Notwithstanding the above, the one common structure found in almost all convertible notes is the concept of the principal and any accrued but unpaid interest under the note shall convert into preferred stock of a given company upon a "Qualified Financing" (sometimes referenced to as a different term such as an "Equity Financing"). Such "Qualified Financing" will be defined in each convertible note. Sometimes this is any bona fide financing where the company issues preferred stock and other times this will be a bona fide financing where a certain dollar threshold is raised by the company. Regardless of how "Qualified Financing" is defined, the benefit to the noteholder/investor is that the investor is rewarded for investing in the company early on by receiving either a pricing discount on the preferred stock issued in the "Qualified Financing." The discount is seen as a price per share calculated using (1) a specified valuation cap on the enterprise value of the company as set forth in the note, (2) a discount rate on the price per share paid by new money investors in the "Qualified Financing," or (3) a combination of both, with the investor receiving the benefit of whichever approach yields the lowest price per share.

Pros of Convertible Notes

Both convertible notes and simple agreements for future equity (Safes), as discussed in further detail below, are ways for a company to raise funds without giving out equity right away (i.e., a given investor will be a shareholder of a company and hold shares in that company only once such instrument is converted). Therefore, a pro to both convertible notes and Safes is that a company does not give out shareholder rights immediately. This means that at the time these agreements are entered into, there is no immediate dilution to the existing shareholder of a company and the investors are not given any shareholder rights such as the right to vote on certain matters, or certain shareholder inspection rights in accordance with Delaware corporate law. Furthermore, unlike Safes, convertible notes can be drafted in any way that a given investor and company agree to. Unlike Safes, there is no market form that investors or companies will push to adhere to, so there is quite a breath of drafting flexibility when it comes to convertible notes and the deal terms set forth therein. Much like Safes, convertible note rounds tend to be much quicker and cheaper than preferred stock financing rounds, so these are quicker and cheaper alternatives to raising capital.

Cons of Convertible Notes

Despite the convertible note being a cheaper and faster way to raise capital in comparison to a preferred stock financing round, this instrument is still a debt instrument and is "treated as such on the company's books and records." The instrument will accrue interest until it is repaid upon maturity or converts pursuant to the terms set forth therein. Another feature of debt is that in the case of a dissolution event, debt will need to be repaid first before any shareholder can receive a dime, which is of course a good protection for the investor but not as beneficial for the company's shareholders. In comparison to Safes, a convertible note round of financing will be more expensive and time-consuming because there is no form to start from. Any investor or legal team reviewing on an investor's behalf will need to review ab initio. Finally, since convertible notes are not treated as equity in the hands of the holder at the time of issuance, not only is it difficult for a company to see what their capitalization table will look like at the time of conversion but also, investors' qualified small business stock (QSBS) holding period will not start until the convertible instrument actually converts into shares of the company (please see Lowenstein's article on QSBS for more details).

Simple Agreements for Future Equity (Safes)

Safes, another type of a convertible instrument, also allow investors to infuse cash into a company in exchange for the potential future right of discounted preferred stock. The conversion mechanics upon a "Qualified Financing" are often very similar between convertible notes and Safes, meaning that the discounted price per share will be determined using a valuation cap, discount rate, or some combination of both. Despite their similarities, there are a handful of differences. One is that a well-known American technology startup accelerator, Y Combinator, has maintained various forms of Safes (depending on different discount metrics to be used) which the industry has accepted as market. Therefore, besides updating the form with a specific valuation cap or discount percentage, these forms are very much left unchanged from investor to investor and company to company. Another major difference is that Safes are treated as equity for tax purposes, rather than debt.

Pros of Safes

In addition to the benefits that both convertible notes and Safes share, as set forth above, there are a handful of benefits associated solely with Safes. Since Safes are treated as equity for tax purposes, an investor's QSBS holding period is often deemed to be at the time the Safe was granted rather than if and when the Safe converts into preferred equity of a given company. Another major benefit of Safes is how quick and simple they are. With the Y Combinator forms of Safes being deemed as the market standard, Safe agreements can often be negotiated in a matter of minute. Unlike convertible notes, Safes do not have a maturity date which would trigger required repayment by the company, which oftentimes will be tight on cash as founders often bootstrap their startups before outside funds are obtained (repayment under Safes are only required upon liquidation or dissolution events as set forth therein) and no interest accrues that the company is obligated to repay or to issue additional securities upon conversion to cover.

Cons of Safes

Much like with convertible notes, it is often hard for a company to see what the company's capitalization table will look like at the time of conversion. Furthermore, Safes are very simple instrument, which is how they earned their name. Sometimes companies or investors will like a more detailed instrument setting forth their respective rights or they would like to have additional rights and privileges associated with their investment. This is where an equity financing round will come into play; it is the most detailed out of the three options, and also provides for the most investor rights and privileges.

Equity Financing

Many companies may decide that raising a full round of financing in exchange for preferred stock is the best path forward when raising outside capital. Due to the additional legal fees and time commitment associated with a preferred equity priced round, a financing round makes the most sense when larger sums of money are raised (typically over one million dollars).

Immediately prior to a company's initial preferred financing round, which will often be called either a Series Seed or Series A financing round, most companies will only have holders of common stock on their capitalization tables. The preferred stock that these investors will receive have preferred benefits over the common holders, the most notable of which are set forth below.

- **Liquidation preference.** Upon a liquidation event, the holders of preferred stock will be paid their liquidation preferences (usually the higher of 1x their initial investment into the company and the amount each investor would receive if such investor's shares of preferred stock were converted into common stock). In the case of a liquidation event, any debt will be repaid first, followed by the payout to preferred shareholders and then common holders will be last.
- **Dividend preference.** Preferred shareholders will receive preferential dividend payments over the holders of common stock if and when the board declares any.
- **Protective provisions.** The protective provisions are set forth in the company's certificate of incorporation and require the consent of the holders holding a certain percentage of preferred stock (most often a majority) to take certain corporate actions such as effectuating a dissolution or liquidation event, issuing an additional class of preferred stock that is senior to the outstanding preferred stock, increasing the size of the board, amending the company's organizational documents (i.e., bylaws and/or certificate of incorporation), increasing or decreasing the authorized capitalization of the company, and declaring any dividends or the company's redemption of certain shares.
- **Conversion features.** Preferred stock has the ability to convert into common stock at the request of its holder (usually on a 1:1 basis). This is beneficial to its holder in situations where common stock prices begin to increase.
- **Anti-dilution protection.** In almost all situations, the certificate of incorporation will provide for broad-based weighted average anti-dilution protection. This provision protects preferred shareholders from the risk of dilution in the case that a company issues additional shares of capital stock at a lower price. If the anti-dilution protection is triggered, an anti-dilution formula is used to adjust the price of the existing preferred shares. This formula takes into account the new stock's price per share, the amount of money previously raised and now intending to be raised by the company, and the price per share of the existing preferred stock.

In addition to the innate benefits of preferred stock mentioned above, in connection with an equity financing round, all preferred investors, or, most often, just those investing above a set dollar threshold (e.g., $500,000 or above) will receive contractual "Major Investor" rights. These rights often include certain information rights, inspection rights, preemptive rights, and right of first refusal and co-sale rights.

Pros of Equity Financing

The first benefit of conducting an equity financing round is that there is no mystery as to what the company's capitalization table will look like post-financing. Unlike with convertible instruments, actual shares of preferred stock are being issued upon the closing of the financing round and all new investors and existing shareholders will see exactly how the financing affects their ownership. Investors will also favor a preferred financing round because of the innate benefits of preferred stock, as well as the contractual rights each set forth above. Usually, larger sums of money can be raised in preferred financing rounds, and collaboration opportunities often arise with institutional investors on the cap table, especially if preferred director seats or observer rights are given in the round. Furthermore, assuming that the company qualifies for QSBS treatment and that there have been no disqualification events, an investor's holding period for QSBS treatment will commence as soon as the preferred stock is issued. Finally, although equity financing rounds are still the most costly approach to capital raising, there are agreed forms, most notably the National Venture Capital Association (NVCA) forms, that are used and accepted as market. Therefore, much like with Safes, there are documents accepted as market, which are used as a starting point for these transactions. In addition to the NVCA forms, in more limited cases, the seriesseed.com financing documents are used. See below for a description of each of these documents.

Cons of Equity Financing

Out of all three options, listed financing means listed in this practice note, an equity financing round is the only method where, immediately upon receipt of the investor's funds, existing shareholders' ownership stakes will be diluted. Also, this is the only method of raising capital pursuant to which investors will receive shareholder rights (e.g., voting rights and certain statutory inspection rights and often preemptive rights and right of first refusal / co-sale rights for certain investors) immediately. In addition to these basic shareholder rights, oftentimes board observer rights and investor-director seats are negotiated in preferred financing rounds. While having a strategic investor associated with a company's board of directors results in great synergies, this can be viewed as a negative for founders looking to retain as much control as possible. Due to the additional paperwork required and state filings required to initiate a preferred financing round, this is the most costly and time-consuming of the fundraising methods set forth in this practice note. In addition, by issuing preferred stock, a company provides liquidation preference to its preferred investors so that now the company's common holders (often the founders) will be paid out only after all debt and preferred shareholders are paid.

Equity Financing Documentation

As alluded to above, one major benefit of an equity financing round is the existence of standard NVCA agreements recognized as market for venture capital financings in the United States. The standard NVCA model documents include:

- **Certificate of incorporation.** Sets forth the rights and privileges of the preferred stock, including but not limited to its liquidation preference, anti-dilution protection, and voting rights.
- **Preferred stock purchase agreement.** The document pursuant to which investors purchase their shares of preferred stock.
- **Investors' rights agreement.** Agreement which sets forth certain rights of the preferred investors, including registration rights, certain information rights, inspection rights, and preemptive rights. In most cases, all of these rights, other than the registration rights, are limited to just those defined as "Major Investors," which are investors investing at least a certain amount in the financing round. The total round size will help dictate what this "Major Investor" dollar threshold should be so that it captures only those select investors writing sizeable checks relative to the total capital raise. See Investor Rights Agreement (NVCA Model Document) (Delaware).
- **Voting agreement.** The voting agreement will set forth the board composition and how the shareholders of the company agree to vote their shares, in order to fill all of the board seats. In addition, this agreement will contain a drag-along provision, which is important in connection with a future company sale.
- **Right of first refusal and co-sale.** The right of first refusal contained in this agreement is triggered when a holder of common stock proposes to sell its shares (subject to limited exceptions). Once a proposed transfer is made to a third party, the company first gets the opportunity to purchase these shares pursuant to the terms set forth in the proposed transfer and then the right passes along to the investors (usually just the "Major Investors") if the company does not purchase all shares of transfer stock. The co-sale right in this agreement allows investors to tag along with a selling common holder to sell shares to such a third party in the case that the company and other investors do not agree to purchase all of the proposed transfer shares.

While the NVCA form documents are used in most circumstances, in smaller deals, the seriesseed.com financing documents are sometimes used. These documents contain many of the rights set forth in the NVCA documents, but consolidate them into two main documents as set forth below:

- Certificate of incorporation
- Stock investment agreement (a single agreement which consolidates, in less detail, many of the rights listed above in the last four NVCA documents listed above)

Conclusion

Oftentimes, founders of new companies look for first checks from friends and family and angel investors, but other times, large venture capital funds are willing to invest. Fundraising is a time-consuming process for founders, regardless of the investment method chosen, and finding the person to write the first check can be exhausting. There is no right or wrong approach for a company to take when preparing for its first cash infusion. The purpose of this practice note is to provide a high-level overview of the main financing options available and to help companies make informed decisions based on their individual facts and circumstances. Any well-versed startup lawyer will spend the time walking a founder through important considerations and decisions to make around the various types of fundraising options, the pros/cons of each, and the key terms you should understand when you embark on investor discussions.

Related Content

Practice Notes

- Venture Financing Overview
- Venture Capital Financing: Conducting the Transaction
- Pre-seed and Seed Stage Convertible Note and Note Purchase Agreement Transactions
- Preparing for a Pre-Seed Financing Round
- Pre-seed and Seed Stage Equity Investment Transactions
- Preferred Stock Purchase Agreements, Related Agreements, and Supporting Documents: Drafting Considerations

Templates

- Due Diligence Request List for Venture Capital Financing
- SBIC Side Letter (Venture Capital Financing)
- Venture Capital Financing Loan Agreement (SBIC)
- Term Sheet for Series A Round of Financing of Any Unnamed Corporation, Inc.

Clauses

- Convertible Note Subordination Clause

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Chandra works with growth stage and early stage startups and venture firms and other angel and strategic investors who fund them. Chandra provides legal and strategic advice to founders, investors and boards on corporate governance matters, debt and equity financings and mergers and acquisitions. Chandra also provides general legal and strategic guidance through all phases of her startup clients' life cycles, from formation to exit and everything in between.

Chandra serves as a member of the leadership committee for both the Women's Initiative Network and the Diversity Leadership Network at Lowenstein. She is dedicated to advancing the role of women in the legal profession and increasing diversity and inclusion initiatives at the firm and beyond.

Prior to joining Lowenstein, Chandra served as a judicial extern to the Honorable Arthur S. Weissbrodt, United States Bankruptcy Court, Northern District of California, and held positions as a legal extern in the Worldwide Commercial Transactions group at Sandisk Corp. and under the General Counsel at Force10 Networks Inc. (acquired by Dell).

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Laura provides legal counsel on an array of corporate transactions for tech startups, private equity and other investment funds, and financial institutions. She advises innovators and established organizations on diverse business matters such as capital raising, strategic financing and acquisitions, licensing, joint ventures, IPOs, and full-scale exits. Laura is also involved in deal structuring and drafting services for investment funds and other entities that supply critical financing for organizations at various stages of the business lifecycle.

Earlier in her career, Laura worked with private equity clients and large public companies on a variety of financing transactions, including term loan credit facilities, asset based lending credit facilities, refinancing transactions, subscription credit facilities, and accounts receivable financings. She advised private equity and portfolio companies on general corporate governance issues and assisted banks and other financial institutions regarding regulatory, litigation, and transactional matters.

Laura is the author of "Online Shopping: Buy One, Lose Legal Rights for Free" 46 Seton Hall L. Rev. 991 (2016).

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A veteran of high-profile representations in the digital advertising, media, and entertainment sectors, Matt brings a proven track record to his work for a broad range of clients.

Matt has represented clients in copyright, trademark, trade secret, and right-of-publicity matters—with a particular emphasis on how new and emerging technologies are disrupting traditional businesses.

His work also includes counseling clients on information privacy and data security issues (including the California Consumer Privacy Act [CCPA]), cybersquatting, domain name disputes, and technology licensing. He represents The Estée Lauder Companies Inc. in connection with various investments and acquisitions, with a particular emphasis on intellectual property and right-of-publicity issues. He also represents News Corp. in connection with its digital advertising initiatives, and regularly drafts and negotiates endorsement, sponsorship, and personal appearance deals for athletes, celebrities, and major brands.

During his time as a litigator, Matt handled various entertainment, intellectual property, false advertising, right-of-publicity, and privacy disputes, including defending a copyright infringement suit filed by the Estate of Frank Zappa and assisting in the successful defense of David Chase in connection with The Sopranos.

Prior to joining Lowenstein, Matt worked for the Department of the Army, negotiating and drafting multi-million dollar procurements for communications and electronics equipment and related services, with an expertise with the FAR, DFARS, and AFARS.