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Start-up Seed Financing

Start-up companies use seed financings primarily to raise the capital required to build a minimum viable product and test their product-market fit. This article provides guidance to company counsel and founders on how to identify a seed investor and choose the financing method that best fits the company's needs. The article assumes that the company is a Delaware C corporation, which is the market standard for venture-backed companies.

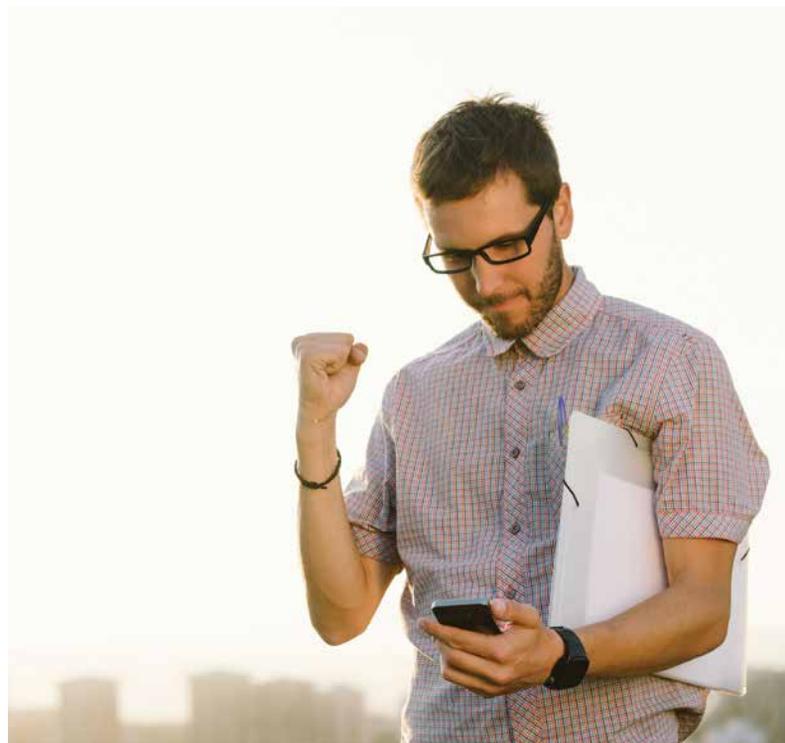
Understanding the Goals of Various Types of Investors

A typical seed financing features a founding team (and perhaps up to a handful of employees) raising between \$500,000 and \$2 million to allow for 12 to 24 months of operational capital. During this time, the founders will attempt to prove out their idea and develop the traction required for raising the next round of financing (known as a Series A financing) from a professional venture capitalist.

A seed investor's purpose is typically to test an investment hypothesis (either on a founding team, idea, or market) by providing capital to a company that will test the hypothesis. Investors at this stage will often make a large number of small investments in a variety of companies on the theory that, while many of them will fail, the few that are successful will generate significant returns for the investor. At the seed stage, investors are deciding to make their investment primarily on their assessment of the quality of the founding team and the market opportunity presented by the business model.

A few traits of founders that are seen as positive signals to investors include, but are not limited to:

- Technical/domain expertise in the planned business
- Prior successful entrepreneurial forays
- Strong introductions from people in their network
- Promising early traction
- Strong educational background (e.g., engineers from Stanford)



To decide whether to invest in a seed round, an investor will likely meet with the founding team, who will give the investor a pitch on their product/idea, market, team, and business model. Often the company's existing contacts (e.g., advisors, former co-workers, or lawyers) set up these pitch meetings (known as a warm introduction).

Types of Investors

There are a variety of typical investors in such financings:

- **Later-stage professional venture capitalists (VCs).** Many blue-chip firms (e.g., Sequoia, Andreessen Horowitz, and NEA) have separate funds for seed-stage investments. They often will invest \$200,000 to \$1 million and will be the only lead investor in a seed financing. VCs are sophisticated and often represented by outside legal counsel for seed financing transactions. They often use their seed funds as a mechanism for ensuring access to competitive Series A and Series B investments, which are the first and second rounds of financing after seed financing has been provided.
- **Seed funds.** These funds (e.g., SV Angel, First Round Capital, Slow Ventures, and BoxGroup) base their investment thesis on investing small amounts of capital in a large number of companies. They are well versed in this type of transaction and are able to quickly decide whether to invest and then move to close the transaction. They often invest between \$50,000 and \$500,000.
- **Incubators/accelerators.** These organizations (e.g., Y Combinator, TechStars, and 500 Startups) provide small amounts of capital (such as \$100,000) and a formal educational program in exchange for a fixed percentage of a company (often 6–8%). They also separately invest in their companies through seed financings without companies going through their formal education program.
- **Professional angels.** These are individuals (e.g., Ron Conway) who invest as their primary occupation. They are often extremely well-connected within their community and able to introduce founders to other investors and provide advice to early-stage founders. They often invest between \$25,000 and \$100,000.
- **Seed funding platforms/syndicates.** On these platforms (e.g., AngelList) individual investors come together to pool their money and follow the lead of an angel investor they trust to invest on their behalf or otherwise discover companies in which to invest. Typical investments for each individual can range from \$2,500 to \$50,000.
- **Serial entrepreneurs.** These are individuals who have accumulated wealth due to prior successes. They tend to invest in order to pay it forward and to mentor other founders as they start their companies. These individuals typically invest between \$25,000 and \$100,000.
- **Industry experts/advisors.** These individuals have expertise in the field in which the start-up is interested and can deliver mentorship and guidance as the company begins its journey. Investing gives these advisors the opportunity to have skin in the game and see upside for their time

spent advising the company. These experts typically invest \$10,000 to \$25,000.

- **Wealthy individuals (including friends and family).** These are individuals with a broad range of sophistication, which can often be as little as having watched an episode of Shark Tank. They have money to deploy, want to feel connected to the energy of a technology company, may see tech investing as a risky asset class within their broader portfolio, or want to help out a founder who is a friend/family member. These individuals may invest as little as \$2,500 and as much as \$250,000.

Most rounds of seed financing consist of a blend of the above investors, as each brings its own value to the table (beyond just capital). One balancing act to consider is whether to include a professional VC in the seed round. While it can be seen as a positive signal initially, it can be a double-edged sword in that the VC's decision to either lead, participate in, or elect not to participate in the subsequent preferred stock financing will be a very strong signal in the market (and often the VC will elect not to participate or lead the round, which reduces potential new investors' confidence).

Overview of Seed Financing Legal Instruments

The three most common types of series seed financing instruments are convertible notes, simple agreements for future equity, and preferred stock. These three instruments cover virtually all seed financing transactions in Silicon Valley and with start-ups across the country. The company almost always determines which instrument to use, unless there is a significant (lead) investor that negotiates the terms of the entire financing round on behalf of all other investors and feels strongly about the form the seed financing takes.

You should note that sales of common stock are not typically used for seed financing for two primary reasons. First, common stock does not come with the various investor-friendly terms (described below) that other instruments include, so it is less appealing to investors. Second, it places a price on the outstanding common stock, which then will set the price for grants of options and restricted stock to employees. Typically, a valuation firm using 409A methodology (i.e., performing a valuation before a liquidity event such as an initial public offering in accordance with Section 409A of the Internal Revenue Code) will value common stock in an early stage start-up at around 20–25% of the preferred stock. Thus, a priced common round with investors would eliminate this lower price benefit, which is one of the key recruiting tools for early employees.

CONVERTIBLE NOTES ARE THE DEFAULT METHOD FOR RAISING SEED CAPITAL AND DEFINITELY FOR SEED ROUNDS RAISING LESS THAN \$2 MILLION. IN TERMS OF PROCESS, CONVERTIBLE NOTE FINANCINGS MAY OR MAY NOT BEGIN WITH A FORMAL TERM SHEET.

Convertible Notes

Convertible notes are loans (i.e., debt) by an investor that convert into an equity interest in the company upon a priced preferred stock financing meeting certain conditions. Convertible notes are by far the most common instrument used to complete seed rounds.

Key Terms

In drafting convertible notes, you should include the following key terms:

- Conversion events, which usually consist of a qualified subsequent financing (usually a preferred stock financing raising new money above a certain threshold (typically \$2 million)), a company acquisition, or (sometimes) the maturity date
- Automatic or voluntary conversion feature
- Conversion price, which is typically the lower of (a) an agreed cap on the valuation of the company prior to further investment (pre-money) at the time of conversion, and/or (b) a discount (typically 15–25%) of price per share of the shares issued in the qualifying financing
 - Almost all notes are capped, as the cap establishes an approximate valuation for the company and sets the general bounds for what percentage of the company the investor is purchasing when the notes convert.
- Change of control premium, which is usually a premium payment (50–100% of the principal and interest outstanding) or conversion to common stock at the valuation cap
- Interest rate, which is nominal and can be as low as the applicable federal rate
- Maturity date (e.g., 12–24 months)
- Events of default
- Protective provisions (i.e., consent from the noteholder(s) is required to take certain actions, such as creating an equity incentive plan or selling the company) (unusual)
- Security interest (unusual)

Advantages

The advantages of convertible notes include:

- **Well-established and understood.** Companies, investors, and their lawyers understand the mechanics. This results in a short timetable to complete (e.g., 1–2 weeks in their simplest form) and relatively low legal fees.
- **Operating flexibility.** For a company, convertible notes give founders more freedom to make decisions as they do not contain the typical controls on a company that a preferred stock investor would require.
- **Valuation.** The company can put off negotiating a valuation until the priced preferred stock round (though the cap and/or discount function as a maximum approximate valuation).
- **Amendment.** A note facility (i.e., many investors investing under one note purchase agreement) means that all notes can usually be amended by a majority of dollars invested in the note round. This can sometimes be necessary if, for example, the maturity date needs to be extended or other terms changed before or in connection with a priced preferred stock financing. For this reason, you should structure a convertible note round as a facility whenever possible, rather than as a series of individual independent notes.
- **Unsecured.** In the event of a liquidation of the company, the notes will receive payment prior to any payments flowing to other types of investors, but the note investors cannot foreclose on the company's assets since the notes are typically unsecured.

Disadvantages

The disadvantages of convertible notes include:

- **Repayment.** Notes need to be repaid upon maturity or in event of default, and the company may not have the funds to do so. However, if the maturity date passes and the company has not yet raised a priced preferred stock round (so the notes have not converted), then investors usually will agree to extend the maturity date so that the company has additional time to raise the Series A round.



- **Dilution to founders.** Typically, outstanding convertible notes are included in the pre-money capitalization in the next financing, so these notes are dilutive to the existing stockholders (e.g., the founders and early employees) but not to the new preferred stock investors.
- **Liquidation preference windfall.** If not drafted to convert to a shadow preferred (which is a different series of preferred with liquidation preference equal to the price at which the applicable note(s) convert) or partial preferred/common blend, they can create extra liquidation preference above all common equity (i.e., for the discounted portion of the note due to the discount or cap).

Process

Convertible notes are the default method for raising seed capital (and definitely for seed rounds raising less than \$2 million). In terms of process, convertible note financings may or may not begin with a formal term sheet. Because the terms are relatively straightforward, it is often customary for you, the company counsel, to simply draft the convertible note documentation based on rough parameters agreed to by the company and its initial lead seed investor. Often there is little to no negotiation outside the key terms listed above, as they are legally straightforward to implement (which is another benefit of using a convertible note structure).

Simple Agreements for Future Equity

In December 2013, Y Combinator (a leading start-up accelerator) introduced its alternative to convertible notes—Simple Agreement for Future Equity (SAFE), <https://www.ycombinator.com/documents/#safe>. It provides four types of SAFEs, each of which is freely accessible on the Y Combinator’s website:

- The first SAFE includes a cap but with no discount.
- The second does not include a cap but does include a discount.
- The third contains both a cap and a discount.
- The fourth contains a most-favored nation clause, but neither a cap nor a discount.

Key Terms

In drafting SAFEs, you should be familiar with the following key terms:

- **Valuation cap.** The valuation cap is a maximum value ascribed to the company, such that in a qualified financing, the SAFE converts as the lower of the price per share calculated using the valuation cap and the actual price per share of preferred stock sold in such financing.
- **Conversion discount.** The conversion discount (e.g., 15–25%) is the amount the price per share in a qualified financing is discounted for determining the price per share at which the SAFE converts.
- **Most-favored nation status.** The holder of the SAFE may be entitled to receive the benefit of any preferential terms received by any subsequent purchaser of convertible securities of the company.
- **Pro rata rights.** SAFEs by default provide that the investor will receive pro rata rights to purchase more shares in all future financings by the company excluding the financing in which the SAFE converts, without limiting this right to those investing above a certain amount (as is typical during a financing).

Note that SAFEs include neither an interest component nor an obligation to repay absent a conversion.

Advantages

The advantages of SAFEs include:

- **Quick and Simple.** Like convertible notes, they are relatively quick and inexpensive to negotiate and draft.
- **Stand-alone agreements.** By default, SAFEs are structured as stand-alone agreements. This allows for a company to sell them to investors individually as the investors are ready to close, avoiding the need to coordinate a simultaneous closing with many investors.

Disadvantages

The disadvantages of SAFEs include:

- **Stand-alone agreements.** As discussed above, SAFEs are structured as stand-alone agreements. A company could issue a different type of SAFE to each of its investors, creating disclosure issues and potentially massive coordination challenges when the SAFEs convert in an equity financing if there are multiple varieties of SAFEs outstanding. In addition, amending each SAFE requires the consent of each holder, making changing terms in connection with a financing much more difficult.
- **Multiple valuation caps.** By default, SAFEs convert into a series of shadow preferred stock in order to provide the correct liquidation preference (i.e., only the amount of capital actually invested by the investor). If a company issues SAFEs with different caps, multiple series of shadow preferred stock will be required, causing great administrative complexity at the time the SAFEs convert to preferred stock.
- **Pro rata rights.** Pro rata rights are extremely atypical and not customary for small seed investors to receive. You should either remove pro rata rights from the SAFE before it is presented to investors or limit them by incorporating an investment threshold.
- **Some ambiguity regarding proper tax and accounting treatment.** While Y Combinator has asserted that SAFEs are equity instruments, not debt (and thus no minimum applicable federal rate is required for interest, and they are not subject to various other debt legal requirements), the sentiment among Silicon Valley lawyers and accountants is that this is not a settled question. There is not complete agreement in the tech community about whether these instruments are properly characterized as debt or equity. This can lead to confusion and complexity for the company's (and investors') tax and accounting records.

Process

SAFEs are becoming more and more common as the market becomes more accustomed to them. Since they have very few inputs and, if used as provided by Y Combinator, require few changes to the provisions, founders tend to use them without consulting outside legal counsel first, who will often explain the above issues and either tweak the documents to resolve them or guide the company to use a more traditional convertible note structure. In general, closing a seed financing with SAFEs is straightforward once the company and investors agree to the key terms.

Preferred Stock

There are two types of preferred stock documents used in seed financings: the lightweight version www.seriesseed.com and a full Series Seed set of documents.

Full Series A Documentation

Some professional VCs have interpreted Series Seed to mean full-blown Series A documentation (with all the related rights and privileges) as per the National Venture Capital Association's model legal documentation, <http://nvca.org/resources/model-legal-documents/>. This includes five major transaction documents:

- Stock purchase agreement
- Certificate of incorporation
- Investors' rights agreement
- Voting agreement and right of first refusal
- Co-sale agreement

There are also additional ancillary documents like a legal opinion and closing certificates.

The full Series A documentation is typically significantly more expensive in legal fees and requires the negotiation of all the terms and documents that will be used in a later Series A financing. This can be difficult since the seed round often does not include traditional lead investors with which the company can negotiate the documents. This structure of transaction can typically take 4-6 weeks to complete (from finalization of the term sheet to closing of the investment).

Series Seed Preferred Documentation

There is also a set of Series Seed preferred stock documents (<http://www.seriesseed.com/>) that take into account various perspectives from the broader Silicon Valley community, including VCs and entrepreneurs. These documents greatly simplify the transaction and defer the detailed negotiation of a fulsome set of investor rights until the Series A financing.

The Seriesseed.com approach includes most of the key terms included in a traditional full Series A round, including:

- Liquidation preference
- Limited protective provisions (i.e., prohibiting the company from taking certain actions without the consent of the preferred stockholders; such actions may include changing rights of preferred stock, increasing authorized capitalization, creating senior series/class of preferred stock, redeeming stock (subject to customary exceptions), declaring dividends, changing board size, or selling or liquidating the company)
- Board seat
- Preemptive rights
- A drag-along (i.e., the ability to compel an investor to participate in certain sales)

On the other hand, it does not include:

- Typical price-based anti-dilution protection
- Registration rights
- Full right of first refusal and co-sale rights for investors over founder shares

The investors will receive the same rights as the future investors in the Series A financing. Importantly, the Seriesseed.com approach only requires two documents:

- Investment agreement
- Certificate of incorporation

No ancillary documents like a legal opinion and closing certificate are required, so the process is significantly streamlined and therefore less expensive. Using the Seriesseed.com documents is straightforward. All the key terms are defined in a definitions section in the beginning of the investment agreement and the certificate of incorporation.

Securities Laws Considerations

Federal Exemptions

Regardless of how the seed investment is structured, it's critical that the company has a valid federal securities law exemption from registration under the Securities Act of 1933, as amended (Securities Act), for the issuances. The two most commonly used federal exemptions for seed financings are:

- The private placement exemption provided by Section 4(a)(2) (15 U.S.C.S. § 77d) of the Securities Act, which exempts “transactions by an issuer not involving any public offering”
- Rule 506(b) (17 C.F.R. § 230.506) of Regulation D, which provides a safe harbor under Section 4(a)(2) of the Securities Act

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For additional information on convertible notes, see

> UNDERSTANDING CONVERTIBLE DEBT SECURITIES



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For an explanation on the use of Simple Agreement for Future Equity (SAFEs) securities in the crowdfunding context, see

> MARKET TRENDS: CROWDFUNDING – OTHER KEY MARKET TRENDS



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For guidance on managing a private offering, see

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For a sample convertible note to be used in connection with a pre-seed or seed financing transaction for a start-up company, see

> CONVERTIBLE PROMISSORY NOTE



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Historically, the private placement exemption was the traditional exemption relied upon for federal securities exemptions, but Regulation D has now become more common and most companies rely on this exemption because its parameters are more certain than Section 4(a)(2) alone. Rule 506(b) allows for the company to sell securities to an unlimited number of accredited investors (defined in Rule 501(a) (17 C.F.R. § 230.501) and up to 35 other purchasers. If those other purchasers are unaccredited, they must be sophisticated (i.e., have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment). However, it's generally advisable for companies using this exemption to sell only to accredited investors. This is because including non-accredited investors requires a company to deliver exhaustive disclosure and offering documents, which can be prohibitively expensive and time-consuming from a legal and accounting perspective for a young company to prepare. It's also worth noting that if you want to take advantage of the new provisions in Rule 506(c) that allow general solicitation, all investors must be accredited.

A company that makes an offering under Regulation D is required to file a Form D with the Securities and Exchange Commission (SEC) within 15 days of the first sale of securities. Once filed, the Form D is available to the public on the SEC website, and various news organizations will trawl the SEC website and report on start-ups' fundraising activities. Thus, you should advise the company to prepare a press release on a parallel path to the Form D filing in order to manage its public narrative.

Blue Sky

In addition to the federal securities law exemption, the company also needs to comply with state securities laws (blue

sky laws) in the state in which it is located and the states in which each of its investors is located. Compliance regimes vary from state to state, but most often there is either a notice filing if using Section 4(a)(2) or an electronic filing if using Regulation D. For example, if the company relies on the 4(a)(2) private placement exemption in California (and does not file a Form D), it should file a 25102(f) notice (http://www.dbo.ca.gov/forms/doc/DBO-25102f_Packet.pdf) with the California Department of Business Oversight. Some states require the filing to be made in advance of the sale of securities, so you should be careful to check the blue sky regime in each applicable state before the securities are sold. **L**

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