STARTUP LEGAL PLAYBOOK

Startup funding explained: types and strategies

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Read this if: you're thinking about a raise at any stage of your startup's lifecycle

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Go deeper: Raising capital

Startup capital comes in many forms, and the most appropriate one for your business depends on several factors. Below are the most common ways to finance a startup.

Bootstrapping

Bootstrapping is when a founder uses their own personal assets or business revenue to fund the operation and growth of the startup. This is common when the company is in its very early stages or cannot yet attract equity investment. This is sometimes referred to as pre-seed funding. Successful bootstrapping requires a tight adherence to budgets, keeping lean operating costs, and having a business plan for generating revenue quickly. Later-stage startups will sometimes use bootstrapping as a bridge between funding rounds.

Friends and family round

Another form of pre-seed funding is a friends and family round. As the name suggests, this involves receiving funding from friends and family rather than accredited investors. Many founders will offer friends and family an equity stake in their startup in exchange for funding. If you decide to do this, you must be mindful of how much equity, or future equity, you offer and clearly document each offer, or else you can come into issues regarding ownership or excessive unanticipated dilution as your startup grows.

Angel investment

Angel investors are individuals who make investments in startups for an equity stake or convertible debt, generally at earlier stages when there is still a large amount of risk. Accordingly, angel investors have a higher appetite for risk in their pursuit of a higher rate of return. These are accredited investors, and the capital they invest comes from their own net worth. It is common for a group of angel investors to invest together.

Venture capital

Venture capitalists (VCs) also make investments in companies for an equity stake; however, they use capital from an investment fund. The venture capital fund is capitalized by investors designated as limited partners and strategically managed by a general partner.

Stages of VC funding

The initial round of funding for a startup is sometimes referred to as seed funding, with subsequent funding rounds being referred to as series funding. Series funding ranges from Series A, B, C to D. Below are some general benchmarks relating to each series of funding:

- **Series A** funding is raised by startups when they have traction (e.g., revenue, number of customers).
- **Series B** funding is raised by startups that have product-market fit.
- **Series C** funding is raised to allow market expansion, develop new products, or otherwise grow the business. This is often the last stage of funding before a company looks to IPO or be acquired.
- **Series D** funding is sometimes raised if a company wants to raise its value before IPO, or it has identified further opportunities for which additional capital is needed.

Types of VC funding

Venture capitalists invest in startups in a few different ways, called instruments. The instrument you choose will depend on many factors, including how much money you're raising and your company's expected growth trajectory. Pay careful consideration to the rights granted to investors in early-stage fundraising rounds, as mistakes made in these financings can cause issues down the road.

The most common instruments used for VC investments are SAFEs, convertible notes, and preferred share financings.

Simple agreement for future equity (SAFE)

A SAFE gives the investor the right to future equity in your startup following the company's completion of a qualifying priced round of financing in exchange for their immediate, early investment. This is the simplest agreement used in the market to raise funding for early-stage companies and is most appropriate for bridge rounds or rounds that are raising less than $2M.

The biggest advantage of using a SAFE is that you and the investor don't need to agree on the exact valuation of your company at the date of the agreement. This is very valuable for early-stage startups who might not have enough user data, traction, or revenue on which to base a valuation. A SAFE is a simpler, more standardized instrument than a convertible note and is quicker to put together, but it offers investors fewer protections and more limitations due to its simplicity.

A SAFE, like a convertible note, typically provides the investor with some form of economic benefit for their earlier investment in the company in the form of either (or both) a discount or valuation cap which affects the price per share at which the SAFE converts into shares at a later date. However, unlike a convertible note, a SAFE is treated as equity as opposed to debt on the company's balance sheet. Because debt is repaid in priority to equity following a liquidation event of a company, this makes SAFEs an inherently riskier instrument of investment for investors, which can make them less desirable for them than convertible note instruments. That being said, if you sell your company while SAFEs are still outstanding (i.e., they have not yet been converted into shares), they will be senior to the common shares (which is the class of shares typically held by founders). This means that the SAFEs need to be paid out prior to the founders receiving any proceeds in an exit. You can find a sample SAFE here.

Convertible note

A convertible note is like a SAFE in that you can defer valuation to a future date, and it is most appropriate for bridge rounds or rounds that are raising less than $2M. The key difference is that convertible notes are more customized, have a maturity date and bear interest—so they are classified as debt rather than equity from an accounting perspective.

For this reason, early-stage, pre-revenue startups tend to avoid convertible notes in favour of SAFEs. Convertible notes are also less standardized than SAFEs, resulting in more negotiation between the parties. As in the case of a SAFE, convertible notes often include a discount or valuation cap as an economic incentive for investors to invest in advance of a priced round. You can find a sample convertible note here.

Preferred share financings

These instruments tend to be the venture capitalist's instrument of choice. While preferred share financings are far more complex than SAFEs and convertible notes, they offer investors the most protection from an equity ownership perspective, understanding that debt continues to sit ahead of equity on the liquidation stack. Preferred shares are more appropriate for rounds that are more than $2M.

As their terms are usually heavily negotiated and require much more paperwork, you will spend a lot of time structuring the deal which can result in higher legal fees. This is another reason why this instrument is usually reserved for larger financing rounds.

Beyond VC instruments: Term sheets and cap tables

Regardless of the investment instrument, and the amount of capital to be invested, there are two key things that you need to include in your equity fundraising process: a term sheet and a pro forma cap table.

Term sheet

Term sheets are instrumental to the fundraising process as they summarize the principal terms of the deal. The purpose of the term sheet is to make sure that all parties are fully aligned on the key terms of the financing—which can include the financing amount, the type of instrument to be used (i.e., SAFE, convertible note or preferred share financing), the timeline to complete the financing, investor rights, the steps required to complete the transaction and who is responsible for each step.

Many founders will note that they have an agreement *in principle* with their investors and so they want to skip the tertiary stage and go straight to finalizing these documents in a bid to save time and money. However, this is almost always invariably more expensive, as there are legal fees related to negotiating the principal transaction documents, and the more negotiation involved the higher the fee. Therefore, you should spend time discussing and agreeing upon the terms of the deal with the investor at the term sheet stage (to make sure that everything you think has been settled is truly settled) before you incur costs related to the negotiation of the final transaction documents.

However, while it is recommended to have agreed upon the key rights and responsibilities that will be laid out in the term sheet before you engage legal counsel, it is important that you do not sign the term sheet until it has been reviewed by your lawyer. This is because the term sheet may include provisions that will result in you unknowingly conceding less obvious, but no less material, parts of your company.

Your lawyer's job is to identify all scenarios and help you pick the best agreement for your startup. Sometimes founders will realize at the term sheet review stage that the terms offered do not align with what they are looking for; if this happens to you, you can negotiate the terms or not go through with the deal. Once the term sheet is settled, it will serve as a roadmap to your counsel when they are drafting other key transaction documents.

You can find a sample term sheet here.

Pro forma cap table

While the term sheet is being negotiated, you should also be thinking about your pro forma cap table and building out a model of the entire round. The pro forma cap table is designed to show you what your equity stake looks like post-financing. The reason why you want to build it up at the term sheet stage is that, as the negotiations evolve and the terms are changing, you can plug in each of the assumptions and changes and see what the impact is on your equity interest post-closing.

A common misconception is that this is only something you need to do for a priced round because at a convertible round you might not know exactly how the notes are going to convert. However, this kind of forecasting is relevant even in a convertible round or in a SAFE financing, because you can model in certain assumptions about the conversion and see what your equity stake would look like in even the worst-case scenario.

The pro forma cap table is one issue to consider when preparing for legal due diligence before you fundraise.

Venture debt

Venture debt is a loan that is secured by the startup's assets. This kind of loan is offered to high-growth startups that have already received investment from VCs and is often used to complement equity raised. Venture debt helps to generate operating cash and is usually paid back in installments.

Strategic investors

Strategic investors, known as corporate venture capital (CVC), are usually a department or a separate subsidiary of a large operating company. A CVC invests directly from the company's balance sheet, usually in a startup operating in the same or complementary industry. CVCs generally do not invest at the seed stage and instead invest at a later round. CVCs participate on the same customary terms and conditions as traditional VC investors and operate under standard VC documents and market terms.

This article focuses on general market terms; however, there is no one-size-fits all approach to funding agreements and individual deals may include their own unique features.

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

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