PERKINS LAW PLLC

Early Stage Financing Strategies for Small Business Startups in Virginia

One of the biggest challenges for entrepreneurs is finding a way to secure financing for a startup business. As competition in the market increases, it is crucial for business owners to understand their fundraising options in order to avoid getting locked into a structure with long-term negative consequences. Although each round of capital raising is filled with detail-heavy intricacies, this article will offer a brief introductory overview and comparison of three structures: equity, convertible debt and a newer, hybrid option known as SAFEs.

1. Equity

Selling a portion of a company through the sale of equity can be a convenient way to quickly raise capital, especially if cash flow is too unpredictable to comfortably service a significant debt obligation. This option is often best utilized by companies that have already undergone a seed round and are looking for larger raises (>$1 million). Founders should often avoid this option in the early stages in order to limit their dilution. Institutional investors will often seek to purchase at least 25% of the company in a Series A equity round. These purchases typically take the form of a preferred class of equity. It is also common for investors to be granted a liquidation preference, which entitles them to priority over the common holders on receiving their preferred return, or, in the alternative, a right to participate, along with the common holders, in the remainder of a company's sale proceeds.

Early-stage companies might also avoid this structure to limit the risk of overinflating the company's valuation. Since investors are making a direct purchase of a portion of the company, both parties will need to agree on a pre-money equity price. If done too early, the company may be at risk of undergoing a "down round" (sale of shares at a lower price) during its next capital raise. This can create a messy situation for diluted equity holders and can have a chilling effect on recruiting new investors.

ERIC C. PERKINS, ESQ. 4870 SADLER ROAD SUITE 300 GLEN ALLEN, VA 2306

ERIC@ERICPERKINSLAW.COM WWW.ERICPERKINSLAW.COM PHONE (804) 205.5162 FAX (804) 482.2835

From a control perspective, equity investors will frequently demand a board seat and veto rights regarding certain corporate actions (e.g., issuing any new class of equity, adjusting board size, change of control, amending governance documents). Founders should be willing to sacrifice a meaningful degree of control of their company before entertaining this fundraising option.

Advantages:

- Less financial pressure on the company because there is no need to repay funds (compared to debt).
- Access to higher levels of capital. This structure is most heavily used by institutional venture capital investors, which gives a company the ability to build strong connections with high-profile players.

Disadvantages:

- Sets a valuation of company's equity, which creates a risk of over/underinflated equity pricing and for a future round.
- Complex negotiations with certain pre-requisites. For example, if your company is an LLC, institutional investors will likely require the company to be converted to a C-Corp. In addition, professional investors may be more thorough in the due diligence process, which can draw out the timing of the transaction and increase legal fees.

2. Convertible Debt

This financing structure works best for seed round financing when the company expects to raise a larger amount of institutional investment or venture capital funding in the future. In general, the terms are governed by a convertible note, and a company receives money in the form of debt that can later be converted into equity upon the occurrence of certain triggering events. For example, the note may provide that all outstanding principal and accrued interest may convert into equity when the company engages in a future equity financing round of at least $1 million. The conversion price is often equal to approximately 80% of the price of the equity financing and may be subject to a valuation cap or ceiling. This cap mechanism protects note investors against undervaluing a company at such an early stage. Although having a valuation cap is common, it is less advantageous for founders because it can ultimately cause the company to issue equity at an undervalued rate in later financings.

In general, the term of convertible notes can range anywhere from six months to two years, with interest rates around 6-10%. Upon maturity, some notes may automatically convert, while others may either provide for the investor to demand cash payments or accrue interest at a default rate. The latter scenarios can be particularly damaging to a company that has no future investors or cash flow plan in mind. In sum, while a convertible note structure offers some advantages over a direct equity sale, it is most beneficial to a startup company that has a detailed strategy to engage institutional investors for a future Series A equity round.

Advantages:

- Less complicated negotiation compared to equity rounds, which results in lower legal fees and a faster closing schedule.
- Delays a company's valuation. Less risk of a down round, but a company may still be under a valuation cap for purposes of conversion.

Disadvantages:

- Company is under time pressure to repay funds or otherwise convert to equity.
- A secured interest or lien may be placed on all company assets. In rare instances, other investors may even demand a personal guaranty from the founders.

3. SAFEs

"SAFE" is an acronym for "Simple Agreement for Future Equity" and was first introduced a few years ago by Y Combinator as an alternative to the convertible note structure. Since this is a relatively new financing structure, it is more commonly found in West Coast transactions. Although convertible notes may be faster to close compared to equity sales, they remain subject to an array of federal and state regulations because they are categorized as debt and involve commercial paper. For example, state law may impose certain term limits on a convertible note, and the stated interest rate will need to be close to market rates. In addition, it can be challenging at times to extend the term of a note if a company needs additional time to secure a future financing round.

By contrast, a SAFE functions similar to a warrant. It grants the investor the right to obtain equity in a future fundraising round. However, unlike a convertible note, a SAFE may convert with any amount of money to be raised in a future equity round instead of under certain qualifying transactions. The participation right can still be subject to a valuation cap, but there is no term or interest rate. Like a convertible note, a SAFE also has triggering provisions for early exits and dissolutions.

The biggest disadvantage to founders is the fact that SAFE institutional investors may require the company to be structured as a C-Corp prior to funding. Convertible notes are debt instruments and can be easily applied to either LLCs or corporations. However, since SAFEs grant investors the right to directly purchase equity in the company, even if executed at a future date, a corporate structure will likely be a prerequisite. While converting an LLC to a corporation is not necessarily a painful process, it can extend the timeline for receiving funding and result in higher legal fees.

From an investor perspective, the lack of a maturity date may cause heartburn in certain scenarios. For example, if a company is doing well after a SAFE round and does not need to obtain future financing, then a SAFE may technically never trigger a conversion event. However, in such a scenario, it is more likely that the founders will be able to negotiate a fair process with the investors. Nevertheless, the founders will have significant leverage in such discussions.

Advantages:

- One of the least complex financing structures. It offers more flexibility for the company to plan future financing rounds, if any.

- Can be converted into equity. The company is not under pressure to repay the funds because there is no term or maturity date.

Disadvantages:

- If an LLC, then the company may need to convert to a corporation prior to receiving funds. This can delay the closing date and increase legal fees.
- It is a relatively new financing structure, so investors may be unaware or unfamiliar with the terms, depending on the investor's experience.

This article is not meant to suggest that fundraising is necessary for all entrepreneurs. In fact, it is often beneficial for a startup to avoid raising funds from third parties as long as possible. Fundraising is an arduous process that can distract from business development. It introduces a new dynamic of working with investors--outside third parties who are sometimes interested in realizing a profit as soon as possible. This can create significant stress for entrepreneurs, so it is often better to avoid searching for outside capital unless and until you conclude such financing is necessary to fulfill your entrepreneurial vision for the company.