Seed Capital

A Guide for Sustainable Entrepreneurs

SUSTAINABLE ENTREPRENEURSHIP PROJECT

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Seed Capital:
A Guide for Sustainable Entrepreneurs

About the Project

The Sustainable Entrepreneurship Project (www.seproject.org) engages in and promotes research, education and training activities relating to entrepreneurial ventures launched with the aspiration to create sustainable enterprises that achieve significant growth in scale and value creation through the development of innovative products or services which form the basis for a successful international business. In furtherance of its mission the Project is involved in the preparation and distribution of Libraries of Resources for Sustainable Entrepreneurs covering Entrepreneurship, Leadership, Management, Organizational Design, Organizational Culture, Strategic Planning, Governance, Corporate Social Responsibility, Compliance and Risk Management, Finance, Human Resources, Product Development and Commercialization, Technology Management, Globalization, and Managing Growth and Change. Each of the Libraries include various Project publications such as handbooks, guides, briefings, articles, checklists, forms, forms, videos and audio works and other resources; management tools such as checklists and questionnaires, forms and training materials; books; chapters or articles in books; articles in journals, newspapers and magazines; theses and dissertations; papers; government and other public domain publications; online articles and databases; blogs; websites; and webinars and podcasts.

About the Author

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Seed Capital

§1 Introduction

While some founders may be able to raise financing from venture capitalists without a complete business plan or finished product prototype because of their previous track record and existing relationships with those types of investors, the more likely scenario is that founder will need to find smaller amounts of cash from friends, relatives, "angel investors" and others to plant the seeds necessary to begin building their business and help the business survive to the point where the initial business plan is done and a first version of the proposed product is ready to show. While the amount of "seed capital" that may be required may be quite small in relation to the money that will eventually be needed to fully develop the business model, finding sufficient funding from the right sources can be a frustrating experience, even for founders who have previously been successful in raising venture capital funding for prior companies. Approaching friends and family can be uncomfortable for the founders and they need to be sure that they carefully explain the risks to persons who generally have little experience with this type of investment. So-called "angel investors" often promise access to connections and advise based on their own successes; however, caution should be exercised when taking money from professional investors with whom the founders do not have a pre-existing relationship. Venture capitalists set aside only a limited amount of funds for seed financing and "accelerators" and "incubators" often demand a generous percentage of founder's shares while falling short on their promises of support. Also not to be ignored is that raising seed capital will be the company's first step into the world of securities law regulation and bringing new stakeholders into the company beside the founders.

It appears that all of the challenges mentioned above are becoming part of the "new normal" for founders who eventually hope to be supported by venture capitalists. As noted, venture capitalists have backed off from providing the first money to support product development and most founders now expect that they will need to devote anywhere from six to eighteen months to developing relationships with venture capitalists that will be strong enough to create interest in leading or participating in a traditional "Series A round" of financing.[1] During that time the founders will need to demonstrate the viability of their business model and proposed product and they will need sufficient seed capital to get moving and maintain momentum. This means that founders must be able to determine how much seed capital will be required, set a defensible pre-seed valuation for the company and prepare for the seed fundraising process.

In some cases, the founders are able to line up all or most of the desired capital fairly quickly; however, it is not uncommon for companies to go through multiple closings spread out over a number of months. The later scenario is obviously nerve wracking for

[1] For discussion of the issues and activities associated with a company's first round of venture capital financing, generally referred to as the "Series A round" because it is executed through the designation, offer and sale of shares of Series A Preferred Stock, see "Venture Capital" in "Finance: A Library of Resources for Sustainable Entrepreneurs", prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

the founders, since the company will likely be tight on funds with little room for error and the founders will be more distracted by the need for additional capital raising. Companies may have to "get by with less" and hope that there is enough to get to the next financing level. Sometimes founders discover that it makes sense to raise more money than anticipated during the seed funding stage to address unanticipated problems or opportunities or allow investors with valuable connections and experience to get involved with the venture.

§2 Seed capital fundraising scenarios

One thing that makes seed capital and seed round financing confusing to many people is that there is actually several different capital raising scenarios for startups. The "standard seed round", discussed in more detail elsewhere in this chapter, looks to bring in $1 to $1.5 million in the company's first financing outside of "friends and family" from one to three institutional seed investors or larger venture capital funds on either a priced equity structure or a convertible note. The goal for the standard seed round is to provide the company with 12 to 18 months of runway to achieve early-stage milestones and demonstrate eligibility for a Series A round before the seed capital is exhausted. However, as a guide to founders David Beisel identified the "seven atypical rounds of startup funding" summarized below.[2] The first four are positive, arising out of strong demand from investors and/or good progress toward business model milestones; however, the last three are indicators of trouble and a sign that the company is struggling to make progress.

- Genesis Round: Up to $500,000 raised before standard seed round using a convertible note to pre-product companies with a largely founder-only team to provide up to 12 months of runway to allow the company to begin working on its product before approaching institutional seed investors. Pros and cons of this type of "pre-seed" funding are discussed in detail below.
- "Lean-In" Seed Extension Round: $1 to $2 million after standard seed round for companies that have achieved their initial milestones and who are looking for capital to pursue additional milestones before seeking Series A financing. Most of the capital is obtained from existing investors who are excited about progress and eager to put in more capital (i.e., they are "leaning in").
- "Building" Seed Round or "Seed II": Anywhere from several hundred thousand dollars to $1 to $2 million after standard seed round if interest in the company from new outside investors emerges from participation in accelerators or "demo day" events. Companies often wish to take advantage of access to additional capital and are usually able to enjoy more company-favorable terms than the first seed round.
- "Super" Seed Round: A round that begins as a standard seed round and then expands to $2 to $3.5 million due to strong interest from a number of syndicate players including three or more venture capital investors. Demand from investors allows the founders to bump up the valuation from the amount used in early discussions.

[2] The discussion in this section is adapted from D. Beisel, "7 Atypical Rounds of Startup Funding: What Founders Should Know" (July 7, 2014), http://nextviewventures.com/blog/atypical-rounds-of-startup-funding/ [accessed May 29, 2016]

- "Preemie" Series A: Although the founders have achieved sufficient milestones to raise a multi-million Series A round they choose to raise a seed round for an amount that is small than available investor demand. This strategy takes advantage of higher valuation at the time of the seed round, due to more mature state of development, and set up for a less dilutive Series A round in the future.

Each of the categories of rounds described above come at a time when the prospects for the company are positive and interest from new investors is strong. Unfortunately, the reality is that companies at the seed capital stage are typically challenged with executing their business models and delivering on key product development and operational goals. While, as discussed elsewhere in this chapter, founders should make an exhaustive analysis of their capital requirements, actual needs—both in terms of capital and time—often exceed expectations and founders may be forced into the following scenarios:

- "Pass-the-Hat" Seed Extension Round: Occurs after standard seed round when company is running low on cash and it is beginning to look like the company will not be able to achieve the milestones necessary to complete a Series A round. Additional cash comes from existing investors trying to be supportive while minimizing the amount of additional capital at risk.
- Bridge to Sale/Financing: Company is looking at various strategic options, such as a sale of the business, or is on track for Series A round but running low on cash such that there are concerns about the ability of the company to meet its short term obligations until the "good event" occurs. Existing investors are willing to step in to cover the potential gap by participating in a small convertible note bridge financing to cover essential operating expenses for a short period of time to allow founders to close the sale or financing.
- Bridge to Nowhere: Small convertible note bridge financing from existing investors to keep company afloat when cash is running out and no realistic positive event is on the immediate horizon. Often several rounds of notes are used, a practice referred to as "drip feeding" the company, until it become clear that the company must simply shut down.

§3 Potential seed capital investors

While there are different types of seed financings, in general seed capital is early-stage funding that can come from a variety of sources. Money from relatives, friends and business associations—so-called "friends and family" financing—may be used to continue development of a business model and product prototype. New business incubators and venture catalysts, which provide various types of assistance, including seed capital, with the development of business plans. Wealthy individuals, including angel investors, may be willing to provide early-stage support and founders may also go through the more formal capital raising processes required when seeking funding from seed capital funds, venture capitalists and/or corporate partners.

One of the complicating factors with respect to any seed financing is that it often involves two or more distinguishable groups or types of investors. For example, a company interested in raising $1 to $1.5 million might be simultaneously pursing capital from multiple “funds”, each of which might be looking to invest between $200,000 and $700,000, and different types of angel investors who will invest smaller amounts (i.e., $50,000) but will participate either because they have strong preexisting relationships with the founders or they are perceived by the founders to be capable of providing significant “value” to the venture in terms of contacts and credibility.

As discussed in more detail below, seed financing generally utilize preferred stock or a debt instrument, generally with the right to convert the preferred stock or debt into common stock (or options or warrants exercisable for common stock). The investors are thus given "downside" protection, in the form of a preference with respect to dividends or liquidation or, in the case of a debt security, a senior position in the event the company's business takes an adverse turn, and the opportunity to participate in the appreciation of the common stock's value should its business prosper. Seed round investors typically have their own targets for overall return on investment, and will limit their investments to those companies which appear to provide a reasonable opportunity for achieving those objectives within a specified time frame, such as three to five years.[3]

§4 --Relatives, friends and business associates

Founders typically do not have the personal financial resources to fully fund the early stage financial requirements of the new company and will need to rely on support from outside parties. However, unless the founders have a strong track record and/or an exceptionally strong business concept that attracts the immediate interest of venture capitalists and other investors willing to provide large amounts of capital before the product or service has been fully developed, they may find that funding is difficult to secure on reasonable terms. For example, banks will rarely loan money to a start-up company without unlimited personal guarantees from the principals, which means their personal assets will be placed at risk, and the amount of cash that can be obtained from government funding programs for “small businesses” may not be sufficient to get the company to the point where the product is ready to show to professional investors. Also, while some venture capitalists might be willing to provide seed capital most are unwilling to fund a new venture until there is a clearer picture of the products and/or technologies upon which the business will be built. Those who do make investments at this embryonic stage may extract a high price from the founders by demanding a larger percentage of equity ownership and other concessions relating to influence over management of the company in the future.

Lacking viable alternatives, the founders often turn to their family and friends, as well as long-standing customers and suppliers, for financial support. These types of potential

[3] From a securities law perspective, seed financings are “private placements” and must be conducted in accordance with specific rules governing the availability of exemptions from the registration and qualification requirements of federal and state securities laws. For discussion of the regulation of private placements and the advantages and disadvantages of relying on a private placement exemption from registration or qualification of securities, see “Sources of Capital” in “Finance: A Library of Resources for Sustainable Entrepreneurs”, prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

investors usually are familiar with the operating history of the business and know its need for capital and are already well acquainted with the founders and can therefore be relatively easily interested in providing capital. While private funding from these sources can often be closed relatively quickly and with far less formality than what is expected when dealing with venture capitalists and other professional investors, the founders must proceed with caution and consider the impact on management of the business and their ability to raise the additional funds that will inevitably be necessary in the future to expand operations. One important legal issue for founders in the US to consider is making sure that the sale of securities to family and friends does not run afoul of federal and state securities laws. If stock is to be sold to be sold only to persons with high net worth who are only committing a small portion of their personal assets than they will likely qualify as "accredited investors," which significantly reduces the formal disclosure obligations of the founders (e.g., preparation of a private placement memorandum). However, if capital is being raised from unaccredited investors who are familiar with the enterprise but lacking other business sophistication the founders may need to incur legal fees and other expenses satisfying disclosure requirements.

Another thing to consider is the new relationship between the founders and their family and friends. These types of investors generally are not interested in monitoring day-to-day operations, nor will they demand the protections typically provided to venture capitalists because of the trust and familiarity developed through their prior personal relationships with the founders; however, they do have certain statutory rights to information and the founders must be mindful that they have fiduciary obligations that must be observed. With respect to the investors, they must understand the need to maintain the confidentiality of information that they receive about the business and must be sure that their investment does not violate any contractual obligations they might have to their employer. The founders must also prepare for the time when venture capital funding is obtained and disclose the potential consequences to their family and friends—for example, subordination of their rights upon liquidation and the possibility that oversight of their investment will be transferred from the founders to a new group of professional managers that they do not know. Finally, while relatives and friends may be excited to be part of the venture at the outset and eagerly contribute financial support they may be less enthusiastic if and when problems develop with the progress of the company and many personal relationships have crumbled under the stress that arises when the founders are unable to provide the promised investment returns.

§5 --Business incubators

A business incubator is, in effect, a "community" of young firms who brought together under a single roof (or in a common area, such as a "science park") to take advantage of hands-on management assistance, access to financing, and exposure to essential business and technical support services. Entrepreneurial firms also gain access to shared office services, equipment, and flexible leases which allow them to easily expand their space as needs change. In addition, entrepreneurs may participate in education programs, many of which are offered through local universities that support the incubator. Information about business incubators can be obtained through The National Business Incubation

Association, which has a Web site that is intended to serve as a clearinghouse of information on the business incubation industry, and from the Center for Technological Innovation and Austin Technology Incubator.

Companies usually remain in the incubation stage for 18-36 months, at which time they should be financially viable and ready to stand on their own with assistance from one of the more traditional sources of funding. Studies have shown that more than four of five recent graduates of an incubation program remain in business. In order to remain in the program, companies must set and achieve clear and concise milestones and adhere to specified policies and procedures. Almost half of the incubators are “mixed use,” which means that they provide support to a full range of industries and services. Other incubators will focus on a particular niche, such as technology, manufacturing, services, empowerment, or a specific industry (e.g., biomedical, arts, food production, fashion, etc.). The focus of the incubator usually comes from the interests of the surrounding business community, since community support is a key benefit of incubation and often a source of funding and business alliances.

§6 --Venture catalysts

A “venture catalyst” is a new breed of start-up investor. These organizations, usually quite small and operated by former entrepreneurs who have been through one or more companies on their own, provide both seed capital (usually up to $500,000) and a substantial amount of consulting services to fledgling businesses to prepare them for presentation to venture capitalists. In many cases, venture catalysts will spend one or two days a week with a portfolio company over a six to nine month period assisting the entrepreneurs with refining their business and marketing strategy, attracting board members and senior personnel, and meeting venture capitalists. A well-networked venture catalyst can be the key to getting the company’s business plan into the hands of the right investors and, more importantly, getting it read and taken serious. Venture catalysts typically specialize in a particular area, such as software development, consumer retailing, packaged goods, and e-commerce, and will often have informal relationships with one or more venture capital funds. They raise funds from high net-worth individuals and often have anywhere from $10 to $25 million to invest. They generally will take a significant equity position in portfolio companies and charge a monthly retainer.

§7 --Wealthy individuals and angel investors

Wealthy individuals have always been benefactors of fledgling businesses, particularly when a company is involved in an area in which the individual has substantial prior experience. Recently, however, increasing focus has been placed on so-called “angel” investors, who are high net worth individuals, often businesspeople or professionals with high incomes or individuals from wealthy families who seek high-risk/high-return investment opportunities. These individuals, like a venture capitalist, frequently want to participate in the management activities of the company and help guide the company's progress through representation on the board of directors. The business acumen and contacts of these individuals can often be a valuable asset, as can the experience that they often bring from their own business ventures. The angel investor community has also been buoyed by the entrance of individuals who have previously been involved as founders and/or senior executives of successful businesses and who exited those businesses with significant sums of money from a public offering or acquisition by an outside party. These persons are not only looking for ways to invest their wealth but also seek relationships with other entrepreneurs that can enhance their own reputations. Some of the key characteristics of angel investor preferences and contributions include the following:

- Angel investors are willing to accept more risk and to provide small amounts of money to allow the entrepreneur to develop the company's business plan and complete work on new product prototypes that can be shown to venture capital firms and potential business partners. Venture capitalists generally prefer to make fewer investments and each investment must equal or exceed a certain minimum amount to justify the time and effort that the venture capitalist will spend on the company. In contrast, angel investors (alone or as part of a group of several investors) are often able to provide seed capital in amounts ranging anywhere from a few thousand dollars to several million dollars.
- An individual angel investor can often react to opportunity much quicker than a venture capital firm and typically has only their own interests to serve as opposed to a financial backer or group of investors. As such, the due diligence and negotiation process for taking capital from angel investors is generally much shorter and simpler than similar activities with venture capitalists.
- Angel investors are generally more patient than venture capitalists and less likely to require a rapid exit from the investment. Also, the required rate of return for many angel investors is lower than the requirements of venture capitalists, which must satisfy their own investors in order to raise new funds.
- Angel investors tend to place greater emphasis on the attributes of the entrepreneur and personal chemistry, and are more likely to get involved with a company due to interest or experience in a particular industry and their desire to bring their network of contacts to assist the company.
- Angel investors tend to be more proactive than professional investors in providing “hands on” assistance to their portfolio companies, thereby helping to strengthen the skill base of the firm's management team. Studies have shown that primary assistance from angel investors is in the area of general strategic advice and in specialized areas such as marketing, finance and accounting.

However, while angel investors can be an attractive alternative, particularly since closing the deal with an angel is usually quicker and easier than it is with a venture capitalist or institutional investor, an obvious problem is that angel investment alone is generally not sufficient to permit portfolio companies to bring their products to the marketplace. Angel investors are not good sources of capital to build out manufacturing facilities or marketing and distribution channels; these projects are best left to larger investors once the product or service has been polished and verified. In addition, angel investors can be difficult to locate; however, various networks and organizations of angel investors have been formed to ease the process of matching investors with opportunities.[4] At a deal-specific level, entrepreneurs must also be mindful that angel investors may not be able to provide the extensive network of contacts and resources that venture capital firms make available to companies that join their investment portfolio. Also, while the personal chemistry between the investor and the founders may be good, the actual experiences and specialties of the angel investor, such as marketing, may not be a good fit for the needs of the company, thus reducing the actual "value add" provided by the angel investor. Angel investors also impact the equity positions of the founders and may cause disruptions in management and control of the company. Finally, while angel funding is less formal than a venture capital transaction, the company and its principals must still comply with applicable laws and regulations with respect to disclosures and the manner of offering regardless of the actual size of the investment.

If, after taking all of the factors mentioned above, a decision is made to move forward with an angel financing round, consideration should be given to which of several financing structures might be appropriate for the company and the investor group. Some of the alternatives that might be used include the following[5]:

- Common stock, the same form of equity instrument issued to the founders and set aside for employees, may be sold to the angel investors at an agreed valuation; however, this approach as drawbacks for almost everyone. The investors have none of the protections that will inevitably be given to the next group of outside investors who demand and received preferred stock and the company will have set a valuation for the common stock that undermines its ability to issue stock options with attractive exercise prices to employees, advisors and others needed to assist the company in getting off the ground.
- The most common form of investment instrument for angel investors is probably a convertible note that provides for automatic conversion of the principal and accrued interest into the company's initial preferred stock financing round provided that certain requirements with regard to that financing are satisfied (e.g., size of the round and closing on or before a specified date). In order to reward the angel investors for the risk that they took on to finance the company at an early stage, the conversion rate will reflect an agreed discount from the price paid by the preferred stock investors. They will also gain the benefits of all of the rights given to the preferred investors, including the full liquidation preference even though a discounted price has been paid. Early investors may also receive warrants and other benefits.
- A twist on the traditional convertible note is the so-called "capped" convertible note that provides for conversion into the first round of preferred stock financing at either

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[4] For example, Active Capital, formerly known as the Angel Capital Electronic Network (ACE-*Net*), is a nation-wide Internet-based option for matching individuals and institutions that qualify as "accredited investors" under Regulation D promulgated under the federal Securities Act of 1933, as amended, with companies that have satisfied the requirements for issuing securities imposed under applicable federal and state securities laws.

[5] The following discussion is adapted from a summary presented by R. Karamali, "Starting Up the Start-Up: Approaching the Angel Financing Round", Social Media Update (April 6, 2011), http://www.socialmedialawupdate.com/2011/04/articles/startups/starting-up-the-startup-approaching-the-angel-financing-round/ [Accessed May 31, 2011]

an agreed discount or at an agreed capped valuation, with the outcome based on what provides the most benefit for the angel investors. Assume, for example, the angel investors have agreed that upon the closing of the preferred financing a 25% discount and $3 million "cap" would apply. If the pre-money valuation at the closing is $2 million, the notes would convert at a per share price determined as if the pre-money valuation was $1.5 million (i.e., the 25% discount would apply). If, however, the pre-money valuation was $5 million, the cap would apply and the conversion would occur at a per share price determined as if the pre-money valuation was $3 million rather than 75% of $5 million (i.e., $3.75 million).

- Some angel investors and law firms have suggested "light" preferred stock as an appropriate way to provide early stage funding instead of convertible notes, arguing that fairly simple terms can be created as an "industry standard" to facilitate efficient preparation of documents without too much expense. Light preferred stock instruments go by a variety of names, including Series AA Equity Financing, Plain Preferred and Series Seed Financing. In reality, however, no standard has emerged from among the various examples that have been proposed and angel investors have also complicated the process by becoming more aggressive about receiving management rights and legal opinions.

§8 --Seed capital funds

As the challenge of closing the initial round of funding from venture capital investors increased the demand from founders for financing at the early development pre-revenue stage led to the emergence of seed capital funds that purport to specialize in seed round financings ranging from $25,000 to $2 million. The size of these seed capital funds varies from $5 to $50 million and while some of them have raised money from the same institutional investors that participate in larger venture capital funds it is more common to see seed funds being support by capital obtained from wealthy individual investors, sometimes referred to as "super-angels" who have made investing in startups their full time passion and are well known in the startup community, and smaller family endowments. The principals of the seed funds typically argue that they will be able to give more attention to smaller companies than the larger venture capital firms and thus be able to guide the founders of those companies through the milestones that needed to achieve in order to secure the interest of venture capitalists and close the elusive Series A round. The reality is that many of the promotors of the seed capital funds lack the experience and external relationships found among larger venture capital firms to provide meaningful assistance to their portfolio companies. In particular, many of the seed capital funds lack the strong relationships with venture capital firms that would be helpful in securing additional financing for their investees. As a result, data shows that companies that obtain seed financing only from seed capital funds have more difficulty in closing a Series A round than those companies that have forged financial and business relationships with larger venture capital firms that also invest a portion of their available capital in seed stage deals.

While founders should exercise care in vetting potential seed capital fund investors, there are several funds who have carved out a strong reputation for their focus on seed-stage companies in specific geographic areas and/or industry sectors and their ability to provide funding, accelerator programs and entrepreneur events.[6] Go observed that while there are now a large number of funds willing to consider investing at the seed stage, not all of them are positioned to "lead" deals.[7] Go suggested that the capacity of a seed fund to act as a lead is constrained by the number of partners and the time and effort required to do spot promising ideas, interview the founders, conduct due diligence and contact the references provided by the founders, draft and issue a term sheet and coordinate finalization of the terms with other investors. According to Go, the best lead investors limit themselves to less than six investments per year per partner and are typically willing and able to get everything done in a few weeks and provide the founders with regular reports on their progress. Go cautioned that if an investor is not willing to commit to an efficient and transparent deal process, or does so and then disappears, it is a sign for the founders to look elsewhere. Go also advised that founders should not waste too much time on convincing investors who are skeptical about the proposed business model and that the fundraising efforts should be focused on identifying the "true believers".

§9 --Venture capitalists

Financing from venture capital companies will be available for companies that are involved in high-growth industries which offer the promise of substantial returns, albeit at loftier levels of business and financial risk. Venture capital is a unique source of funding that covers a broad range of activities, and venture capitalists can be characterized in a number of different ways. Venture capitalists are looking for businesses with strong management teams and an innovative product or service capable of producing extraordinary returns. Venture capitalists realize that such returns may carry substantial risks and are more willing to invest in speculative situations. However, venture capitalists are distinguishable from other sources of investment financing because of their interest in becoming actively involved in the management of the company, generally through participation as members of the company's board of directors, to build the business to the point where the venture capitalists can realize the desired returns on investment through a public offering or the sale of the company to a larger firm. Put another way, venture capitalists provide a commitment beyond mere money to the development of the firm. This type of involvement can be extremely beneficial to companies and the members of their management team but founders and managers need to proceed very carefully before making a final selection of a venture capital investor partner since venture capitalists can be extremely demanding and generally have little patience for poor management practices or failure to meet agreed milestones.[8]

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[6] For further information see C. Tice, "Money for Startups: Top 10 Seed Funders of 2013", Forbes (January 15, 2014), http://www.forbes.com/sites/caroltice/2014/01/15/money-for-startups-top-10-seed-funders-of-2013/#467e667191f5 and the funds appearing on the slide found at http://www.slideshare.net/schlaf/raising-a-seed-round/27-NOTABLE_SEED_FUNDSRRE_VENTURES_RAISING [both accessed May 31, 2016]

[7] The discussion in this paragraph is adapted from R. Go, "How to Raise Seed Capital: Crucial Steps to Know" (June 20, 2014), http://nextviewventures.com/blog/how-to-raise-seed-capital/ [accessed May 30, 2016].

[8] For discussion of factors that founders and managers should take into account when evaluating prospective venture capital investors, see "Venture Capital" in "Finance: A Library of Resources for

There are actually a number of different types of venture capitalists, including private venture capital funds (i.e. partnerships funded by wealthy individuals, pension funds, etc. and operated by professional general partners); public venture capital funds; corporate investors; funds organized and managed by investment banking firms; small business investment companies; individual investors; and state governments. Venture capitalists generally have distinct preferences as to the types of investment (e.g., the size and stage of financing, industries, and national or regional companies). For decades venture capitalists often pursued and closed Series A rounds with companies that had not completed the development of their initial products and/or the identification of the target markets; however, in the mid-2000s many of the large venture capital funds began stepping back from early stage investments and left that field to angel investors and seed capital funds. In this way the venture capitalists could wait to see which of the new companies successfully emerged from the travails of the first 12 to 18 months and place larger bets on firms that had demonstrated product/market fit and traction.[9] By 2012 this trend reversed a bit and a survey conducted by CB Insights found 112 active venture capital firms investing in seed-stage companies.[10]

A company which successfully completes a private placement financing with a group of venture capitalists will essentially cease to be a closely held business, even though day-to-day management control will usually remain with one or more of the founders, generally with the assistance of professional managers which may be brought in at the insistence of the investors. The investors may seek the right to elect representatives to the company's board of directors, and will impose various recordkeeping and reporting requirements on the company. Also, since venture capitalists are looking to gain liquidity for the investment within a specified time frame (e.g., two to five years), provisions will be included in the terms of the investment regarding registration of the investors' shares for a public offering and/or sale of the business to a third party. Most venture capital firms employ executives with significant industry experience, or have a network of experienced managers who can be called on to provide assistance to portfolio companies. These industry veterans are often pressed into service as a director of the start-up or emerging company that receives the investment.[11]

Sustainable Entrepreneurs", prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

[9] For detailed discussion of the evolution of the marketplace for seed stage and Series A round investment, see M. Kumar, "The New Venture Landscape" (April 10, 2014), http://www.k9ventures.com/blog/2014/04/10/new-venture-landscape/; and R. Go, "'Seed Is the New Series A': Making Sense of the Confusion" (June 30, 2015), http://nextviewventures.com/blog/seed-is-the-new-series-a-making-sense-of-the-confusion/ [both accessed May 31, 2016].

[10] For further information see C. Tice, "Money for Startups: Top 10 Seed Funders of 2013", Forbes (January 15, 2014), http://www.forbes.com/sites/caroltice/2014/01/15/money-for-startups-top-10-seed-funders-of-2013/#467e667191f5 and the funds appearing on the slide found at http://www.slideshare.net/schlaf/raising-a-seed-round/28-VCs_w_SEED_DEALSRRE_VENTURES [both accessed May 31, 2016] The CB Insights Venture Capital Database is a good source of detailed information on the dynamics of the seed capital fund industry.

[11] Information about venture capital firms in the US can be found in the directory published annually by the National Venture Capitalists Association and in "Pratt's Guide to Venture Capital Sources," produced by Venture Economics, Inc. Trade and industry groups can also be used to gather information about venture

§10 --Corporate partners

Another important source of capital for new technology-based companies is "corporate partnering," sometimes referred to as a "strategic alliance." Corporate partnering is the creation of a relationship with a large established company that is interested in participating in the development and commercialization of the technology that the founders have identified. In addition to providing funding the corporate partner will also provide contractual support for specific research and development activities and/or functional needs such as manufacturing and distribution. The corporate partner benefits not only from what it hopes will be a good return on its investment but also from being to access new technologies that allow it to remain competitive in its existing marketplace and perhaps expand into new areas without having to do all the work internally. The founders obviously secure the needed capital to finance the development work; however, they also are able to leverage the resources of the corporate partner in manufacturing and distribution to introduce products more quickly without the need to raise additional capital to build those functional capabilities internally. In addition, a deal with a well-known and respected corporate partner makes the founders' business plan more credible and can lead to opportunities with suppliers and customers.

It is fair to say that corporate partners are more interested in the strategic return on their investment in a company than they are about how much they eventually will receive when their equity position is liquidated; however, corporate partners will certainly run a conventional financial analysis before committing capital for the purchase of securities as opposed to funding a particular project of strategic interest. All potential corporate partners have different strategic goals and interests and companies actively engaged in partnering with smaller firms should have their own processes for establishing goals for their alliances and measuring performance. For example, if the corporate partner is funding technology development work by a smaller company than the partner will measure success by reference to the revenues that it receives from licensing the technology back and using it in various applications and markets that have been mutually agreed upon by the parties.

§11 Decision to seek seed financing

Beisel suggested the following three questions that founders should consider when deciding if it is the right time to seek seed capital from outside investors[12]:

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capitalists that might have an interest in a particular type of business or product. For example, trade groups for entrepreneurs active in the software area will sponsor forums at which venture capitalists will speak on financing and management issues and make themselves available to answer questions regarding business plan development. For further discussion of venture capitalists and the impact they can have on the strategy and management of a new business, see "Entrepreneurship: A Library of Resources for Sustainable Entrepreneurs", prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

[12] The discussion in this section is adapted from D. Beisel, "When Is the Right Time to Raise Outside Seed Capital?" (November 19, 2015), http://nextviewventures.com/blog/when-to-raise-seed-capital/ [accessed May 30, 2016].

- *What kind of company are you looking to create?* While founders aspiring to go "really big" should probably begin taking in financing as soon as the market is willing, others may prefer to avoid taking in too much capital before the company is generating cash flows from operations. Founders need to consider that closing a seed capital deal means assuming fiduciary responsibilities to the seed investors and accepting an accelerated product development and commercialization schedule, a shift that will also increase the risks confronting the venture.
- *How difficult will it be to fundraise?* Beisel suggested that the answer to this question can be gleaned by asking the following: "A year from now, will you have gone "faster" and accomplished more because of outside capital accelerating the business, which justifies your time spent fundraising today? Do you have the experience, reputation, and network that make it relatively easy to raise seed capital? Or is there uncertainty with risk that the time spent fundraising could be better used proving out some initial product or market milestones?" Beisel's advice was that it might be best for founders to focus on gaining initial traction and learning if they feel that raising seed capital will be a time-consuming "uphill battle".
- *Do you have asymmetric information about the company's future compared to investors?* Even if the founders are confident of their ability to reach upcoming milestones, raising a seed round may not make much sense if investors cannot access sufficient information about the business to understand the likelihood of short-term success. In that situation the founders might want to defer the fundraising until they can demonstrate tangible results on a handful of key development metrics.

Beisel recommended that even if founders decide to defer the formal fundraising process they should still selectively share their ideas on an informal basis with prospective investors and others who are influential in the company's specific ecosystem so that they can hit the ground running when the time comes to kick off the official capital campaign.

§12 Size of the seed round

Beisel noted that when deciding how much seed capital to raise the "conventional VC wisdom" is that founders should ask for enough cash to give them 18 months of runway. While this rule of thumb certainly finds its way into the presentations made to many investors, Beisel recommended that founders should go through a process that covers the following activities and issues[13]:

- Begin by building a basic financial model that reasonably predicts the expenses that the company will have over the next 18 months. Beisel suggested that since employees are usually the key drivers of costs during this period it makes sense to lay out the expenses on an employee-by-employee basis.
- Once the basic financial model has been laid out, factor in reasonable adjustments to take into account real-world scenarios that are likely to occur over the period covered by the model. Some of the adjustments include lag time for recruiting time for new

[13] The discussion in this section is adapted from D. Beisel, "How Much Seed Capital Should You Actually Raise?" (October 22, 2015), http://nextviewventures.com/blog/how-much-seed-capital-should-you-actually-raise/ [accessed May 30, 2016].

employees and getting them up to speed and additional time, at least three months, for raising the next round of funding. In addition, of course, expenses may be offset by revenues; however, Beisel warned founders to be very conservative with estimates of revenue.

- Adjustments to the timing of the model should also be considered separately, in effect challenging the applicability of the 18-month rule to the particular company. Beisel counselled founders that the amount of seed capital they raise should be sufficient to "empower you to reach the next important milestone in order to raise the next round immediately after . . . not leave you just shy of the interim prize". This means that if 22 months, rather than 18, seems right for this venture the model should extend for at least 22 months and the capital raise amount calculated accordingly. On the other hand, if the milestone is landing a major customer within 12 months, the size of the seed round can be reduced to cover this shorter period.
- While the founders should have a fairly good idea of the optimal capital raise amount at this point, further tweaks should be considered. For example, since startups are fundamentally risky, Beisel recommended adding 10%-20% to cover "foreseeable unforeseen circumstances". In addition, Beisel admonished founders to take investor community optics into consideration when fixing the amount of the capital raise: if the model is saying $1 million, try and keep the actual number a little under that amount to position the fundraising as a pre-seed round so the company can go out for another seed round in the future if necessary; and avoid a number that is so precise that it signals investors that the founders do not understand that managing a startup is far from an exact science (e.g., when the model says $1.55 million, round up or down to $1.6 or $1.5 million).

After working through the model and arriving at a reasonably defensible target number, the founders need to take a step back and assess their fundraising abilities. Some founders take the process easily and may be able to tap into accelerator connections to move the process along; however, others can anticipate problems due to lack of experience, the lack of traction in the business to date, industry conditions or geography. If, after careful introspection, the numbers coming out of the model appear too daunting, the founders should seriously consider reducing the size of the current round to a level that feels more manageable but still adequately covers progress toward a significant milestone. Whatever number is chosen, Beisel suggested that founders think in terms of a range of possible outcomes, even though a single dollar amount should be used to start the process. Beisel counseled founders to begin with an amount that is slightly lower than what they are actually hoping to raise and then increasing the amount gradually as interest grows, an approach that certainly beats starting with a higher number and then having to reduce it if demand for the deal is weak.

Even for the most talented fundraisers, the process is time-consuming and threatens to be a continuing drain to attention to the other important aspects of the business. Failure to set the right amount of the capital raise means that the company will be forced to live in a state of heightened anxiety and Beisel cautioned about the need to depend on "drip feeding" from existing and/or small new investors if the initial capital raise was insufficient to get to the desired milestone. The founders may also discover that some additional capital may be needed after the seed round closes to ensure that the company does not run low on funds just as the desired milestone appears on the immediate horizon. Since this is a common scenario, the founders should stay in touch with investors who were interested in the past but did not participate as they may be good candidates for contributing the small amount of extra capital required with a minimum amount of additional formal fundraising effort. The founders should also be aware that the amount of capital needed will influence the type of seed financing instrument used (i.e., when a company is looking to raise more than $1 million it will typically need to issue equity securities, such as "Series Seed Preferred Stock", rather than relying on non-equity securities such as convertible notes or simple agreements for future equity ("Safes").

§13 Pre-seed rounds

Commentators have noted that startups often have to raise several rounds of seed capital before they are ready to move forward with a serious effort to secure funding from venture capitalists in a Series A round.[14] This phenomenon has led to the recognition of two types of seed financing rounds: "pre-seed", which is often referred to as "genesis stage", and more traditional institutional seed rounds. Go explained that it is reasonable to think of pre-seed rounds as being relatively small, $750,000 or less and typically between $50,000 and $500,000, and closed relatively early in the development of the company, usually well before the first product is completed. The institutional rounds are larger, generally bringing in anywhere from $1 million to $3 million, and close within twelve months of the date that the pre-seed funding arrives. Go went on to offer a more precise definition of a pre-seed round as being "an early round of financing that is designed to help a company achieve certain intermediate milestones PRIOR to the magic combination of strong PMF + meaningful traction". He noted that while the "intermediate milestones" will obviously vary depending on the circumstances, examples would include "recruiting a critical team member (e.g., technical co-founder); overcoming some sort of regulatory hurdle or some other near-term existential risk to the business; creating a hack of a product that demonstrates the likelihood of PMF; moving to a new geography; and/or building the credibility of an unproven team".

According to Go, amount of capital raised in pre-seed rounds is smaller for several reasons: the teams are smaller, which means that the projected burn rate is smaller; less capital is needed since the time that is reasonably expected to be necessary to achieve the milestones is shorter; and the founders are anxious to minimize dilution of their ownership interests at this point since the value of those interests is lower. As noted above, most of the companies receiving pre-seed capital are at a very early stage of development; however, Go noted that full-blown seed rounds may be available to certain types of founders (i.e., persons who have previously been successful entrepreneurs or first-time founders that are well-known to, and well-respected by, the lead investor) even though they are just starting out because the investors have a reasonable belief that their capital will be successfully applied by the founders to clear all the milestones necessary to achieve the goal of a Series A round.

[14] R. Go, "What Are Pre-Seed Rounds and Why Do They Exist?" (January 26, 2016), http://nextviewventures.com/blog/what-are-pre-seed-rounds/ [accessed May 30, 2016].

Beisel discussed whether or not a pre-seed round might have an adverse impact on the ability of the founders to close a seed round down the road.[15] His view was that seed investors generally do not care if the founders have previously raised under $500,000 and consider those efforts to be "friends and family" rounds that have been done for years. If the founders have raised $750,000, most seed investors will still not hold that against them; however, when pre-seed capital exceeds $1 million the founders can anticipate tough scrutiny from seed investors as to just what they have done with that amount of money and whether or not anything has occurred that raises significant concerns that the seed round capital will be squandered. Beisel cautioned though that the answer really depends on the type of startup, the types of investors and the structure of the rounds and noted that for many companies it simply takes a little more time "to hit their stride".

§14 Key steps in the seed capital fundraising process

Go provided the following simple and solid list of the crucial steps in raising seed capital, cautioning that activities on the list typically proceed in parallel and that the amount of effort required for each step will vary depending on the circumstances and whether or not the founders are adequately prepared for the fundraising process and done their homework on important basic questions such as how much capital to raise and a reasonable starting point for valuation[16]:

- Before contacting any investors the founders should "line up support" by making sure that they have credible group of references who know their work and can report positively on their experience and the proposed business model. It is important to have an idea of what the persons will say and make sure that they have been walked through the proposed business model in advance.
- Work hard to get solid commitments from individuals who will be participating based primarily on their preexisting relationships with the founders. This process provides an opportunity to begin working on the "pitch" that will need to be made to other types of investors and also builds credibility. These investors typically commit for relatively small amounts, such as $25,000, and the founders should be sure that they are "in the deal" and will to confirm their intended participation with other investors. At the same time, it is fair to give them the option to back out of the deal if the final terms are unreasonable or the valuation demanded by other investors is materially lower than what may have been discussed with the founders at the beginning.
- With references and a handful of friendly angel investors in hand, the next step is usually the toughest: find an investor willing to commit to a significant piece of the desired funding and act as the "lead" that issues the initial term sheet and coordinates

[15] D. Beisel, "Can Pre-Seed Capital Hurt an Entrepreneur's Chances to Raise Seed from VCs?" (March 26, 2015), http://nextviewventures.com/blog/can-pre-seed-capital-hurt-an-entrepreneurs-chances-to-raise-seed-from-vcs/ [accessed May 30, 2016].

[16] The discussion in this section is adapted from R. Go, "How to Raise Seed Capital: Crucial Steps to Know" (June 20, 2014), http://nextviewventures.com/blog/how-to-raise-seed-capital/ [accessed May 30, 2016].

due diligence and negotiation and finalization of terms when other funds show an interest in joining the round. In most cases, the lead will come from local funds; however, traveling to other geographic areas should not be ruled out and provides an opportunity to get different perspectives on the proposed business model. Founders should anticipate frustrations in getting the initial meeting and collecting feedback and the process may seem to hit the wall many times (e.g., a promising lead decides to pass or simply cuts off communications with no explanation). But, once a lead is found things should move quickly and the founders may find that the deal is over-subscribed.

- Once a lead investor has been identified and commits to that role, attention can turn to finding other investors to fill out the round. One or two other seed funds may be interested in investing, even if they do not have the bandwidth to act as a lead, and they will typically rely on the reputation of the lead investor as well as the business model. The founders may also want to add other individuals with whom they do not have preexisting relationships if they are perceived as being able to provide credibility and/or introductions to potential business partners.
- While fundraising is a time-consuming process the founders still need to keep pushing forward with continuing the development of the business model with the resources they already have on hand and try and achieve milestones (e.g., successful completion of initial product tests or adding new employees or advisors) that will inform and impress investors and wet their appetite to step into the deal.
- Once the term sheet has been circulated and due diligence has been completed, try and move quickly to close the deal provided that the valuation is reasonable and the investor group includes the desired range of good initial partners. Go cautioned that founders often push too hard to maximize the valuation and let much time go by, a strategy that may cause the investors to turn their attention elsewhere.

While the list of steps above illustrates what appears to be a natural progression, the reality is that there is no way to reliably predict how long it will take the founders to close their desired seed round. Go suggested that with proper management of the process and the right investors partners, founders may be able to get through most of the due diligence and receive a term sheet within three to five weeks of the starting date and complete the initial closing a few weeks after that assuming that the everyone is able to agree on using standardized documents that do not require excessive lawyering. Timing may be impacted by the internal approval process of one or more of the investors and the founders should seek firm commitments from each investor as to when they will be able to close. Speed is obviously important to the founders as they want the capital to accelerate development of their business model; however, Go cautioned that companies do not want to be “in the market” for funding for too long as word of struggles to close a deal will get around among seed investors and may scare them off. When absolutely necessary, funds can be taken in over multiple closings; however, the founders should be careful about leaving a deal open for too long and should try to close the entire round within the 30 to 45 days of the initial closing.

Steps for Managing and Completing a Seed Capital Financing

Regardless of the type of instrument selected and used for capital raising, sustainable entrepreneurs should be prepared to take the following steps for managing and completing a seed capital financing:

- Prepare a business plan or business model canvass that provides prospective investors with all necessary material information regarding the company's business model and strategies and, most importantly, the projected path to a Series A Preferred stock financing.
- In consultation with investors, select the appropriate form of instrument for the financing (e.g., convertible note, preferred or common stock or Safe) and prepare the related term sheet to ensure parties are in agreement on fundamental issues included the anticipated amount of time before a Series A Preferred stock financing will close.
- Ensure that all investors have received and completed documentation necessary qualify them as "accredited" or otherwise "sophisticated" investors and that such investors have been advised of risk factors associated with their investment.
- With the assistance of counsel, prepare the necessary documentation for the transaction, such as investment agreement (i.e., note or series seed preferred purchase agreement; charter documents; form of note or Safe).
- Prepare required resolutions for board and stockholder consents and ensure that all necessary federal and state securities law filings will be completed.
- Complete the "closing" including execution and delivery of all required documents and receipt of cash from the investors.
- Log all documentation into company's record retention system and calendar all material post-closing actions such as maturity date of promissory notes, distribution of financial and business information to investors etc.

§15 Seed capital financing instruments

Founders, as well as investors contemplating a significant amount of investment in seed capital financings, need to have a basic understanding of the most commonly used types of instruments for seed financing. In general, these include the following[17]:

- **Convertible Notes:** Convertible notes are arguably the most frequently used instrument for seed financings and should be thought of as debt securities (i.e., including principal amounts due at a maturity date, accrued interest provisions and a claim on the company's assets as an unsecured creditor (although in rare instances a convertible note will also be "secured"). It is intended that the notes will eventually, prior to the maturity date, convert into the same preferred equity security that the company issues in its Series A round to venture capitalists and institutional investors. The terms of that conversion will depend on provisions negotiated by the company and the noteholders, including the discount rate and the valuation cap. Provisions are also included to address what happens in the even the company is sold prior to a Series A round and what happens if the notes remain outstanding on the maturity date.
- **Convertible Preferred Stock:** Although less common in the range of seed capital financings, companies may issue some form of convertible preferred stock in the later stages of seed financing and/or when the size of the financing is relatively large and the investor group is experienced and sophisticated and each investing fairly large amounts of money (i.e, over $100,000 per investor). The instrument is often referred

[17] Adapted from *Startup Seed Financings: Overview* (New York: Thomson Reuters Practice Law Corporate and Securities, 2017).

to as “Series Seed Preferred Stock” and will include several of the same protections and rights afforded to investors in the Series A round such as information rights and rights to vote separately on certain actions proposed by the founders as common stockholders. At the same time, Series Seed Preferred Stock typically does not include some of the more complex terms seen in Series A rounds such as registration rights, rights of first refusal and co-sale, price-based anti-dilution provisions, drag-along rights and rights to designate a representative on the board of directors. The liquidation rights of Series Seed Preferred are typically limited to a return of the purchase price before distributions are made to common stockholders, with a right to convert to common stock and waive the liquidation preference.

- **SAFEs (Simple Agreement for Future Equity):** Safes were developed as a company-friendly alternative to convertible notes that have the same conversion features of notes (and the same variables to consider, such as discount rate and valuation cap) without a maturity date or interest accrual. Safes seem to be more prevalent among “hot” deals where investors are scrambling to be included and have less leverage to negotiate more protections like those normally seen in convertible notes. Safes were developed to provide a quick and low cost solution to seed financing, and this can be accomplished if investors understand what they are buying. Investors seeking some protections or rights while accepting a Safe can bargain for information rights, rights of first refusal etc. to be included in a side letter.
- **Common Stock:** While not frequently used for raising capital from seed investors, companies can issue common stock, which is the same security that will be held by the founders and employees of the company. The main reason for using common stock is simplicity and relatively low legal costs. However, while investors issued common stock can be given voting rights and rights to receive dividends and distribution on liquidation, they would generally not have the same rights, preferences and privileges given to later round investors unless those are negotiated separately, which would increase the cost of issuing the common stock. Moreover, issuing common stock significantly complicates valuation of those types of shares for equity incentive purposes. All in all, common stock has drawbacks for both sides of the transaction—founders and investors—and it is therefore unlikely that common shares will be used for seed capital financing.

Choosing the Right Seed Capital Instrument

Choosing the right instrument for raising seed capital involves weighing several different factors:

- ***Investor sophistication:*** As discussed in the text, there are several different categories of potential seed investors and they often vary dramatically in their level of sophistication regarding investing in startup companies. These disparities will in knowledge regarding investment and startup often drive transactions toward a particular form of seed capital instrument. For example, less experienced investors will have difficulty understand and “negotiating” some of the terms that are typically included in more complex seed financing instruments and may be reluctant to hire their own legal counsel to educate them. In these cases, a simple form of convertible note or Safe may be most appropriate; however, the company should take care to disclose the risks associated with those instruments to investors. On the other hand, seed capital funds are generally quite sophisticated and may insist on detailed documentation similar in length and complexity to a Series A preferred stock round.
- ***Investor preference:*** The preferences of the larger investors in a seed round also play an important role

in determining the instrument the company ultimately uses. Founders of early-stage startups typically want to minimize negotiation and friction with their seed investors and don't want the capital raising process to get too bogged down to the point where the company plunges into a financial crisis (which can put the founders at a serious disadvantage with respect to any negotiations that do take place). If the investors are most comfortable and familiar with convertible notes, the founders will generally agree to issue notes. If the investors have experience investing in preferred stock and prefer that instrument, as is often the case with seed capital funds, the company likely issue preferred stock. A Safe is an innovative alternative to convertible notes, but it is clearly "company friendly" (e.g., no maturity date and no accrual of interest) and may not be acceptable to investors unless they are given additional rights similar to those included in preferred stock transactions.

- ***Cost vs. amount raised:*** Obviously cash is an important and limited resources for most businesses, particularly companies in the startup phase, and certainly one of the last priorities or preferences for the founders is writing checks for legal fees in order to raise seed financing. In the extreme situation, legal fees can eat up a significant of the proceeds of the financing if the amount raised is relatively small yet the investors insist on complicated documentation and the founders lack the experience to push back and/or respond efficiently to investor requests on their own. If a complex financing instrument is used, the founders need to expect more negotiation and documents, particularly if the amount being raised is at the higher end of the seed capital range. The ratio of legal fees to amount raised is the key metric and it is fair for the founders to make that point to the investor group, be it sophisticated angel investors investing large amounts or friends and family putting in smaller amounts. Efforts have been made to simplify and standardize the document; however, things can still seem complicated. With larger deals, the costs can be mitigated if investors can agree on a lead investor and give it authority regarding terms and words. With smaller deals, the founders need to stand firm on avoiding customization for each investor.
- ***Time:*** While the amount of money raised in seed capital financings is less than in Series A round deals, this does not necessarily mean that the process of completing the small funding will go any quicker, an ironic situation that causes great frustration for founders. One program is that seed stage financings often have more investors than later-stage deals and this means that the founders will have to spend time "herding" the members of the investors group, with their different schedules, attention spans and level of experience, to a definite closing date. Founders need to find a way to build momentum toward a specific closing date, generally be concentrating on three or four of the largest investors and making sure they are committed to the specific financing instrument and documentation. With these "major" investors on board, the founders can prod the others along, particularly if the financing instrument is kept relatively simple to avoid too many questions and opportunities for negotiation. Seed capital financings often have multiple closings because some investors simply are not available or need a little more time for their due diligence; however, if this approach is taken the documents need to be frozen since modifications after the first closing require a significant amount of time and legal costs.
- ***Market cycle:*** As with any financial market, the "market" for seed capital varies from time-to-time depending on general economic conditions and specific factors such as the amount of capital available from potential seed investors and the number of suitable companies and their specific financing requirements. Also relevant is the state of the venture capital market, since it will impact expectations of founders and seed investors about the timing and feasibility of a future Series A round that will convert the instruments sold to seed investors (or otherwise adjust their rights when seed investors receive a "lite" version of preferred shares). When the market is "hot", founders can generally convince investors to accept more company-friendly seed capital investment instruments and get deals closed quicker because there will be less negotiation on "bells and whistles" outside the basic form of the instrument. On the other hand, companies that are not necessarily in the latest "hot market" can expected that investors will exert their leverage in their demands with respect to the terms of the investment.

Source: Adapted from *Startup Seed Financings: Overview* (New York: Thomson Reuters Practice Law Corporate and Securities, 2017).

§16 Standardized forms for seed financings

Advocates of relying on standardized forms in seed financings cite several potential advantages including reduced transaction costs and time to closing, reliance on a framework that reflects industry standards and consistency among transactions. In addition, standardized forms come with annotations that allow the parties to understand the reasoning behind the use of various provisions and how and when the parties can use alternative and optional provisions to structure the documents to meet their specific circumstances. However, the availability of standardized documents has often emboldened founders to negotiate and sign contracts without soliciting input from experienced legal counsel, a strategy that often backfires when the time comes to raise additional financing. Experienced counsel can provide assistance in making sure that changes to provisions in the standardized documents are made correctly and consistently and can also draft provisions that cover issues that commonly arise in seed round deals but which may not be covered in the standardized forms that the parties have chosen. Involvement of counsel is also recommended to ensure that the offer and sale of the securities is made in compliance with applicable federal and state securities laws.

While there is a decided trend toward document standardization, founders and investors must still choose among multiple possibilities. When the investment security takes the form of preferred stock, the parties may choose from among the following[18]:

- Series AA Equity Financing Documents (Y Combinator): These documents were created for companies that had received support from Y Combinator, a well-known incubator, to use in negotiating with prospective angel investors. Investors are issued shares of "Series AA Preferred Stock" with the following notable characteristics: 1x non-participating liquidation preference (i.e., investors get their money back first and any remaining amount goes solely to common shareholders); no anti-dilution protection; three person board (two common and one preferred); protective provisions limited to changes in Series AA Preferred Stock and merger/sale of company; investors entitled to unaudited annual and quarterly financial statements; and right of first offer on new financings.
- Model Seed Funding Documents (TechStars): TechStars, another incubator, developed these documents as a framework for founders and lead investors to use to discuss the terms of seed and angel financing rounds involve the raise of $250,000 to $2 million. Investors are issued shares of "Series AA Preferred Stock" with the following notable characteristics: dividends pro rata with common shares; 1x non-

[18] The discussion in this section and the summaries of the characteristics of the various models of standardized documents and terms in this section are adapted from M. Storms, "Angel Financing Transaction Form Documents", http://alphatechcounsel.com/blog/angel-financing-transaction-formdocuments/ [accessed May 28, 2016] and Y. Taku, "How do the sample Series Seed financing documents differ from typical Series A financing documents?, Startup Company Lawyer (March 14, 2010), http://www.startupcompanylawyer.com/2010/03/14/how-do-the-sample-series-seed-financing-documents-differ-from-typical-series-a-financing-documents/ [accessed May 28, 2016], each of which should be consulted for links to other commentaries on the terms for seed round financings. While the discussion in this chapter assumes that the company is organized as a corporation, the economic principles associated with each of the instruments discussed may easily be adapted for use by limited liability companies.

participating liquidation preference (i.e., investors get their money back first and any remaining amount goes solely to common shareholders); broad-based anti-dilution protection; three person board (two common and one preferred) if holders of Series AA Preferred Stock own at least 5% of the company on a fully-diluted basis; protective provisions limited to changes in Series AA Preferred Stock; investors entitled to unaudited annual financial statements; right of first offer on new financings; and future rights (i.e., if subsequent investors get "better" rights with respect to registration, anti-dilution protection, redemption, etc. than holders of Series AA Preferred Stock will also get those rights).

- Series Seed: These documents are based upon the model documents for venture capital financings developed by the National Venture Capital Association ("NVCA") and are intended for angel financing in the range of $500,000 to $1.5 million. Since they are a short-form version of the NVCA documents, proponents argue that they will already be familiar to experienced investors and that this will allow the contract phase to move quickly. A short time to close is also facilitated by the principle that the documents are suitable for use "as is", without further negotiations, and that the parties simply have to fill in a few key blanks in order to close. Investors are issued shares of "Series Seed Preferred Stock" with the following notable characteristics: dividends pro rata with common shares; 1x non-participating liquidation preference (i.e., investors get their money back first and any remaining amount goes solely to common shareholders); no anti-dilution protection; three person board (two common and one preferred); protective provisions similar to those found in a company-friendly venture capital financing; investors entitled to unaudited annual and quarterly financial statements; right of first offer on new financings; assignment of company right of first refusal on transfer of common shares to investors; "drag-along" obligations on both investors and founders triggered upon approval of board and approval of majority of both common and Series Seed Preferred Stock holders; future rights (see TechStars above); and up to $10,000 in legal fees to investors' counsel.

In general, there is a great deal of similarity among the various options discussed above; however, the Y Combinator and TechStars documents are generally considered to be more company-friendly, even though the TechStars documents provide investors with anti-dilution protection that is missing in the other documents. Consistent with the stage of development of the company, the documents do not address issues that are typically raised in venture capital financings such as registration rights and a legal opinion from company counsel. Redemption rights are not included based on the belief that companies relying on seed financing are not likely to be in a position to redeem the investors' shares and remain solvent and viable. Representations and warranties from the company are streamlined to take into account the stage of development and are typically limited to due organization and good standing; authorization of the transaction; absence of conflicts with other agreements; absence of violations of charter documents, laws and regulations and materials contracts; and compliance with applicable consent or approval requirements. Companies will also be asked to confirm their ownership rights to essential intellectual property rights and founders may be asked to make representations regarding the relationships with former employers.

The universe of standardized documents is not limited to the three alternatives described above, although they are the models that appear to have gotten traction in the seed financing community. As discussed below, startups may issue convertible notes or rely on a simple agreement for future equity, or "Safe", which has all the same conversion features of convertible notes but lack certain features of a debt instrument such as a maturity date or accrual of interest. Another approach for an equity investment is to issue common shares to the investors that they will hold until a liquidity event unless they decide to exchange those shares for the same kind and class of securities issued by the company in any follow-on financing in which the company issues new securities having rights superior to the common shares. Investors would be given "drag along" rights in connection with specified liquidity events, such as a merger or sale of the company, which would allow them to cause the sale of all of the shares of the company (i.e., including the shares held by the founders and other employees).[19] Some investors prefer to push companies toward a board structure that includes independent members (e.g., a five person board that includes two members of founding team, one investor representative and two mutually agreed independent members). Share and option vesting for founders and employees is also an important issue for seed round investors. Finally, requirements for delivery of financial information may be supplement by duties to prepare and deliver update reports from the management team that include an analysis of key indicators and a summary of both good and bad news relating to the company's progress toward achieving its operational and financial milestones.

§17 Terms of convertible notes

The preferred investment instrument for seed rounds involving a capital raise of less than $1 million is a "convertible note", which allows the founders to raise funds at a relatively low cost while deferring most the haggling about valuation for the "Series A round" that all parties hope will be coming down the road in a reasonable period of time. In fact, while a convertible note is a formal debt instrument with the corresponding elements of such an instrument, many investors view a convertible note as a commitment to make an equity investment that is deferred until the market comes up with a fair price. The documentation for a convertible note deal is generally based on one of several sets of standardized documents that include forms of a convertible note and a note purchase agreement. Key issues for a convertible note deal, which may be covered in relatively short term sheet, include the following[20]:

- The aggregate amount of the round (i.e., the maximum principal amount of all of the notes that may be sold and issued in the round) and the percentage-in-interest of the noteholders who would have the right to approve amendments to the note or note purchase agreement, allow prepayment of the notes and/or approve conversion of the

[19] The discussion in this paragraph is adapted from Angel Blog, "The One Page Term Sheet for Angel Investors", http://www.angelblog.net/The_One_Page_Term_Sheet.html [accessed May 28, 2016].

[20] The discussion of the terms of convertible notes in this section is adapted from B. Springmeyer, "Term Sheet for Angel Investment/Pre-Series A", http://www.calstartuplawfirm.com/business-lawyer-blog/convertible-note-term-sheet.php [accessed May 30, 2016].

notes into equity upon a sale of the company or at the maturity date if an automatic conversion has not occurred before then.

- The interest rate, which will generally be set at market rates for high risk investments, and the rights or obligations of the investors to convert interest owed to them into equity at the time that the principal amount of their notes is converted.
- The minimum terms of the anticipated equity financing that will trigger automatic conversion of the notes into shares of Series A preferred stock issued to venture capitalists and other institutional investors at that time. Typically, automatic conversion cannot occur unless the company has raised a specified minimum amount in that round and other conditions, such as minimum valuation, may also be included.
- The “discount rate”, which will be used to determine the discounted conversion price that noteholders will be entitled to when their notes are converted into Series A preferred stock. This feature “rewards” the noteholders for putting their money in early and deferring pricing negotiations until the company’s business model is further developed. Discount rates vary between 60% to 90% and a 60% discount rate would mean that if the company prices its Series A preferred stock at $1.00 per share for new investors the noteholders would convert their notes at $0.60 per share.
- The “price cap”, which is expressed as a mutually agreed expected pre-money valuation of the company at the time of the Series A round. The price cap, often referred to as the “valuation cap”, only comes into play if the company achieves a higher pre-money valuation when negotiating with Series A investors and protects the investors from suffering too much dilution from the company’s success during the period the notes were outstanding by capping the conversion price for the notes. In general, if a note contains both a discount rate and a price cap, the conversion price for the notes will be the lessor of the price calculated based on the discount and price determined by application of the valuation cap.
- The maturity date, which should be set after taking into account the anticipated uses of the funds and the time thought to be reasonably necessary for the company to get to the point where it should be able to negotiate and close a Series A round on the minimum terms discussed above. Each deal is different; however, maturity dates tend to cluster in the twelve to eighteen month range from closing.
- An option in favor of the noteholders to convert their notes into common stock of the company on the maturity date if a Series A round has not occurred before then. Such an option, which may be given to each noteholder individually or require approval by a specified percentage-in-interest of the noteholders (which would bind all noteholders), relieves the company from the obligation to repay the loan but will certainly cause a serious dilution in the ownership stake of the founders.
- The rights of the noteholders in the event of a sale of the company prior to automatic conversion or the maturity date. As with the option to convert upon maturity discussed above, the rights may be distributed individually or may require collective action by a specified percentage-in-interest of the noteholders. Noteholders may be given a choice to elect repayment of their notes (principal and interest) or convert their notes into common stock at a pre-set valuation and have those shares purchased in the sale at the price per share offered by the party purchasing the company. Notes often provide for a premium on the repayment option (e.g., 150% of principal and interest) and the premium may be varied based on value placed on the company in the

sale (e.g., 150% if sale valuation is in the range of $5 million to $10 million and 200% if sale valuation exceeds $10 million).

Practicing Sustainable Entrepreneurship: Checklists, Forms and Other Resources

Forms for convertible note financings, including annotations, are included in the Sustainable Entrepreneurship Project's "Seed Capital—Checklists, Forms and Other Resources" available for viewing and download on the "Finance" page of the website of the Project (www.seproject.org).

§18 Terms of seed round preferred shares

While most seed financings use convertible notes and other types of convertible securities in order to defer negotiations on valuation and pricing until a later date when more information on the business model is available, a minority of seed deals are completed using some form of preferred stock, which is often designated as "Series A1 Preferred Stock" in the articles or certificate of incorporation of the company.[21]

As is the case when preferred stock is issued to venture capitalists and other investors at the time of the Series A round, the process begins with negotiations on the "pre-money" valuation of the company, the amount of cash that will be raised through the sale of the Series A1 Preferred Shares and other terms. In a Series A round, the pre-money valuation is spread over all of the outstanding common shares of the company and a pool of shares set aside at that time for issuance to employees in the future in the form of outright grants or options. At the seed stage, however, the employee pool is generally ignored. The number of common shares outstanding, pre-money valuation and the amount of required capital are all used to arrive at the basic terms of the offering (i.e., number of shares and price of each share). For example, if the pre-money valuation is $8 million and 8 million common shares are outstanding, the pre-money value per share is $1.00. If the company will be raising $2 million it will issue 2 million Series A Preferred Shares at $1.00 per share. In some cases a range in the offering size may be set, such as a minimum of $1 million and a maximum of $2 million.

The issuance of the Series A1 Preferred Shares will require amendments to the articles or certificate of incorporation. The key terms typically include the right to receive dividends in preference to the common shares—a fixed dividend payment is also often included; however, these dividends usually do not become payable until there is a liquidation event or the company actually declares a dividend on the common shares; preferential distributions upon liquidation of the company (including a sale of the entire company); voting rights; optional conversion rights (i.e., the right to convert into common shares) and mandatory conversion into common shares upon the occurrence of certain events, such as an initial public offering of the common shares; and anti-dilution provisions. Redemption rights, which allow investors to put their shares to the company for repurchase upon terms agreed upon at the time the shares are originally issued, may

[21] The discussion of the terms of series see preferred shares in this section is adapted from B. Springmeyer, "Term Sheet for Angel Investment/Pre-Series A", http://www.calstartuplawfirm.com/business-lawyer-blog/angel-investor-term-sheet.php [accessed May 30, 2016].

be included in some instances; however, they are relatively rare in seed deals where the financial position of the company is already precarious as the company is striving to develop its business model.

While the terms of the Series A1 Preferred Shares are similar to those typically seen when companies issue Series A Preferred Shares to venture capitalists, there are some differences at the seed stage. For example, venture capitalists often demand that they receive two or more times the amount of their investment upon the occurrence of a liquidation event before any amounts are paid to common shareholders (venture capitalists also demand the right to participate with common shareholders in distributions of amounts remaining after they receive their preferred distribution). At the seed stage, however, the preferential distribution to the Series A1 Preferred shareholders is usually limited to the amount of their investment plus any accrued but unpaid dividends. Voting rights for Series A1 Preferred shares are usually not as extensive as those given to venture capitalists purchasing Series A Preferred Shares. Series A1 Preferred Shares typically vote with the common shares in a single pool and will only have separate voting rights as mandated by statute.

Seed round investors purchasing Series A1 Preferred shares will usually enter into an investors' rights agreement with the company that covers issues similar to those negotiated with venture capitalists. The most common topics for these agreements include the right of the investors (sometimes only "major" investors, which are investors who invested at least a specified minimum amount) to participate in future financing rounds on a pro-rata basis; information rights, such as the obligation of the company to provide investors with quarterly and annual financial statements and budget forecasts and allow investors to enter and inspect the company's premises and meet with company management; and registration rights (i.e., the right of investors to have the company register their shares for resale). Seed round investors typically do not have the right to designate a representative to serve on the board of directors; however, there are exceptions and a representative may sit on the board in order to closer observe the management of the company but without any ability to override decisions made by the majority of the board elected by common shareholders. Affirmative and negative covenants, similar to those found in loan agreements and other financial institutions, might also be included in the investors' rights agreement; however, they will be deliberately limited in scope out of recognition that the management of the company is already stretched and unable to track too many operational metrics. With respect to registration rights, seed investors may not be given a right to "demand" a registration that takes the company public before management is ready, since it is just too speculative at that stage to predict when the company might mature to the point where it can handle the rigors of public company status.

Practicing Sustainable Entrepreneurship: Checklists, Forms and Other Resources

Forms for seed round preferred financings, including annotations, are included in the Sustainable Entrepreneurship Project's "Seed Capital—Checklists, Forms and Other Resources" available for viewing and download on the "Finance" page of the website of the Project (www.seproject.org).

§19 Simple agreement for future equity ("Safe")

The "Simple Agreement for Future Equity", or "Safe", was developed by Y Combinator as an alternative to seed financings based on preferred shares or convertible notes and provides for investors to be issued a "right to certain shares of the company's capital stock", subject to terms outlined in the Safe.[22] The developers of the Safe were particularly focused on replacing convertible notes to avoid requirements associated with debt instruments (e.g., regulations, interest accrual, maturity dates, the threat of insolvency, security interests and subordination agreements) that they believed could have unintended negative consequences. Their goal was to come up with a simple document that would reduce legal fees for all parties and allow them to proceed quickly to financing the business once they reached agreement on the "Valuation Cap". When that stage is completed, the Safe is signed and the parties have procedures in place to deal with three key potential future events: an equity financing (i.e., a financing that results in the issuances of preferred shares to new investors, such as venture capitalists), a liquidity event (i.e., a sale or merger of the company or an initial public offering) and a dissolution event. The lengthy discussion in the next section describes the operation of a "Standard Safe", which operates with only a Valuation Cap; however, Y Combinator created three alternatives to the Standard Safe which are described below that allow the parties to create Safes that correspond to various types of convertible notes (e.g., Valuation Cap and a discount, a discount and no Valuation Cap, and a "most favored nation" provision with no Valuation Cap or discount).

Practicing Sustainable Entrepreneurship: Checklists, Forms and Other Resources

Forms for Safe financings, including annotations, are included in the Sustainable Entrepreneurship Project's "Seed Capital—Checklists, Forms and Other Resources" available for viewing and download on the "Finance" page of the website of the Project (www.seproject.org).

It should be noted that while the Safe documents developed by Y Combinator continue to dominate the market for forms used for this type of financing strategy, variations of Safes can be found among "retail crowdfunding" portals such as WeFunder and Republic which have been launched to facilitate capital raising from non-accredited investors, not the sophisticated accredited seed capital investors discussed elsewhere in this chapter, pursuant to Section 4(a)(6) of the Securities Act of 1933, as amended, implemented as part of the so-called "Jumpstart Our Business Startups Act", or "JOBS Act". Startup financing lawyers and non-legal financing professionals also continue to experiment with the terms of the Safe, primarily to try and build in some of the rights traditionally found in convertible notes and provide investors with more opportunities to share in the upside

[22] The discussion in this section is adapted from materials relating to the Safe available at the website maintained by Y Combinator that can be accessed at http://www.ycombinator.com/documents/#safe. In particular, see the Safe Primer, which describes and compares each of the main types of Safe instruments and provides examples on how certain of the variable provisions work in practice.

of the companies they are funding even when the companies do not engage in a financing event that would otherwise trigger the automatic conversion feature in the Safe.[23]

Key Terms and Considerations for Safe Financings

While Safe instruments are touted for having the advantage of reducing the issues that need to be negotiated between companies and investors, and the time and legal expense associated with drafting the outcome of such negotiations, the standard Safe terms suggest a number of things that both sides should considered before moving forward with the investment:

- *"Equity Financing":* Default definition is a bona fide transaction or series of transactions with the principal purpose of raising capital, pursuant to which the company issues and sells preferred stock at a fixed pre-money valuation (such preferred stock is defined as the "Standard Preferred Stock"). Investors often demand more specificity, such as requiring that the company must raise at least a specified minimum amount and/or that the documentation for the financing is based on sophisticated models such as the forms available from the National Venture Capital Association.
- *"Standard Preferred Stock":* Default definition is the same series of preferred stock issued to the investors investing new money in the company in connection with the initial closing of an equity financing. Standard Preferred Stock will be issued to the investors if the pre-money valuation is less than or equal to the Valuation Cap. If the pre-money valuation is greater than the Valuation Cap, Safe Preferred Stock (as defined in the Safe instrument) will be issued to the investors.
- *"Discount Rate":* Defined as the discount rate negotiated between the company and the investor that applies to the price per share of the Standard Preferred Stock sold in the Equity Financing. The discount rate, generally between 10% and 30%, will depend on general market factors and the amount of time that is expected to pass before the company will reasonably be able to close the Equity Financing.
- *"Valuation Cap":* Refers to the maximum valuation an investor will convert their investment into shares of preferred stock if an Equity Financing occurs before the expiration or termination of this instrument. The Valuation Cap determines whether the investor will receive Standard Preferred Stock or Safe Preferred Stock, with Safe Preferred Stock being issued if the pre-money valuation for the Equity Financing is greater than the Valuation Cap. While a Safe is recommended because it "simply" requires negotiation of a Valuation Cap, in reality this can be one of the most difficult things for a company and investors to agree upon.
- *"Liquidity Event":* Default definition is a change of control (e.g., sale or merger of the company that results in a change in controlling ownership) or an initial public offering. The default rights of investors in the event of a Liquidity Event vary depending on the type of Safe. While a sale of the company prior to an Equity Financing is unlikely, it is a scenario that needs to be considered and addressed in advance in the Safe.
- *"Dissolution Event":* Default definition includes (i) a voluntary termination of operations, (ii) a general assignment for the benefit of the Company's creditors or (iii) any other liquidation, dissolution or winding up of the Company (excluding a liquidity event), whether voluntary or involuntary. While a Safe is not a debt instrument, investors are generally given a priority over stockholders with respect to distributions upon liquidation.
- *"Pro Rata Purchase Rights":* Default provisions provide for investors to receive "pro rata purchase rights", which are described as an agreement between the company and the holder of a Safe executed in connection with the issuance of Standard Preferred Stock or Safe Preferred Stock, as applicable, that gives the holder a right to purchase its pro rata share of private placements of securities by the company occurring after the equity financing (subject to customary exceptions), unless the holder is already included in such rights in the transaction documents related to the equity financing. A company may decide to restrict pro rata rights to certain investors, such as only investors that purchase

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[23] For discussion of some of the potential limitations of a Safe for investors promised participation in the upside of the issuing companies in retail crowdfunding campaigns, see J. Green and J. Coyle, "Crowdfunding and the Not-So-Safe Safe", Virginia Law Review, 102 (December 2016), 168.

a Safe for a purchase price that is equal to or greater than a specified minimum dollar amount.

- *"MFN Provision":* If included, requires that if the company subsequently issues Safes with provisions that are more advantageous to the investors holding a Safe containing the MFN Provision (such as a valuation cap and/or a discount rate), the Safe can be amended to reflect the terms of the later-issued safes.
- "*Side Letter Topics":* In some cases the parties may supplement the Safe instrument with a side letter that provides investors with certain special rights that are not included in the standard template for the Safe such as the MFN Provision discussed above, rights of first offer (or preemptive rights), "Major Investor" rights, expense reimbursement rights, information rights and observer rights. Side letters may be necessary to attract certain investors; however, they will generally add to the cost of the transaction and slow down closing of the funding.

§20 --Standard Safe

The Standard Safe, which operates with only a Valuation Cap, provides that in the event of an "equity financing", defined as a bona fide transaction or series of transactions with the principal purpose of raising capital, pursuant to which the company issues and sells preferred stock at a fixed pre-money valuation, the company would automatically issue shares of preferred stock to the investors; however, the rights and preferences of those preferred shares would depend on the pre-money valuation of the equity financing. If the pre-money valuation is less than or equal to the Valuation Cap, the investors would receive shares of the same series of preferred stock issued to the investors investing new money in the company in connection with the initial closing of the equity financing ("Standard Preferred Stock"), with the number of such shares being determined by dividing the amount that the investor originally paid for the Safe ("Purchase Amount") by the price per share of the Standard Preferred Stock.

On the other hand, if the pre-money valuation is greater than the Valuation Cap, the investors would receive shares of a different series of preferred stock ("Safe Preferred Stock") having the identical rights, privileges, preferences and restrictions as the shares of Standard Preferred Stock issued to the new investors in the equity financing, other than with respect to: (i) the per share liquidation preference and the conversion price for purposes of price-based anti-dilution protection, which would equal the price per share equal to the Valuation Cap divided by the "Company Capitalization" (as defined below) (such price per share is referred to as the "Safe Price"); and (ii) the basis for any dividend rights, which will be based on the Safe Price, with the number of such shares of Safe Preferred Stock being determined by dividing the Purchase Amount by the Safe Price. The Company Capitalization used to determine the per share liquidation preference and the conversion price for shares of Safe Preferred Stock would be the sum, as of immediately prior to the equity financing, of: (1) all shares of the company's capital stock (on an as-converted basis) issued and outstanding, assuming exercise or conversion of all outstanding vested and unvested options, warrants and other convertible securities, but excluding all Safes and convertible promissory notes; and (2) all shares of common Stock reserved and available for future grant under any equity incentive or similar plan of the company, and/or any equity incentive or similar plan to be created or increased in connection with the equity financing.

The Standard Safe provides that in connection with the issuance of Standard Preferred Stock or Safe Preferred Stock, as applicable, by the company to the investor: (i) the investor would execute and deliver to the company all transaction documents related to the equity financing; provided, that such documents are the same documents to be entered into with the purchasers of Standard Preferred Stock, with appropriate variations for the Safe Preferred Stock if applicable, and provided further, that such documents would have customary exceptions to any drag-along applicable to the investor, including, without limitation, limited representations and warranties and limited liability and indemnification obligations on the part of the investor; and (ii) the investor and the company would execute an agreement with the company and holders of other Safes, as appropriate, giving the investor a right to purchase its pro rata share of private placements of securities by the company occurring after the equity financing (subject to customary exceptions), unless the investor is already included in such rights in the transaction documents related to the equity financing.[24]

In the event of a “liquidity event”, defined as a change of control (e.g., sale or merger of the company that results in a change in controlling ownership) or an initial public offering, the investor would have the option to either (i) receive a cash payment equal to the Purchase Amount (subject to the limitations described below) or (ii) if the investor fails to select the cash option, automatically receive from the company a number of shares of common stock equal to the Purchase Amount divided by the Liquidity Price, which would be the price per share equal to the Valuation Cap divided by the “Liquidity Capitalization” (i.e., the number, as of immediately prior to the Liquidity Event, of shares of capital stock (on an as-converted basis) outstanding, assuming exercise or conversion of all outstanding vested and unvested options, warrants and other convertible securities, but excluding: (i) shares of common stock reserved and available for future grant under any equity incentive or similar plan; (ii) any Safes; and (iii) convertible promissory notes). If there are not enough funds to pay the investor and holders of other Safes (collectively, the “Cash-Out Investors”) opting for a cash payment in full, then all of the company’s available funds will be distributed with equal priority and pro rata among the Cash-Out Investors in proportion to their Purchase Amounts, and the Cash-Out Investors will automatically receive the number of shares of common stock equal to the remaining unpaid Purchase Amount divided by the Liquidity Price.

In the event of a “dissolution event”, defined as (i) a voluntary termination of operations, (ii) a general assignment for the benefit of the Company’s creditors or (iii) any other liquidation, dissolution or winding up of the Company (excluding a liquidity event), whether voluntary or involuntary, the company would pay an amount equal to the Purchase Amount, due and payable to the Investor immediately prior to, or concurrent with, the consummation of the dissolution event. The Purchase Amount will be paid prior and in preference to any distribution of any of the assets of the company to holders of outstanding capital stock by reason of their ownership thereof. If immediately prior to the consummation of the dissolution event, the assets of the company legally available for distribution to the holders of all of the Safes (the “Dissolving Investors”), as determined

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[24] A company may decide to restrict pro rata rights to certain investors, such as only investors that purchase a Safe for a purchase price that is equal to or greater than a specified minimum dollar amount.

in good faith by the company's board of directors, are insufficient to permit the payment to the Dissolving Investors of their respective Purchase Amounts, then the entire assets of the company legally available for distribution will be distributed with equal priority and pro rata among the Dissolving Investors in proportion to the Purchase Amounts they would otherwise be entitled to receive.

§21 --Alternatives to Standard Safe

While the Standard Safe is recommended for its simplicity, Y Combinator also created three alternatives to the Standard Safe that allow the parties to create Safes that correspond to various types of convertible notes (e.g., Valuation Cap and a discount, a discount and no Valuation Cap, and a "most favored nation" provision with no Valuation Cap or discount). The discussion in the previous section regarding the Standard Safe when reviewing each of these alternatives as they contain many of the same provisions that are included in the Standard Safe.

The "Cap and Discount Safe" is a Safe with a negotiated Valuation Cap and Discount Rate. Either the Valuation Cap or the Discount Rate applies when determining the Conversion Price to be used when converting this form of Safe into shares of Safe Preferred Stock. The Discount Rate applies to the price per share of the Standard Preferred Stock sold in the Equity Financing. If this calculation results in a greater number of shares of Safe Preferred Stock for the investor, the price per share based on the Valuation Cap is disregarded (and vice versa). The following example of the operation of this provision is provided in Appendix II of the Safe Primer.[25] Assume that Investor has purchased a safe for $100,000; the Valuation Cap is $8,000,000 and the Discount Rate is 85%; the company has negotiated with investors to sell $1 million worth of Series A Preferred Stock at a $10,000,000 pre-money valuation; and the company's fully-diluted outstanding capital stock immediately prior to the financing, including a 1,000,000 share option pool to be adopted in connection with the financing, is 11,000,000 shares. In this situation, the company will issue and sell 1,100,110 shares of Series A Preferred at $0.909 per share to the new investors. The company will issue Series A-1 Preferred to the safe holder, based on the Valuation Cap or the Discount Rate, whichever results in a lower price per share. The 15% discount applied to the per share price of the Series A Preferred is $0.77265. The Valuation Cap results in a price per share of $0.72727. Accordingly, the company will issue 137,500 shares of Series A-1 Preferred to the safe holder, at $0.72727 per share. The Discount Rate does not apply in this case. The conversion of the Cap and Discount Safe in a Liquidity Event is the same as a Standard Safe.

The "Discount, No Cap Safe" is a Safe with a negotiated Discount Rate, e.g., a 20% discount off the price per share of the Standard Preferred Stock, applied to the conversion of this safe into shares of Safe Preferred Stock. The following example of the operation of this provision is provided in Appendix II of the Safe Primer. Assume that Investor has

[25] The Safe Primer can be accessed at http://www.ycombinator.com/documents/#safe. It describes and compares each of the main types of Safe instruments and provides examples on how certain of the variable provisions work in practice.

purchased a safe for $20,000; the Discount Rate is 80%; the company has negotiated with investors to sell $400,000 worth of Series AA Preferred Stock at a $2,000,000 pre-money valuation; and the company's fully-diluted outstanding capital stock immediately prior to the financing is 10,500,000 shares. The company will issue and sell 2,105,263 shares of Series AA Preferred at $0.19 per share to the new investors. The 20% discount applied to the per share price of the Series AA Preferred is $0.152. Accordingly, the company will issue 131,578 shares of Series AA-1 Preferred to the safe holder, at $0.152 per share. If the Discount, No Cap Safe is converting in a Liquidity Event, the investor could elect to have the Purchase Amount repaid, or to convert the safe into shares of common stock, based on the fair market value of the common stock at the time of the Liquidity Event with the Discount Rate applied to the common stock price.

The "No Cap or Discount, MFN Provision Safe" initially operates without a negotiated Valuation Cap or Discount Rate, but provides that if the company subsequently issues Safes with provisions that are advantageous to the investors holding this type of Safe (such as a Valuation Cap and/or a Discount Rate), the original version of the Safe can be amended to reflect the terms of the later-issued Safes. The amendment term is the so-called "MFN Provision". If there is an Equity Financing before this Safe is amended pursuant to the MFN Provision, the investor would receive the same shares of preferred stock as the investors of new money in the Equity Financing, at the same price. However, this Safe does not automatically convert into shares of preferred stock unless the amount of new money raised in the Equity Financing is at least $250,000 (a suggested amount which can be changed by the parties). This threshold amount provides the investor with some protection against an insignificant equity round raised at an artificially high valuation. If there is a Liquidity Event before this Safe is amended by the MFN Provision, the investor could elect to have the Purchase Amount repaid, or to convert the safe into shares of common stock, based on the fair market value of the common stock at the time of the Liquidity Event. Investors relying on an MFN Provision should understand that, unless the later Safes include an MFN Provision, the MFN Provision of the original version of the Safe is amended away once the safe holder decides the MFN Provision is triggered (i.e., the investors will typically only have one opportunity to amend their original version of the Safe and take advantage of better terms that might offered if the company continues to issue additional Safes).

§22 Post-seed round activities

The closing of a seed round financing is certainly a memorable day for the founders, a moment that represents the culmination of months of effort, highs and lows and distraction from product development and calling on prospective customers. Many founders want to shift quickly back to operating the business; however, there are some key activities that still need to be completed in order to be sure that investors are informed, news of the closing is disseminated strategically and plans are laid for upgrading the company's capabilities in important areas such as governance, finance and human resources. The following list of post-seed round activities is based on a post-seed checklist for founders prepared by NextView Ventures (http://nextviewentures.com)[26]**:**

- Investor communications: Make sure that all of the investors receive all of the legal documents associated with the seed round, including a final capitalization table that lists all of the investors and shareholders of the company.[27]
- Recognition and celebration: Send personalized and genuine "thank you" communications to everyone outside of the company who provided introductions and other support during the fundraising process and hold an event at which all company employees can come together to celebrate the funding milestone and, hopefully, built on the team camaraderie necessary to overcome the challenges that lie ahead.
- Governance: Now that the company has outside investors it is time to obtain directors' and officers' insurance and hire an accounting firm or part-time CFO to set up a financial reporting system to track the business and deliver required reports to investors. A schedule for directors' meetings going out nine to 12 months should be set to avoid tedious coordination of schedules every few months and input should be solicited from outside directors on their preferences regarding the agenda and presentations for each meeting.
- Funding announcement: Develop a strategy for maximizing the impact of announcing the closing the seed round to the investment community, prospective customers and other potential stakeholders. The announcement will surely accelerate the flow of resumes for new positions and will hopefully open the door to additional public relations opportunities. In most cases the announcement comes soon after the closing; however, some companies wait until other events, such as a new product launch, can also be announced.
- Hiring plans and human resources activities: Develop proposed "compensation bands", including salary and equity, for proposed new employees and have them reviewed and approved by the directors so that everyone is aligned regarding headcount growth and management can move quickly to hire needed talent. Commission a "409A valuation" to determine the "fair market" value of the common shares in order set the strike price for employee stock options. Finally, develop a strategy for carrying out basic human resources activities, process payroll and providing health insurance to all employees (including the founders).

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[26] D. Beisel, "Critical Tasks to Complete After Raising Seed Capital [Checklist for Founders]" (January 5, 2015), http://nextviewventures.com/blog/checklist-entrepreneurs-critical-tasks-after-seed-fundraise/ [accessed May 30, 2016]. The post also includes links to useful tool for founders such as a "Board Deck Template" for seed-stage startups.

[27] Some companies are concerned about the number of investors that may be needed in order to complete a seed financing round and believe that having a large number of investors will make their capitalization tables unwieldy and difficult to explain to venture capitalists conducting due diligence for a Series A Preferred Stock round. While it is not clear that this is a real problem, companies sometimes arrange for the formation of special purpose limited liability companies that will aggregate the capital collected from many small investors and then invest those sums into the company. The company would issue a single instrument, such as a Safe or a convertible note, to the limited liability company, thus allowing it to have a single investor on the capitalization table. The investors would own a proportionate beneficial interest in the instrument through their membership in the limited liability company.

- Legal and regulatory matters: Check with company counsel to be sure that all regulatory filings relating to the seed round will be made, remembering that information on investors in Form D filings will be picked up by the media (Form D filings should be coordinated with funding announcement discussed above). Now is a good time to discuss the terms of engagement with company counsel to ensure that legal help is available when needed on terms that fit within the company's budget.

References and Resources

The Sustainable Entrepreneurship Project's Library of Resources for Sustainable Entrepreneurs relating to Finance is available at https://seproject.org/finance/ and includes materials relating to the subject matters of this Guide including various Project publications such as handbooks, guides, briefings, articles, checklists, forms, forms, videos and audio works and other resources; management tools such as checklists and questionnaires, forms and training materials; books; chapters or articles in books; articles in journals, newspapers and magazines; theses and dissertations; papers; government and other public domain publications; online articles and databases; blogs; websites; and webinars and podcasts. Changes to the Library are made on a continuous basis and notifications of changes, as well as new versions of this Guide, will be provided to readers that enter their names on the Project mailing list by following the procedures on the Project's website.

08.2017