SEED FINANCINGS

The first round of financing that a startup completes is commonly referred to as a seed round. If the investors are mostly close connections of the founders, this initial financing round may also be referred to as a friends and family round. Startups often close multiple seed rounds before they are in a position to complete a Series A round led by an institutional venture capital ("VC") fund.

SEED FINANCINGS

A seed round typically occurs towards the end of the idea stage of a startup's life. At the beginning of the idea stage, a prospective startup's founders are often still employed full-time by a third party while working nights and weekends on their startup concept. At this point, the founders are usually bootstrapping the company. This means that they are spending their own money (or small amounts of informally borrowed money from friends and family) to develop their idea before raising an outside round of capital.

Sometimes a bootstrapped company can develop the first testable version of its product (a so-called alpha version), or even a second version with greater functionality (a beta version), before needing to raise a seed round of capital. Many founders, however, raise seed capital so that they can either: quit their day jobs and focus on their startups full-time; and/or, if they lack technical skills, hire contracted developers to create the first functional iterations of their concepts.

The scale and structure of seed financings vary widely, but many share these characteristics:

- Amount raised: Companies usually raise anywhere from $50,000 up to $1 million.
- Investors: Investors typically include family, friends, high-net-worth angel investors, or super-angel investors, which are angel investors who have become full-time investors in early-stage startups and who often create their own mini-VC funds allowing contacts in their personal networks to co-invest.
- Instruments: Seed-stage companies generally issue: convertible notes; simple agreements for future equity (SAFEs); or seed equity, usually in the form of convertible preferred stock (but, occasionally, using common stock).

CONVERTIBLE NOTES

While convertible preferred stock is the most common venture financing tool for more mature startup companies, at the seed stage, the most frequently used instrument for raising modest amounts of capital is the convertible promissory note. Convertible promissory notes (or convertible notes, as they are more commonly called) are debt securities that have the following key terms: principal amounts that are due at a maturity date; a fixed rate at which interest accrues on the principal balance; and a claim on the company's assets that is senior to all equityholders and typically pari passu with all other unsecured non-senior debt.

Although formally a debt instrument, many investors view convertible notes as deferred or unpriced equity in substance. The goal of their investment in the notes is to convert them into the same preferred equity security the company issues to its first institutional VC investor in the company's Series A round, rather than to receive their principal plus interest at maturity. Therefore, investors typically view the conversion features discussed in this Section as the most important provisions in a convertible note deal, as they are the mechanisms by which the noteholders will eventually become stockholders of the company.

CONVERSION EVENTS

Convertible notes convert into different types of equity when certain events occur:

- Next Equity Financing conversion. A later preferred stock financing (referred to as a Next Equity Financing) is the most common trigger for note conversion. In this scenario, the principal and interest of each note converts (at the relevant conversion price) into shares of the same series of preferred stock that the new equity investor purchases in the subsequent financing round.
- Corporate Transaction conversion. If the company is sold while the notes are still outstanding, noteholders may: elect to have their principal and accrued interest (or perhaps the interest plus some multiple of the principal) repaid; or convert the balance of their notes into shares of common stock at a discount to the price at which the acquirer has offered to purchase shares of the company's common stock in connection with the sale transaction.
- Maturity conversion. If the company reaches the maturity date without having triggered a Next Equity Financing conversion or Corporate Transaction conversion, convertible notes often give investors the option to: convert their notes into shares of common stock at a predetermined price; or leave the notes outstanding.

Investors rarely choose to convert to common stock because continuing to hold debt of the company while leaving open the possibility of receiving preferred stock in a post-maturity Next Equity Financing is generally seen as more attractive than holding common stock alongside the founders.

CONVERSION PRICE

When a conversion event occurs, convertible noteholders receive equity based on the principal and interest balance of their promissory notes but at a price that is lower than the price paid by the new equity investors. The lower price the noteholders pay is calculated based on either a:

- Discount rate. When notes convert at the Next Equity Financing (usually the company's Series A round), they convert at a per share price that is less than the per share price of the preferred stock the company issues to its new investors in the equity financing. The rationale for giving this discount is that the startup has typically "de-risked" to some extent since the noteholders made their original investment and, therefore, they should be compensated for having shouldered additional risk early on.
- Valuation cap. Most convertible notes also contain a ceiling, or cap, on the pre-money valuation at which the notes may convert in a Next Equity Financing to protect the noteholders against runaway valuations.

When notes contain a discount and a valuation cap, the price at which the notes convert is the lesser of: the price calculated based on the discount; and the price implied by the valuation cap.

SIMPLE AGREEMENTS FOR FUTURE EQUITY (“SAFE”)

The SAFE is a relatively recent addition to the seed financing toolkit, popularized by the premier startup accelerator Y Combinator. The SAFE has become an alternative to issuing convertible notes when a company is reluctant to issue debt for fear of reaching the maturity date before having concluded a Next Equity Financing. In this scenario, the founders generally negotiate an extension with the noteholders, who may try to extract better terms in exchange for their consent. The SAFE instrument was created to avoid this situation.

The SAFE has all of the same conversion features of convertible notes but lacks the following hallmark debt features:

- No maturity date. Until a conversion event occurs, the SAFE remains outstanding indefinitely.
- No accruing interest. Investors receive only a right to convert the SAFE into equity at a lower price than the investors in the subsequent financing (based either on the discount or valuation cap in the SAFE).

A SAFE is otherwise substantially the same as a convertible note. It converts into stock on the same terms as a convertible note and using the same mechanics.

EQUITY SEED INVESTMENTS

When a startup chooses to raise seed capital by selling equity, it can issue shares of common stock or shares of preferred stock. Companies issuing seed equity usually issue convertible preferred stock, which is preferred stock that can be converted into shares of common stock (a hybrid of the two share classes).

CONVERTIBLE PREFERRED STOCK

While not as prevalent at the seed stage as in later rounds of financing, it is still somewhat common for seed investors (who are likely not institutional VCs) to purchase convertible preferred stock. The security these investors receive is often designated Series Seed Preferred Stock.

Series Seed stock includes most of the same rights, preferences, and privileges that are usually included in Series A Preferred Stock, as well as the various contractual stockholder rights that are conventional in Series A financings. However, to simplify the documents and with the understanding that seed investors are often not as sophisticated as institutional VCs, Series Seed rounds often do not include some of the more mechanically cumbersome provisions that are fairly standard in a Series A financing.

For instance, Series Seed financing documents often do not include some or all of the following terms: registration rights, rights of first refusal and co-sale, price-based anti-dilution provisions, drag-along rights, and investor designees on the board of directors.

COMMON STOCK

Common stock is the simplest form of equity investment. Investors who purchase shares of common stock typically receive the same security that the startup's founders hold. Common stockholders generally have the right to: vote for the company's board of directors and on other stockholder matters; receive dividends, if and when declared by the board; and receive their proportional share of the company's remaining assets if the company is liquidated.

However, they do not usually have additional rights, preferences, or privileges compared to the founders.

Common stock is not the favored equity instrument for startup companies raising capital for several reasons, including that:

- Investors who are purchasing equity, even at the seed stage, often want the rights, preferences, and privileges that preferred stock conventionally offers.
- Startups typically want to maximize their ability to use their common stock as equity incentives to recruit and retain talent. When a company sells common stock to its outside investors, this typically means that the common stock it issues to its employees under its stock plan will have a higher valuation than it would have had if the company had sold preferred stock or convertible notes to its outside investors. This can lead to the company's options having a higher strike price, making the options less attractive to early employees.