



WILMER CUTLER PICKERING HALE AND DORR LLP

WEBINAR

Seed Fundraising: How to Get Organized, Attract Investors and Negotiate Your First Round

MAY 29, 2019

Speakers:

Peter Buckland and Jason Kropp – WilmerHale

Lily Lyman – Underscore VC

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Webinar Guidelines

- Participants are in listen-only mode
- Submit questions via the Q&A feature
- Questions will be answered as time permits
- Offering 1 CLE credit in California and New York*

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WEBINAR

Speakers



Peter Buckland
Co-Chair, Emerging Company
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WilmerHale



Jason L. Kropp
Partner
WilmerHale



Lily Lyman
Principal
Underscore VC



Overview

1. Preparing your Company for the Financing Process
2. Sources of Capital
3. Structuring the Investment and Financing Alternatives
4. Legal and Regulatory Overview
5. Some Dos and Don'ts
6. Conclusion



Preparation: Raising Capital

- What are the goals in seed rounds?
 - Right size the raise
 - Seek sophisticated seed investors
 - Who are “accredited investors”
 - Who know early-stage investing and its risks
 - Who have strong networks
 - Seek standard (VC-friendly) terms and conditions
 - Speed and efficiency
 - Minimize number of stockholders
 - Avoid future legal and other hurdles

... all while continuing to grow the business



Preparation: Get Your Legal House in Order

- Incorporate and establish a bank account
- Divvy up equity among cofounders
 - Pay for your shares—and keep records!
 - 83(b) elections for restricted stock
- Ensure all IP is assigned to the company
 - Everyone has executed IP assignment
 - May have to hunt down former teammates
- Assemble all documentation in a central repository



Preparation: How Much Money Do You Want to Raise and Who To Ask?

- Know exactly how much you want/need to raise and how you intend to use those funds
 - Valuation inflection point
 - The “why” is critical part of your pitch
 - Premoney valuation
- Research potential funding sources and connections within your network to these sources
 - Who invests in my space?
 - Who is investing now?
- Network relentlessly



Preparation: Valuation

- Before you ask for money, do your best to get a sense of your company's value
 - Leading Indicator-Comparable companies
 - Net Present Value (NPV)
 - Based on discounted cash flow analysis
 - Difficult for startups because it's assumption upon assumption
 - VC Method-Project exit value and discount it back to today
- In reality, there's no magic formula, but you must start somewhere. The more reasoned the approach the better.



Sources of Capital

- Friends and family
- Angels
- Venture capitalists
- Strategic investors
- Government grants



Structuring the Investment: Financing Alternatives

- Four primary ways to raise money:
 - Loans
 - Sell common stock
 - Sell preferred stock
 - Convertible debt / equity hybrid-SAFE (Simple Agreement for Future Equity)

Debt always has first claim upon the company's assets;
stock has only a second, "residual" claim



Financing Alternatives: Loans

- Pros:
 - Easy
 - Low transaction costs
 - No ownership dilution
- Cons:
 - It becomes due, usually within 12-24 months
 - May not be viewed favorably by future investors
 - Unlikely to be available at the seed stage



Financing Alternatives: Common Stock

- Pros:
 - Fairly simple
 - Transaction costs can be lower than a preferred stock round
- Cons:
 - Need to set a valuation, which can create equity compensation problems
 - Dilution
 - Not an attractive investment



Financing Alternatives: Common Stock

- Basic unit of equity ownership
- Entitled to share in residual assets after payment of liabilities to creditors and lenders and claims of holders of senior equity securities
- Except for matters expressly governed by a vote of senior equity securities, entitled to vote on all matters presented to stockholders
- In special cases, common stock may be divided into classes with disproportionate or no voting rights; often used to maintain control of founding family shareholders or for regulatory reasons



Financing Alternatives: Preferred Stock

- Pros:
 - Less dilution than common stock
- Cons:
 - Need to set a valuation
 - High transaction costs
 - May give up too much control to a seed investor for too little money



Financing Alternatives: Preferred Stock

- Preferred stock may be a “straight” preferred (non-convertible into common stock) or convertible into common stock at the option of the holder or upon the occurrence of certain events.
- Preferred stock may be “permanent” (not redeemable under any circumstances) or redeemable (at set times or at the option of the holder or the company).
- Generally, has a preference over common stock or other junior equity securities as to rights in liquidation and/or rights to receive dividends.
- Liquidation event includes dissolution or winding-up of the company and, typically, a merger or sale of the company or other transaction involving a change of control.



Financing Alternatives: Convertible Debt

- Pros:
 - Quick, efficient and lower-cost
 - No current valuation
 - Only minimum control constraints
 - Attractive to investors because of preferred stock upside
- Cons:
 - Ultimately issuing more “real” preferred
 - Often accompanied by an “equity kicker”
 - Current trends include price “ceiling” (valuation cap)



Financing Alternatives: Convertible Debt

- “Market” Terms
 - Not secured against assets
 - Interest rate: 5–8%
 - Maturity Date: 12–24 months
 - Automatic (not optional) conversion upon Qualified Financing
 - Qualified Financing defined as:
 - First sale of convertible preferred stock with agreed-upon minimum amount raised
 - Try to avoid Note Purchase Agreement
 - Adds complexity and cost



Financing Alternatives: Convertible Debt

- “Market” Terms (Continued)
 - Probably comes with equity kicker to sweeten deal
 - Discount rate upon conversion (10–30%)
 - Less complicated capitalization table
 - Fewer terms to negotiate (warrant terms detailed)
 - Warrant (10–30% principal amount of debt)
 - Possible negative tax consequences of discount to investor holding note
 - Other investors in the financing could disapprove of discount
 - May come with cap on conversion price based on pre-money valuation
 - Investor-favorable term to convert at lower price



Financing Alternatives: SAFEs

- Like a convertible note, but without the obligation to repay cash at maturity
- Pros
 - Company friendly, not debt that has to be repaid, not equity that requires a valuation
 - No security agreements, subordination agreements or insolvency concerns
 - No maturity date, no interest rate
 - Quick to execute, low transaction costs
- Cons:
 - Investor unfamiliarity (though this is decreasing)
 - Terms can become complicated by caps, discounts and MFNs

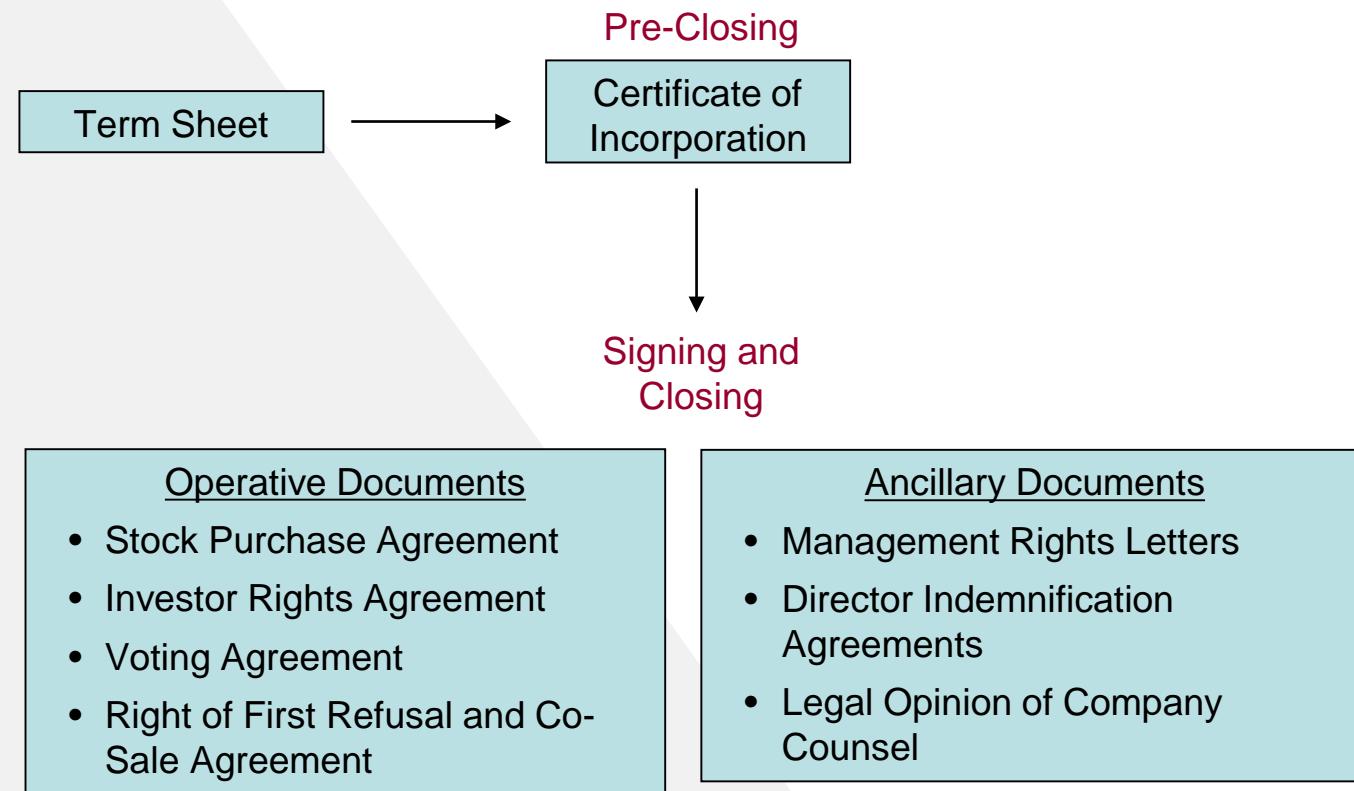


Financing Alternatives: What to Look For in a Seed Stage Investor

- Experienced and sophisticated start-up investors
 - Who are “accredited investors”
 - Who know angel investing and its risks
 - Who will be constructive partners if (when) things don’t go as planned
- Standard (VC-friendly) terms and conditions
- Speed
- Minimize transaction costs, number of stockholders
- Avoid future legal and other hurdles

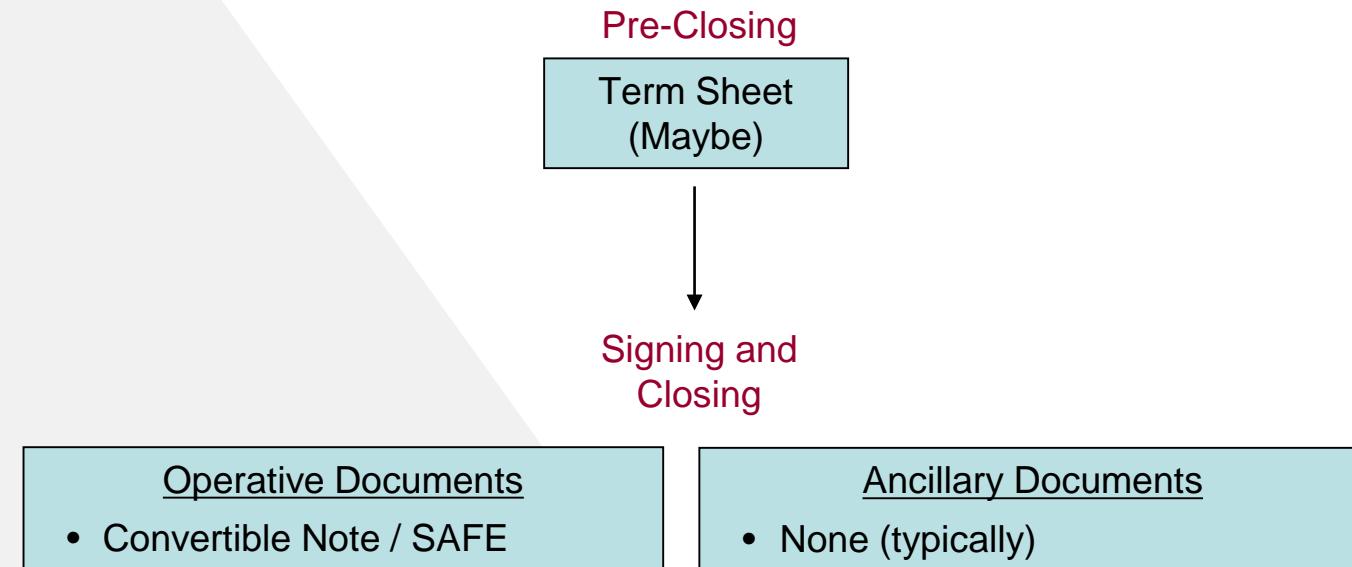


Financing Alternatives: Preferred Stock Financing Transaction Documentation Overview





Financing Alternatives: Convertible Note / SAFE Financing Transaction Documentation Overview





Legal and Regulatory Overview

- Securities Law Compliance
 - Under federal securities laws, every issuance of a security must either be registered under the Securities Act or exempt from registration.
 - All issuances of securities that are not being registered with the SEC must also be reviewed for compliance with state securities laws, or so-called "blue sky" laws.
 - Almost any fundraising falls into the purview of the securities laws.



Legal and Regulatory Overview: Keeping It Private

- Key is not to do something that requires registration as a public offering
- Traditional prohibition: No "general solicitation" or "general advertising," JOBS Act has changed this, allowing general solicitation to accredited investors only
- Accredited investors
- Regulation D Safe Harbor and Section 4(2) of the Securities Act



Legal and Regulatory Overview: The JOBS Act – Crowdfunding

- JOBS Act benefit—introduction of crowdfunding concept—a broadening of Rule 504 which will permit general solicitations
- Limited to offerings of \$1,000,000 (including amounts raised within prior 12 months)
- Not limited to accredited investors but can only be done through a registered broker or funding portal
- VERY specific disclosures required
- Specific limits on investment amounts by individual investors



Raising Capital: Dos & Don'ts

- **Do** have a business plan
 - Focus on the executive summary
 - Highlight your market, competitive advantage and team
- **Don't** have a poorly articulated one
- **Do** understand financing structures and terms



Raising Capital: Dos & Don'ts

- **Don't** just take money from anyone who offers or from unaccredited investors
- **Don't** utilize a “finder” to secure investments
- **Do** comply with ALL securities regulations
 - Rescission liability
 - Broker-dealer issues



Additional Resources

- For more information visit WilmerHaleLaunch.com
 - A website full of vital information, tools and connections needed to position entrepreneurs and startups for success
 - Draws on experience of WilmerHale's extensive team of lawyers practicing in areas critical to emerging companies in various stages of growth
 - Features library of video insights from lawyers, investors and other experts
 - Allows entrepreneurs and investors to build knowledge, research topics with everyday impact and connect with dedicated lawyers
 - Contains Document Generator

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START EXPLORING

-  Startup Dictionary
-  Knowledge Navigator
-  Document Generator
-  Equity Calculator
-  Q&A Forum

What's Trending Now:

Venture Capital Debt
Patent Vesting
Compensation Tax



Questions

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