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Choosing the Right Seed Financing Instrument for Startups

Insights
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Practical Law's **Choosing the Right Seed Financing Instrument for StartupsChecklist** compares the pros and cons of the most commonly used startup seed financing instruments. When advising startup founders or investors about structuring a seed-stage investment, counsel should evaluate the advantages and disadvantages of each of the following types of instruments:

- Convertible notes.
- Simple agreements for future equity (SAFEs).
- Convertible preferred stock (Series Seed).
- Common stock.

Note that many of the items discussed below as pros from the perspective of a company's founders may well be cons from their investors' perspective (and vice versa).

Convertible Notes

Pros

- **Familiarity.** Convertible notes have recently been one of the most popular instruments for seed investments. As a result, seed investors are often most familiar with this instrument.
- **Simplicity.** Convertible note documents tend to be short and have relatively few negotiated terms. Notes are also fairly easy to explain to unsophisticated investors.
- **Cost.** The cost advantage of using convertible notes over preferred stock is largely due to the longer and more complex equity transaction documents and the necessity of amending and restating the company's certificate of incorporation (or charter), which incurs filing fees from state governments and service providers.
- **Equity incentives.** Structuring a seed investment as convertible debt typically minimizes the impact of the investment on the fair market value of the company's common stock, making the company's equity incentives for employees more attractive and valuable.

Cons

- **Uncertainty.** Convertible notes create uncertainty for founders and investors related to the percentage of the company they each may eventually own once the notes convert into equity.
- **Maturity and interest.** Many founders dislike that convertible notes eventually mature, potentially giving their investors leverage to extract a better deal if the notes have not yet converted. Even if the noteholders are willing to extend the notes without any financial sweeteners from the company (which they often are), the company typically still incurs some legal fees to document the extension. Founders also often view offering accruing interest as inconsistent with the notion that convertible notes are effectively deferred equity.
- **Unintended outcomes.** The terms of convertible notes can sometimes lead to unintended outcomes when compared with the market terms and conventions for seed equity. For instance, a plain-vanilla convertible note has features that may effectively give the noteholders more than full ratchet anti-dilution protection or a liquidation preference that is several times the purchase price of the notes, both of which would be considered wildly off-market in a seed equity deal for an identically situated company.

Simple Agreements for Future Equity (SAFEs)

Pros

- **Simplicity.** SAFE documents tend to be even shorter than convertible note documents and have fewer negotiated terms (only the discount and valuation cap).

- **No maturity or interest.** Many founders consider the fact that SAFEs never mature (and the peace of mind it brings them) to be a major selling point for using SAFEs instead of convertible notes. The lack of interest also saves the founders from additional dilution at conversion, though the amount of dilution resulting from the interest on convertible notes tends to be minimal.

- **Similarity to convertible notes.** Aside from the lack of interest and maturity, SAFEs are designed to have the same economics and mechanics as convertible notes, an instrument that most seed-stage investors are already familiar with.

- **Cost.** The cost of documenting and closing a SAFE round is generally comparable with the cost of a convertible note financing (see "Cost" under Convertible Notes: Pros). Over the life of the two instruments, SAFEs may be slightly less expensive in certain cases because they do not mature. Some convertible note issuers may incur additional legal fees to extend the maturity of their notes.

- **Equity incentives.** When compared to convertible notes, structuring a seed investment using SAFEs may have an adverse effect on the fair market value of the company's common stock for equity incentive purposes. However, the effect is still likely less adverse than it would have been if the company structured the investment using convertible preferred stock and significantly less adverse than using common stock.

Cons

- **Unfamiliarity.** Many seed investors who do not regularly invest in startup companies may have never heard of a SAFE and may struggle to understand exactly what it is.

- **Uncertainty.** SAFEs result in the same pricing uncertainty found in convertible notes (see "Uncertainty" under Convertible Notes: Cons).

- **No maturity or interest.** Some investors may prefer investing in early-stage companies through convertible notes because SAFEs have no maturity date and offer no interest.

- **Unintended outcomes.** SAFEs can result in the same unintended outcomes discussed in the context of convertible notes (see "Unintended outcomes" under Convertible Notes: Cons).

- **Tax treatment.** Market participants remain uncertain about the proper tax treatment of SAFEs.

Convertible Preferred Stock (Series Seed)

Pros

- **Certainty for investors.** Some of the more sophisticated seed investors may prefer investing in convertible preferred stock because they have control over the negotiation of the price and terms of the stock at the time of the investment.

- **Certainty for founders.** Structuring a seed investment using convertible preferred stock allows founders to know exactly how much of the company they own immediately after the financing closes.

- **Simplicity of next financing.** There are several ways to calculate the conversion of convertible notes and SAFEs in connection with a Next Equity Financing, and the method is rarely legislated ahead of time. This means that the Next Equity Financing is often more complex (and therefore more costly) when notes or SAFEs are converting as part of the round. Companies can avoid this additional complexity when they structure their seed rounds using convertible preferred stock.

- **Familiarity.** If a seed round consists mostly of sophisticated seed investors (or a sophisticated lead investor), they are likely familiar and comfortable with convertible preferred stock and its terms.

Cons

- **Complex documents.** Preferred stock financing documents tend to be longer and more complicated than convertible note or SAFE documents.

- **Cost.** Due to the greater length and complexity of the documents and the necessity of amending and restating the company’s charter, preferred stock financings typically cost more in legal and filing fees than convertible note or SAFE financings.

- **Equity incentives.** When compared to convertible notes or SAFEs, structuring a seed investment using convertible preferred stock typically has an adverse impact on the fair market value of the company’s common stock for equity incentive purposes. However, the effect is still significantly less adverse than it would be if the company structured the investment using common stock.

Common Stock

Pros

- **Simplicity.** Common stock is by far the simplest of the seed investment instruments. It typically does not include any special rights, preferences, or privileges. However, it is possible to contractually provide many of the same protections that are typical of preferred stock investments.

- **Cost.** The documents that the founders used to acquire their common stock at the company's incorporation (such as a founder stock purchase agreement) can often be easily retooled for use with investors who are willing to purchase common stock, creating savings on legal fees. In addition, if there are sufficient shares of common stock available for the investors, there is typically no need to amend and restate the company's charter, creating savings on filing fees.

- **Equality.** Some founders and investors like that they receive the exact same security. Their rationale is that this closely aligns the incentives between the founders and their earliest investors because they are all treated the same.

Cons

- **Equality.** Equality can also be a drawback for investors purchasing a startup's common stock. Investors naturally prefer to have the additional rights, preferences, and privileges that later institutional investors that purchase preferred stock in future financing rounds receive.

- **Equity incentives.** Structuring a seed investment using common stock typically has the most adverse effect of all the seed investment instruments on the fair market value of the company's common stock for equity incentive purposes.

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