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April 6, 2011 by Sheppard Mullin

Starting Up the Start-Up: Approaching the Angel Financing Round

By Riaz Karamali

This blog post picks up where the last post in this start-up series left off, with the assumption that the start-up has been in incorporated, completed its founders' round of financing, created an executive summary and pitch deck and is ready to begin the hunt for "angel" investors (as used in this post, the term angel investors will include all types of potential investors in a company's initial or seed round of funding, including founders' friends and family, "super-angels" and early stage funds). There are several different structures an angel or "seed round" can take -- among them, sale of common stock, sale of convertible notes, and sale of a "light" preferred stock. While ultimately, the investor group may have the final say over the structure of the financing, it makes sense to understand the alternatives in advance and approach investors with a clear plan in mind.

Sale of Common Stock. Historically, a start-up's very first round of financing was raised was raised from a small circle often including (if not limited to) the founders, their immediate friends and family and early advisors who have been providing input and guidance to the founders. For the sake of simplicity, this round was often structured as a sale of Common Stock at an agreed valuation. While this is an easy and inexpensive way to go, it provides investors with none of the rights that later investors in the company's preferred stock will have, and leaves them at risk of significant dilution if, in hindsight, the agreed valuation turns out to be too high in comparison with the next round of financing. From the company's perspective, you have now set a valuation for the common stock which acts as a precedent for the exercise price of stock options to be issued to advisors, consultants and early advisors. In practice, this may mean that these options will need to be priced at an exercise price that is higher than would have been the case if the company had pursued one of the alternative financing structures discussed below.

Sale of Convertible Notes (Uncapped). Probably the most widely used mechanism for angel financing rounds is the sale of convertible notes which automatically convert into the company's first round of preferred stock financing that meets certain threshold requirements. The conversion typically takes place at an agreed discount from the price paid by the new investors in the preferred stock financing to help compensate the note purchasers for the early investment risk they incurred. Sometimes the notes come with warrant coverage and/or other features that are designed to provide additional benefits to the early investors. Documenting and negotiating a convertible note round is relatively inexpensive and straightforward, and generally fits well into the current "lean startup" model. A great advantage of this structure for the company is that it is not necessary to agree upon a valuation, and the company receives investment today that can be used to help grow the business and justify a healthy valuation for its first priced round. One minor complication for the company is that when it completes its round of preferred stock financing and these angel noteholders convert in at a discount, they will have the benefit of the full liquidation preference granted to the preferred stock investors. So, if the preferred stock investors are paying $1.00 per share and the notes carry a 20% discount enabling the note holders to effectively pay $0.80 per share, then on a liquidation or sale event, both sets of investors will typically be entitled to a liquidation preference of $1.00 per share, which the new preferred investors may view as inequitable. On a separate note, from the perspective of the angels, there is a potential downside posed by the fact that we are living in an age when the hottest social media start-ups can quickly go viral and achieve profitability on a much smaller initial investment than in the past. If the preferred stock round is at a very high valuation, then the angel investors, although getting the agreed discount, may feel that they have largely funded the company's meteoric growth but are not able to share equitably in the ensuing increase in valuation. Also, if the company does not outperform expectations, then there is a risk that the preferred stock investors will, as a condition to closing, require the angel note holders to relinquish their conversion discount, warrants and other negotiated benefits.

Sale of Convertible Notes (Capped). As sophisticated angels began to understand the double-edged nature of a meteoric rise in valuation (as described in the preceding paragraph), they often began to ask for a cap on the conversion price of the note. In this structure, the convertible notes convert into the preferred stock financing at either an agreed discount or at the agreed capped valuation, whichever is better for the note holders. So, for example, if a note specifies a 20% discount and a $5 million conversion cap, then if the subsequent preferred stock financing occurred at a $4 million pre-money valuation, the notes would convert to preferred stock at the per share price that implied a $3.2 million pre-money valuation. If, on the other hand, the subsequent preferred stock financing occurred at an $8 million pre-money valuation, then the cap would kick in and the notes would convert into preferred stock at the per share price that implied a $5 million pre-money valuation, rather than the $6.4 million valuation that would otherwise apply based on a 20% discount. Depending on where the cap is set, a capped convertible note round can provide the company with most or all of the same benefits of an uncapped round, while ensuring the investors that they will have a fair share of the company if it turns into a huge success. From the company's perspective, the cap amount should be set not at the company's fair market value at the time of the investment, but at a healthy premium from that value assuming that reasonable milestones can be achieved by the company prior to its financing round.

"Light" Preferred Financing. In the past many players in the start-up ecosystem believed that it did not make sense to do a preferred stock financing at less than a certain threshold amount (perhaps around $1 million) in light of the inherent transaction costs. In light of some of the issues involved with convertible notes in the current financing climate, there is an increasing trend towards seed preferred or “light” preferred rounds instead of convertible note financing. While most law firms active in the space always had their own versions of these “light” documents, various angel groups and law firms have come forward with their own “open source” forms, which they are encouraging all parties to use in an attempt to create a standard that does not need to be negotiated if the accompanying term sheet is used in an un-modified form. While this is a laudable concept, the reality of getting these deals done is often different from the stated ideal. To begin with, there are at least four different sets of these documents being circulated (TechStars Model Seed Funding Documents, Y Combinator Series AA Equity Financing Documents, Founders Institute Plain Preferred Term Sheet and Series Seed Financing Documents), with the result that none has truly become a standard. Consequently, there is a fair amount of mixing and matching and negotiations involved in many of these light preferred deals, all of which tend to drive up the transaction costs and the time required to get a deal done. Also, venture capital firms investing in these seed deals will often have additional requirements for management rights or legal opinions which will also increase the costs.

Conclusion. The right deal structure for your seed round really depends on a host of factors, including the size of the round and the identities and motivations of all parties involved. In our opinion, the best of the above alternatives for a small financing round often proves to be uncapped convertible notes. If the investors are uncomfortable with such a structure, the next best choice would, in our opinion, be a close call between convertible noted capped at a reasonable level (not current fair market value) and "light" preferred stock. On balance, when dealing with sophisticated investors and their counsel, we find that there is still a lot to be said for capped convertible notes.

This is the fourth installment of a series of blog posts addressing start-up matters specifically.

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