STARTUP LEGAL PLAYBOOK

Preparing for a seed round

AUTHORS

T

Torys’ Emerging Companies and VC Group

Read this if: you are raising external capital for the first time

You might also like: Startup funding explained: types and strategies

Go deeper: Raising capital

Gearing up to raise money from investors can bring with it a lot of questions and challenges. It's important to go into the process with a firm understanding of both the various financing structures that are available to you, as well as how to streamline the fundraising process so that you can take in capital for your startup as quickly and efficiently as possible. We break down what you need to know when preparing for a seed round below.

What is a seed round?

A seed round is typically the name given to the first external “real” capital that you raise from institutional investors such as early-stage venture funds, VCs, and angel investors. This is different to the money raised from friends and family (i.e., a “friends and family round”).

Depending on the kind of structure you and your potential investors agree upon, the seed round may also be the first time you, as a founder, will put a valuation on your startup and issue preferred shares to investors.

How should I structure a seed round?

Regardless of the kind of fundraising round, a startup will be expected to issue securities, such as shares, in exchange for the money that investors are putting into the company. Investors purchase these securities via specific agreements which are referred to as instruments. These instruments set out the investment terms, i.e., the structure, that will govern the investment.

In a seed round, simple instruments are quite common. They are called simple instruments because they are straightforward agreements, usually with little negotiation needed—compared to the alternative approach of issuing preferred shares to investors and having more complex negotiations around them.

The two most common simple instruments are 1: the Simple Agreement for Future Equity, which is referred to as a SAFE and 2: convertible notes. Both SAFEs and convertible notes are convertible securities, meaning that an investor will invest in a startup today, in exchange for a promise that they will be given shares in the startup when it raises money in the future. Both the SAFE and convertible note are designed to convert automatically into preferred shares upon the next preferred share financing.

There are some differences between the two instruments. A SAFE, as the name suggests, is an agreement to issue shares in your startup in the future and is usually considered an equity instrument on the balance sheet. A convertible note, on the other hand, is an outstanding liability or debt obligation of the company, which will accrue interest. This will have many similarities to a typical loan and tends to be more investor-friendly, meaning more negotiation points to work through.

Despite being categorized as “simple instruments”, SAFEs and convertible notes both require very thoughtful consideration looking to leverage them to raise money. While pushing the issuance of shares to a later date has its benefits, it means that you are also pushing important discussions and negotiations around governance and economic rights. More importantly, SAFEs and convertible notes can be quite dilutive once they convert into shares.

Preparing a financing model or pro forma cap table to better understand how your cap table will ultimately look once the financing is complete is a key step in preparing to fundraise.

What are the alternatives to SAFEs and convertible notes?

Another option to a SAFE or a convertible note is to issue preferred shares at a fixed valuation to your investors. However, to do this, you must put a valuation on your company, which takes time and careful negotiation with your investors. You must be cautious not to set the valuation too high as it will set the floor for future raises.

As this option involves issuing shares directly to your investors, you will also have to discuss the rights, restrictions and privileges that come with those shares. This process will include negotiating shareholder agreements, subscription agreements and other documents. As a result, this process can be very time-consuming and expensive. VCs usually prefer this financing structure because of the additional protections, rights, and certainty that it provides them—however, SAFEs and convertible notes are generally considered standard practice at the seed stage, including by investors in the startup ecosystem.

To discuss these issues, please contact the author(s).

← Back to Startup legal playbook home

Get to know our ECVC practice

→ Learn more about our team

We work closely with players across the startup ecosystem to advise founders on formation, scaling and exits, as well as connect investors to high-growth opportunities.

→ View our Startup terms glossary

Learn the ins and outs of the commonly used terms in the startup and VC ecosystem.