Seed Financing Structures: A High-Level Overview

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Shameless Plug for Mintz Levin

• Mintz Levin is a global full-service law firm with approximately 450 lawyers in 9 offices
  – Boston (HQ), New York, Washington, DC, Stamford, London, Tel Aviv, San Diego, Los Angeles, San Francisco
• Founded in 1933 at the height of the Great Depression = Entrepreneurial DNA
• Deep roots in largest entrepreneurial communities
• More than just lawyers – problem solvers
• Business focused, pragmatic and efficient
• We take our work seriously, but we don’t take ourselves seriously (we’re fun)
• Represent all stages of emerging companies – from incorporation through exit
What is a "Seed Financing"?

- The initial financing of a newly formed startup company
- Precedes the company's initial institutional venture capital financing round (typically referred to as the "Series A Financing")
- Typically $500,000 - $1,000,000, but can be more or less
- Investors are often "Friends and Family," but can also include sophisticated high-net worth "Angel Investors" (e.g., Ron Conway) and/or institutional seed-stage investors (e.g., 500 Startups, a16z, SV Angel, First Round Capital)
### Most Active Seed Investment Funds

#### Top 20 Most Active Venture Capital Seed Investors in 2013

<table>
<thead>
<tr>
<th>Rank</th>
<th>Investor</th>
<th>2012 Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>500 Startups</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>Andreessen Horowitz</td>
<td>3</td>
</tr>
<tr>
<td>3</td>
<td>SV Angel</td>
<td>2</td>
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<tr>
<td>4</td>
<td>Lerer Ventures</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td>First Round Capital</td>
<td>5</td>
</tr>
<tr>
<td>6</td>
<td>CrunchFund</td>
<td>6</td>
</tr>
<tr>
<td>7</td>
<td>Innovation Works</td>
<td>-</td>
</tr>
<tr>
<td>7</td>
<td>Atlas Venture</td>
<td>16</td>
</tr>
<tr>
<td>7</td>
<td>Connecticut Innovations</td>
<td>12</td>
</tr>
<tr>
<td>7</td>
<td>Founder Collective</td>
<td>7</td>
</tr>
<tr>
<td>11</td>
<td>Kapor Capital</td>
<td>26</td>
</tr>
<tr>
<td>12</td>
<td>Great Oaks Venture Capital</td>
<td>16</td>
</tr>
<tr>
<td>12</td>
<td>True Ventures</td>
<td>10</td>
</tr>
<tr>
<td>12</td>
<td>Greylock Partners</td>
<td>20</td>
</tr>
<tr>
<td>15</td>
<td>Red Swan Ventures</td>
<td>-</td>
</tr>
<tr>
<td>15</td>
<td>New Enterprise Associates</td>
<td>9</td>
</tr>
<tr>
<td>15</td>
<td>RRE Ventures</td>
<td>26</td>
</tr>
<tr>
<td>15</td>
<td>CIT GAP Funds</td>
<td>-</td>
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<tr>
<td>15</td>
<td>ENIAC Ventures</td>
<td>-</td>
</tr>
<tr>
<td>20</td>
<td>Freestyle Capital</td>
<td>-</td>
</tr>
<tr>
<td>20</td>
<td>Forerunner Ventures</td>
<td>-</td>
</tr>
<tr>
<td>20</td>
<td>Maveron</td>
<td>-</td>
</tr>
<tr>
<td>20</td>
<td>VegasTech Fund</td>
<td>21</td>
</tr>
<tr>
<td>20</td>
<td>Khosla Ventures</td>
<td>-</td>
</tr>
</tbody>
</table>
Institutional Seed Investing Trend (2010 – 2013)

Active U.S. Seed Venture Capital Investors

By Year, 2010 - 2013

2010: 33
2011: 63
2012: 112
2013: 112

www.cbinsights.com
What are the primary goals and attributes of a seed financing?

- Simplified (and ideally standardized) documentation
- Fast negotiation and closing process
- Minimal legal fees
- "Upside" for investors in exchange for use of money by company to build value
- Automatic conversion into Series A terms when those documents are negotiated
3 Basic Structures

1. Convertible Debt Financing
2. "Series Seed" or "Series AA" Preferred Stock Financing
3. SAFE (Simple Agreement for Future Equity)
Convertible Debt Financings – Basic Elements

• Investors purchase promissory notes with a stated principal amount, interest rate and maturity date (typically 6 – 18 months)

• Upside kicker for investors (to compensate for use of funds beyond nominal interest):
  – Notes typically convert at a discount to Series A price (discount typically ranges from 10-30% with 15-20% being the norm)
  – Alternatively, warrants can be issued in lieu of a conversion discount
  – Usually the notes pay a premium (1.5X - 2X) if company is acquired before notes convert

• Documentation (2-3 primary documents, 15-30 pages total):
  – Purchase Agreement (minimal reps and warranties)
  – Form of Note
  – Form of Warrant (if applicable)
  – Security Agreement (if applicable – usually not)
  – Subordination Agreement (if applicable – usually not)
Convertible Debt Financings – Issues to Consider

• Valuation Cap
  – Most notes that convert at a discount now include a "valuation cap" concept, which means that the notes convert at a price that is the lesser of the negotiated discount price and the price derived by dividing the valuation cap by the company's fully-diluted shares at the time of the Series A financing
  – Valuation caps typically are set at an amount that is a stretch goal for the Series A pre-money valuation (usually $5-10 million)

• Conversion of "Discount Shares" into Common Stock
  – If notes convert entirely into preferred stock at a discount to the Series A price it results in the aggregate Series A liquidation preference after conversion being greater than the amount of money raised by the company (sometimes referred to as a "liquidation preference overhang")
  – Particularly if there is a large (30%+) conversion discount, try to set up the conversion mechanism so that the principal converts into preferred stock at 100% of the Series A price and any additional shares issuable as a result of accrued interest and the conversion discount convert into common stock.

• What happens at maturity?
  – In the event the company does not complete a financing triggering conversion of the notes, the notes can technically become due at maturity with the company unlikely to be able to pay. From the company's perspective, consider automatic conversion of the notes at maturity into common stock at a default conversion price (BUT, beware of potential issues related to impact on common stock 409A valuation).
Convertible Debt Financings – Issues to Consider (Cont'd)

• California Finance Lenders Law
  – Requires license for those "in the business" of making loans
  – Carve-out for "Commercial Bridge Loans" made by a "Venture Capital Company" to an "Operating Company"
    • "Commercial Bridge Loan" is, in short, defined as loan with a maturity date of one year or less and that is made in connection with or contemplation of an equity investment
    • Recommend company representation in purchase agreement that it is an "operating company" to confirm it meets the definition

• Can cause misalignment of interests between founders and seed investors
  – Founders strive for high valuation in Series A financing (built in part using money provided by seed investors)
  – Seed investors may want low valuation so their investment converts into greater % of the company

• Debt does not qualify as "Qualified Small Business Stock" until converted to equity
• Debt may raise complicated issues of securitization and subordination (although unlikely to be relevant for a seed stage company)
"Series Seed" or "Series AA" Preferred Stock Financings – Basic Elements

- Simplified version of typical Series A preferred stock financing
- Priced equity round (so the valuation question has to be addressed)
- Simplified investor rights and voting protections – "Series Seed" version gives investors a “MFN” contractual right to the same rights that are negotiated by the Series A investors
- Usually comes with a board seat
- Documentation (3 primary documents; 35-40 pages total):
  - Certificate of Incorporation (creating "Series Seed" or "Series AA" Preferred Stock)
  - Purchase Agreement (minimal reps and warranties)
  - Investor Rights Agreement (usually with MFN provision)
"Series Seed" and "Series AA" Financings – Issues to Consider

• Less Common than Convertible Debt Structure
  – Typically favored by institutional seed investors (e.g. First Round Capital)

• Valuation Issues
  – Because "Series Seed" and "Series AA" financings are priced equity rounds, the negotiation inherently requires knowledge of how to properly value companies (too high or too low creates problems for future financing rounds) – usually means "Series Seed" and "Series AA" financings are not appropriate for "Friends and Family" rounds and only those led by sophisticated angel investors or seed funds
  – Pre-money valuation usually includes a pre-money option pool of a certain size – triggers the need to create an option pool which may add additional complexity

• Simplified, But Not Simple
  – While the documentation is simplified from a typical Series A financing, you are still likely to wind up discussing and negotiating many of the same issues (e.g., whether or not to include anti-dilution protection, list of preferred stock protective provisions) - negotiations can become protracted and legal fees can add up
  – Need to get stockholder approval to approve amended charter
  – Securities filings and filing fees
Simple Agreement for Future Equity (SAFEs) – Basic Elements

• New structure; conceived and promoted by Y Combinator

• Attempts to solve the “maturity date” and other problems that may arise in convertible debt seed financings

• Structure is similar to a convertible debt financing except that the security purchased by the investor is a contractual obligation and not debt (there is no interest or maturity date)
  – Converts into “next round” Preferred Stock (usually at a negotiated discount price and may include a valuation cap – same as convertible debt) if a financing occurs before a Change of Control or Dissolution; many variations on the theme, which may include a “drop dead” date for conversion into Preferred Stock or a default conversion into Common Stock (same as would happen at “maturity” using convertible notes)

• Documentation (2 primary documents; <10 pages total):
  – Purchase Agreement (minimal reps and warranties)
  – Convertible Security Instrument
SAFEs – Issues to Consider

• Relatively new and not commonly used
  – Conceived and promoted by Y Combinator; not widely adopted outside of the YC ecosystem
  – Until structure becomes better known and understood, it may meet resistance from investors in the marketplace

• Attempts to solve some issues with convertible debt financings, but doesn’t solve all issues
  – SAFEs likely not eligible for QSBS treatment at issuance
  – Fundamentally the same structure as convertible debt (without the debt instrument vehicle), so raises same issues of conversion discount, valuation cap, default conversion into common stock if no preferred stock financing by date specified

• Many unsettled questions
  – Attempts a “fill in the blank” level of simplicity and standardization, but not likely in practice
## Pros & Cons of Various Seed Financing Structures:

<table>
<thead>
<tr>
<th>Convertible Debt</th>
<th>Series Seed/Series AA</th>
<th>SAFEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pro</td>
<td>Con</td>
<td>Pro</td>
</tr>
<tr>
<td>Most Common / Battle Tested</td>
<td>Misalignment of interests</td>
<td>Interests aligned to maximize valuation</td>
</tr>
<tr>
<td>Relatively fast negotiation &amp; closing</td>
<td>Debt can mature without ability to pay</td>
<td>Valuation issues settled up front / no “punting”</td>
</tr>
<tr>
<td>Least expensive (likely); although SAFEs may prove to be even less expensive</td>
<td>Valuation cap provision raises valuation issue debt structure sought to avoid</td>
<td>SH consent required to amend charter</td>
</tr>
<tr>
<td>“Punts” on many important issues (e.g., valuation)</td>
<td></td>
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<tr>
<td>CA Lenders Law Issues (1 yr maturity period)</td>
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<tr>
<td>No QSBS treatment until conversion</td>
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</tbody>
</table>
Further Reading / Links to Forms

• Series Seed Forms
  – http://www.seriesseed.com/

• Y Combinator Series AA Forms
  – http://ycombinator.com/seriesaa.html

• Y Combinator SAFE Forms
  – http://ycombinator.com/safe/

• Seth Levine – Has convertible debt won? And if it has, is that a good thing?
  – http://www.sethlevine.com/wp/2010/08/has-convertible-debt-won-and-if-it-has-is-that-a-good-thing

• Jason Mendelson – The Convertible Debt Debate

• Mark Suster – Is Convertible Debt Preferable to Equity
Questions?

Any QUESTIONS?