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Series Seed Financing

Tech Coast Angels
October 22, 2020

Early Stage Financing

Main Choices

- **Series A Preferred Stock**
- **Convertible Note**
- **SAFE**
- **Series Seed Preferred Stock**



Why Not Series A?

- **Complexity**
 - At least six documents, often eight or more
 - Many terms not needed at angel stage
 - “Too complicated for 90% of the folks out there doing the deals.” Jason Mendelson
- **Commitment to Valuation**
- **Cost – Investor Counsel**
 - Minimum \$20k
 - Average \$50k+



Convertible Notes

Pre-2005 Background



“Bridge Notes”

Bridge from Series X to Series Y

- **Minimal reps and warranties**
 - Often the same investors
 - Short duration < 1 year; relatively certain Series Y will occur
- **No Board seat or information rights**
- **Low interest**
- **Warrants often issued rather than discounts**
- **Low risk about clarity on conversion**
- **No discount on conversion!**
- **No valuation cap!**



2005 Bridge Notes “Converted” to Seed Financing

- \$300k to \$750k could now significantly improve a startup providing a 12-18-month runway before a \$3M+ Series A
- Less complex and quicker to negotiate than Series A
- Maturity dates were no more than one year
- More protection than Common Stock
- Less costly than Series A
- No valuation discussion – no valuations caps used yet
- Only other choice was Series A or Common Stock





Bridge Notes “Converted” and Made More Complex

- Discounts (~15-30%) soon replaced warrants
- Valuation caps; by 2012, 90% had caps
 - Valuation discussion
- Maturity dates extended to 1-3 years after an amendment to the CA Finance Lender’s Law in 2014
 - Original Issue Discount Tax
 - IRC 1202 Tax
- Security agreements
- Conversion to “shadow preferred” to avoid “liquidation overhang”
- “Equity” rights (board and info rights, reps and warranties, veto)
- Conversion terms to avoid the “shuffle”



Three Important Rights*

Up: Pro rata rights

Down: Priority or liquidation preference

What the F* is Going On:** Board seat / information rights



* Brad Feld, May 7, 2012, VC Rights: Up, Down, And Know What The Fuck Is Going On:
<https://feld.com/archives/2012/05/vc-rights-up-down-and-know-what-the-fuck-is-going-on.html>

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Convertible Note Rights



Up	
MFN	✓
Pro Rata	✗
Ownership Clarity (“Shuffle”)	✗
Change in Control Min Return	✓
Down	
Liquidation Pref or Priority	✓
What’s Going On	
Reps and Warranties	✗
Board Seat	✗
Information Rights	✗
Protective Provisions - Veto	✗
Tax	
IRC 1202 or LTCG	✗
Original Issue Discount Income	✗



Series Seed Preferred Stock

2008-2010 Series Seed is Promoted

- 2008 Wilson Sonsini and Y Combinator Series AA
- 2008 Cooley and TechStars Series AA
- 2010 Ted Wang (Fenwick) Series Seed on www.seriesseed.com

Current Sources

- Ted Wang (Fenwick) (last updated Feb 2014):
 - www.seriesseed.com
 - <https://github.com/seriesseed/equity>
- Cooley (Regular updates – last 2017)
 - <https://github.com/CooleyLLP/seriesseed/>
 - CooleyGo: <https://www.cooleygo.com/documents/series-seed-notes-financing-package/>



Why Series Seed

- **Complexity**
 - 2-3 documents (Term Sheet, COI, Investment Agreement)
 - Important terms are included
- **Commitment to Valuation**
 - Notes don't avoid valuation with valuation cap
- **Cost – Investor Counsel**
 - Not significantly different from Notes versus value
- **Tax**
 - IRC 1202
 - Original Issue Discount



Notes versus Series Seed

	Convertible Notes	Series Seed
Up		
MFN	✓	✓
Pro Rata	✗	✓
Ownership Clarity ("Shuffle")	✗	✓
Change in Control Min Return	✓	✗
Down		
Liquidation Pref or Priority	✓	✓
What's Going On		
Reps and Warranties	✗	✓
Board Seat	✗	✓
Information Rights	✗	✓
Protective Provisions - Veto	✗	✓
Tax		
IRC 1202 or LTCG	✗	✓
Original Issue Discount Income	✗	✓



The Shuffle and the Tax

Assumptions:

- Angel Round: \$1M on \$4M Pre or Cap; 20% Discount, 7% Interest
- Series A: 18 months post Angel; \$3M on \$12M Pre; Increase Option Pool
- Exit 5 ½ years post Angel; \$50M

Convertible Notes Scenario 1	Post Money		Payout	OID Tax	LTCG Tax	Total Tax	Take Home
	Shares	%					
Founders / Advisors / Options	11,000,000	65.52%	\$32,760,548				
Angel Investors - Notes	3,038,486	18.10%	\$9,049,315				
> Each Angel at \$50k	151,924	0.90%	\$452,466	\$14,791	\$90,493	\$105,285	\$347,181
Series A Investors	2,750,000	16.38%	\$8,190,137				
Total	16,788,486	100.00%	\$50,000,000				
Convertible Notes "Shuffle"	Post Money		Payout	OID Tax	LTCG Tax	Tax Paid	Take Home
	Shares	%					
Founders / Advisors / Options	11,000,000	63.94%	\$31,971,493				
Angel Investors - Notes	2,762,260	16.06%	\$8,028,507				
> Each Angel at \$50k	138,113	0.80%	\$401,425	\$14,791	\$80,285	\$95,077	\$306,349
Series A Investors	3,440,565	20.00%	\$10,000,000				
Total	17,202,825	100.00%	\$50,000,000				
Series Seed Preferred Stock	Post Money		Payout	OID Tax	LTCG Tax	Tax Paid	Take Home
	Shares	%					
Founders / Advisors / Options	11,000,000	65.19%	\$32,592,593				
Angel Investors - Seed	2,500,000	14.81%	\$7,407,407				
> Each Angel at \$50k	125,000	0.74%	\$370,370	\$0	\$0	\$0	\$370,370
Series A Investors	3,375,000	20.00%	\$10,000,000				
Total	16,875,000	100.00%	\$50,000,000				



“Over time, equity rounds have become cheaper to consummate, and the legal fees argument doesn’t carry much weight these days. In the end, the main force driving the use of convertible debt in early-stage companies is the parties’ desire to avoid setting a valuation.”

- Brad Feld, Jason Mendelson; Venture Deals

“Do priced equity rounds instead of notes. As I wrote seven years ago, the cost of doing a simple seed equity deal has come way down.... Honestly, I wish the whole scourge of notes would go away and we could go back to the way things were done for the first twenty years I was in the venture capital business.”

- Fred Wilson, AVC, March 12, 2017



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