Preparing for a Pre-Seed Financing Round

A Practical Guidance® Practice Note by
Matthew Savare and Chandra Shih, Lowenstein Sandler LLP

Matthew Savare
Lowenstein Sandler LLP

Chandra Shih
Lowenstein Sandler LLP

This practice note discusses preparation for a pre-seed financing round, and actions that founders and their legal advisors can take to avoid stumbling blocks during the financing process.

Benjamin Franklin famously cautioned that "an ounce of prevention is worth a pound of cure." Although Franklin was warning the people of Philadelphia that preventing a fire is better than fighting one, the same admonition holds true when seeking financing at any stage of your company's lifecycle.

Unfortunately, many pre-seed start-ups do not engage competent legal counsel early in the process and either use an online legal technology company that offers cookie-cutter forms not tailored to the company's business, find free forms on the internet, or copy legal documents from companies in the same general line of business. In each of these cases, you often get what you pay for and mistakes made early on compound when you attempt to raise money from people other than friends and family willing to fund your dream.

This practice note focuses on pre-seed start-ups. It is critical at the pre-seed stage for the company to establish the proper legal foundation on which to build and grow. Doing things properly at the inception of your company will set you up for your first fundraise and avoid having to put out costly fires down the road. For additional context on venture capital financing, see Venture Financing Overview, Venture Capital Financing: Conducting the Transaction, and Pre-seed and Seed Stage Equity Investment Transactions.

Formation

One of the most important decisions a founder will make at the outset is deciding what type of entity to form. An overview of all the various entity types is beyond the scope of this note, but any founder who wants a traditional, venture-backed start-up will need to form (or eventually transition into) a Delaware C corporation. Investors do not want the tax-liability that comes coupled with pass-through entity types (LLCs, partnerships, S corporations) and investors and outside board members want the comfort of well-established guidelines and case law that comes with being a stockholder in, or board member of, a Delaware corporation. For any founder who starts with a different entity type or who may have formed in a different jurisdiction, converting or migrating into a Delaware C corporation can sometimes be a costly and time-consuming process, so it is best to discuss with legal counsel as early as possible to see whether it makes sense to flip now or wait until you have a fundraising or other significant event that may help lessen the blow of the cost of doing the flip.

Although pre-seed companies are, by definition, not well capitalized, almost all law firms that specialize in start-ups and emerging companies offer cost-effective packages tailored to structuring and forming your company properly and providing you the fundamental documents and agreements needed at this initial phase. At a minimum, the formation documents should include the company's initial certificate of incorporation, documentation establishing the initial board of directors, a board consent approving basic organizational matters, adoption of the company's initial bylaws, paperwork to transfer the founder(s)' initial business plan and other related intellectual property to the company, and paperwork to establish the founder(s)' initial equity stake in the company (including vesting details and instructions regarding the significance of, and important timing considerations related to, filing an 83(b) election with the IRS). There can be a multitude of other documents that can be included depending on the company's needs, and any well-versed start-up lawyer will spend the time walking a founder through important considerations and decisions to make at formation.

Cap Table/Founder Equity

Another important first step for any start-up company is properly setting up its capitalization table. The single biggest mistake we see pre-seed stage start-ups make is failing to make ensure the founder equity is set up early and documented properly. Failing to properly document the initial equity issuance can be a very costly mistake for a founding team, particularly if the company ends up in a situation where it has investors ready to serve up a term sheet with a high valuation. In that scenario, there can be real-world tax consequences for founders who have yet to properly document their initial share issuance. It is also very important to be thoughtful about how to split equity among a founding team because changing the equity mix later can sometimes result in adverse tax impacts when founders try to rebalance a capitalization table.

Other important pre-seed equity considerations include, among many other things:

- **Setting up a proper equity incentive plan and option pool to incentivize employees, advisors, and consultants.** Often start-up companies lack capital to pay market salary rates to in-demand tech workers—instead, the single most valuable thing a start-up has to offer is the upside associated with the sweat-equity it awards to employees and other service providers via stock options or restricted stock awards. Failing to setup a proper equity incentive plan and option pool and failing to grant equity awards to service providers early may mean that those valuable early employees, advisors, and consultants lose out on the benefit of a much lower price.
- **Establishing vesting schedules for all employees and other service providers.** The last thing an investor or future-acquiror wants to see is a capitalization table riddled with service provider stockholders and option holders that aren't subject to standard vesting terms (or worse, no vesting terms at all). Market standard for employees is a four-year vesting schedule (one year cliff; remainder monthly after the cliff), and the vesting terms help incentivize employees to stay with the company to earn-through their equity award. Vesting schedules for advisors and consultants can vary, but generally should relate to expected term of service. Acceleration of vesting (e.g., in connection with a change in control of the company or termination of service) should only be given on a case-by-case basis and only in situations where the role or circumstances necessitate it.
- **Transferring restrictions over shares of capital stock of the company.** Future investors will expect shares of capital stock of the company to be subject to customary transfer restrictions. These can take a variety of flavors, but all companies should have some way to either block stockholder transfers altogether without permission or to provide for the company to step in front of a buyer to purchase the shares from the stockholder first on whatever the negotiated sale terms are (called a "right of first refusal"). This is important for private companies to ensure the company (and eventually its investors) have a say on who can come onto the company's capitalization table.

SAFEs, Convertible Notes, and Priced Rounds

Typically, a pre-seed start-up company looks for first checks from friends and family and angel investors. Fundraising is a time-consuming process for founders and finding the person to write the first check can be exhausting. Here are a few helpful tips for a pre-seed company to set the proper foundation for a successful fundraise:

- **Have a clear plan on how you want to fundraise (i.e., SAFE, convertible promissory note, or priced preferred financing round); how much you want to raise; and what you plan to do with the money.** These are crucial questions you should have thoughtful answers to when you seek funding to ensure productive investor-outreach. Any well-versed start-up 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.

- **Keep it simple.** The worst mistake a start-up can make when fundraising is to try to over-complicate things. There are vetted form documents that legal practitioners, start-up companies, and investors rely on as the starting point for many different types of fundraising transactions and trying to deviate too much from the market-standard terms for no reason can send a bad message to your investors. On the flip side, it should be a giant red flag to founders if the prospective investor is asking for off-market terms, particularly those that create overly burdensome obligations on the company and/or overly complicate the financing process generally. Remember, any investor who creates huge problems for management during the honeymoon stage (aka when first making the investment) is going to be a challenging stockholder and, if they get a seat on your board, a challenging board member forevermore.
- **State and federal securities laws may pose important limitations and/or considerations on fundraising efforts.** The easiest way to fundraise as a private corporation in the U.S. is to only take checks from "accredited investors" (i.e., high net worth, high income, or otherwise sophisticated investors). There are ways to fundraise from folks who don't qualify as accredited investors, but it is crucial to engage with legal counsel early to see what steps need to be taken in order to raise from nonaccredited investors because those transactions often require additional time, special language and/or documentation, and may sometimes require special filings with the state and federal government to comply with securities laws.
- **Keep good records and pay attention to this early.** Investors, particularly venture funds with obligations to their limited partners, will conduct legal and business due diligence and part of the investment process. Ensuring that the company's records are well documented, well organized, and easily accessible is essential to ensuring a smooth due diligence process. Check-in with legal counsel early and often (even before you start to fundraise) to ask what you can do now to prepare. Oftentimes, companies have time sensitive open items that are important to tackle **before** the company gets a term sheet from an investor (e.g., service provider equity awards at pre-round price). Remember, documenting things properly and in real time is always more cost effective than waiting and trying to document and cleanup records on the eve of a financing transaction.

Working with Employees, Advisors, and Other Consultants

In today's digital age, intellectual property is usually a company's most significant asset. In light of this, it is shocking how many small businesses that hire employees or engage third parties to help create their software, apps, websites, and other materials either do not have written agreements, do not review the agreements their vendors provide them, or use deficient forms they find on the internet. Doing any of the above comes with a variety of potential risks. Without question, you should **ALWAYS** have a **WRITTEN** agreement with your employees, advisors, developers, and consultants. Typically, your agreements with your employees will be a form agreement called a Non-Disclosure Invention Assignment Agreement (NDIAA). Because pre-seed companies normally do not have many (if any) employees, we will not focus on NDIAAs here, but will concentrate on agreements with advisors, developers, consultants, and other service providers (collectively, Personnel).

Agreements with Personnel should include, among many other things:

- A provision that any work product the Personnel creates under the agreement is being commissioned as a "work-made-for-hire" and that your company owns all right, title, and interest in and to such work product, and that to the extent the law does not allow for the work to be considered a work-made-for-hire (not all works qualify), the Personnel irrevocably assigns all right, title, and interest in and to such work product to your company. You would be amazed (and horrified) how many small businesses pay large sums of money to third parties, only to learn that they do not own the work product, but instead have only a narrow license.
- A section that if your company gets sued as a result of the work product infringing a third party's patents, trademarks, copyrights, trade secrets, or other intellectual property, the Personnel will defend, indemnify, and hold harmless to your company and its officers, directors, and employees. Again, companies occasionally get sued based on their Personnel's work product, so it is important to protect your company from these types of situations.

- A prohibition on the developer using open-source software without your prior, express, written permission. Open-source software is software that is generally free to use and modify, but some open-source software requires you to release to the public the source code of any software in which it is incorporated at no cost to the end user, among other obligations. Sadly, we have seen several companies have to release the source code to their "proprietary" products or acknowledge that they do not own all the rights. This tends to dampen investors' willingness to put money into your company or a suitor's desire to purchase it. So, it is important to review the license terms for any open-source software you use in your products, because "free" can sometimes come at a high cost.

Intellectual Property Considerations

An overview of intellectual property law is beyond the scope of this note, but a few items merit special attention for pre-seed companies. Although most companies at this stage will not have the funds to file for patents, which can be expensive, there are several cost-effective things early stage companies can (and should do) to protect their own intellectual property and avoid infringing the rights of others.

- Copyrights are original works of authorship fixed in a tangible medium of expression. Think pictures, sounds recordings, text, and software to name a few. Under U.S. copyright law, you do not need to register your copyright in order to obtain copyright protection. Instead, you have a copyright from the moment you "fix" the work in a tangible way. You do, however, need to register your copyright before you can sue someone for infringement. There are other benefits to registering your copyrights, so you should consider doing so for your more important materials. Registration is inexpensive and easy to do. You should use a copyright notice on all your important copyrighted materials in the following form: "Copyright © [Year of First Publication] [Name of Company]."
- User-generated content is the foundation on which many social media companies are now built. Oftentimes, users (knowingly or unintentionally) infringe the copyrights of third parties when they upload something to your platform. Luckily, the law provides service providers (websites, ISPs, etc.) with a safe harbor for third-party copyright infringement claims. The law is called the Digital Millennium Copyright Act (DMCA), and in order to integrate your platform with most third-party platforms (such as Facebook), you are required to comply with it. To do so, you must:
  - Designate an agent to receive notices of claimed infringement. You may do so at the U.S. copyright Office website
  - Implement and publish a "notice and takedown" process, as required by the DMCA (This is usually set forth in your terms of use, as described below.)
  - Terminate access to your platform for repeat infringers
- Trademarks and service marks are words, phrases, symbols, sounds, colors, or designs that identify and distinguish the source of the goods and services of one party from those of others. Again, you do not need to register your trademark or service mark with the U.S. Patent and Trademark Office (USPTO) in order to have protection under the law; you obtain rights simply by using the mark in commerce. You should use the following notices for your marks: (1) if the mark is not registered, use the ™ symbol for trademarks and the SM symbol for service marks, and (2) if the mark is registered with the USPTO, use the ® symbol.
- Most states recognize the "right of publicity," which is a person's right to control the commercial exploitation of his or her name, image, likeness, signature, voice, and other elements of his or her persona. Although most people are not aware of this doctrine, it is significant when you are using any elements of a person's persona to advertise, market, or publicize your products or services. We have seen many small businesses—and even some very large ones—tripped up by the right of publicity. So, if you plan on using any element of an individual's persona—even if the person is not a celebrity—you should obtain the contractual right to do so. And just because you purchase or license the right to use a photograph or other image—especially from free sites on the internet—that does not necessarily mean you have the right to use the image of the person depicted in the photograph for commercial purposes. Make sure to read the license!

Privacy Policies and Terms of Use

We all know what these are. These are the lengthy, incomprehensible legal documents buried at the bottom of a website that no one reads. Well, although most people do not even look at them, they are very important if you have a website, mobile app, or other online platform in that they govern the relationship between you and your end users, and, in most cases, they are enforceable

against your company and the end user. Many pre-seed businesses fall into the trap of plagiarizing terms of use and privacy policies that they find on the internet. Aside from probably being copyright infringement, such reliance on form documents can lead to problems if you do not actually follow what is stated in them. The Federal Trade Commission (FTC) has oversight of such matters, and it enforces claims that a company has deceived or misled consumers.

Here are a few guidelines when drafting and implementing these policies:

- Your privacy policy should clearly and accurately describe:
  - The types of information you collect. It is advisable to distinguish between the different types of data you collect, such as personal information (e.g., name, address, phone number, email, etc.); financial information (e.g., credit card number, PayPal account information, etc.); geolocational information (i.e., data regarding an end user's physical location gleaned from his or her mobile device's GPS); and other information (e.g., anonymous or aggregate data you automatically collect through an end user's use of your platform, such as IP address, sites visited, how long the end user engaged with a certain element of your platform, etc.), because you may use and disclose the various types of data differently.
  - If you employ targeted/behavioral advertising on your platform. This has become a hot button legal issue, and all third-party platforms regulate the usage of such advertising on their platforms, so if you do, be sure to review the applicable platform's policies carefully.
  - If and how end users can modify the data you collect about them.
  - How you use and share the data you collect. This section of the privacy policy is one of the most important, because it governs what you can do with all the data you collect. Again, it is incredibly important to be accurate in this section, because you can create all sorts of problems if, for example, you say that you do not share data with third-party marketers when you in fact do. We typically recommend that companies state that they may use and/or share the data in at least the following instances:
    - To provide end users access to, and usage of, the platform; process orders; solicit feedback; inform them about their products and services; administer any rewards and promotional programs; and operate, maintain, and improve the platform.
    - To provide current and prospective business partners with aggregated user statistics in order to describe their products, services, and platform.
    - To enable them to employ other companies and individuals to perform functions on their behalf, such as marketing assistance, information technology support, and customer service.
    - In connection with any kind of change in control of the company, whether through merger, acquisition, sale of assets, etc.
    - When required by law, court order, or other government or law enforcement authority or regulatory agency, or whenever the companies believe that disclosing such information is necessary or advisable, for example, to protect the rights, property, or safety of the company or others.

    If you anticipate (now or in the future) sharing data with other companies which may provide end users information about the products and services they offer, we recommend inserting that disclosure as well. Such a disclosure is essential if you are actually sharing data for such reasons. However, in order to comply with various state statutes, it is important to provide your end users the ability to opt-out of such sharing.
  - How you protect the information you collect. It is important to inform your end users that you will use commercially reasonable efforts to protect their data, but no system is 100% safe. It is imperative, especially if you collect any financial or other sensitive information, to implement, maintain, and enforce strong technological, physical, and procedural safeguards to protect the security and integrity of such information. There are numerous consultants who specialize in this area, and you are well advised to seek assistance.
  - That you reserve the right to change the privacy at any time.
- If you do business overseas, many regions—including Europe and Asia—have complex privacy rules, a description of which is beyond the scope of this note. If you do business outside the U.S., especially if you have a physical presence outside our nation's borders, you need to pay particular attention to these foreign laws, as they can have significant ramifications on your ability to collect, use, and share data.

- Your terms of use should typically set forth:
  - A description of your platform, including permissible uses and restrictions (such as that end users will not post defamatory content, upload anything that infringes anyone's intellectual property, or reverse engineer or interrupt the proper operation of your platform).
  - Any payment and refund policies.
  - If you employ and how you handle passwords and usernames.
  - Ownership of your intellectual property.
  - Your right to terminate an end user's access to the platform at any time.
  - The notice and takedown information required by the DMCA.
  - A broad disclaimer of warranties regarding the platform and a limitation of liability provision.
  - Who owns user-generated content submitted to the platform. The trend is for the end user to retain ownership, but grant you a very broad license to, among other things, use, reproduce, modify, and distribute the content.
  - Your right to modify the platform and the terms of use at any time in your sole and absolute discretion.
  - A choice of law and choice of forum clause that specifies the state in which any lawsuit must occur. Please note, if you are incorporated in Delaware, it does not mean that you need to select Delaware for the choice of law or forum. Although there are many considerations that go into this decision, the general rule of thumb is to pick the state that is most convenient for you, which is typically driven by geographic proximity.

Although following the guidelines provided in this note will not guarantee you garner interest from investors or that you will close your round of financing, it will:

- Establish a strong legal foundation on which you can build and grow your company
- Address many of the legal issues that investors will want to diligence before they invest money in your company –and–
- Help you avoid (or mitigate) the time-consuming and costly cleanup work that many early stage companies need to perform to raise money

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
- 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

Matthew Savare, Partner, Lowenstein Sandler LLP

Matt is Chair of Lowenstein Sandler's Commercial Contracts Group where he drafts and negotiates various contracts across a wide spectrum of industries. He is also a member of the firm's Tech Group, Blockchain Technology and Digital Assets Group, and Technology and Media Transactions Group. Matt focuses his practice on commercial contracts, intellectual property, blockchain, digital advertising, entertainment, and privacy issues with a particular focus on start-up and emerging companies.

Matt counsels clients across the complex digital advertising ecosystem, from publishers, ad agencies, and brands to ad exchanges, ad networks, and supply and demand side platforms. He advises clients on a host of intellectual property and transactional issues involving blockchain and cryptocurrencies. He has represented clients in many facets of the media and entertainment industries including film, TV, music, publishing, theater, and social media. Additionally, he has drafted and negotiated countless endorsement, personal appearance, and social media influencer deals involving athletes, celebrities, and other well-known personalities.

Matt also counsels clients on information privacy issues, including compliance with GDPR, CCPA, GLBA, COPPA, and FTC regulations.

Prior to joining Lowenstein Sandler, Matt worked for six years for the Department of the Army, negotiating and drafting multi-million dollar contracts for Night Vision equipment and services.

Chandra Shih, Partner, Lowenstein Sandler LLP

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).