Dean Street Law
Business Life Cycle + Startup Financing + Legal Structure Impact
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PART ONE: BUSINESS LIFE CYCLE & INTRO TO STARTUP FINANCING

SECTION ONE: FUNDING SOURCES IN THE STARTUP LIFE CYCLE

1. Problem/Solution Fit (*Typically Self Funded*)
   a. "What problem am I compelled to solve?"
   b. "Does my proposed solution solve it effectively?"
2. Minimum Viable Product/Service (MVP) (*Self Funded, Debt and/or Seed Financing*)
   a. The MVP is a way to prove demand and learn about customer behavior while minimizing risk. The MVP has just enough functionality to allow the founders to test the market reaction to their product as cheaply as possible.
3. Product/Market Fit (*Self Funded, Seed Financing, Venture Capital, and/or Debt*)
   a. Segment your audience — make sure you are targeting the people who get value from your product.
   b. Figure out what's unique about the users that stick around and those that churn.
4. Scale (*Self Funded, Series A-C Financing, Venture Capital, Private Equity, Debt, etc.*)
   a. Double down on the top channels that showed promise during your channel exploration.
   b. Expand your growth team by hiring specialists with deep expertise in your primary channels.
5. Maturity (*Most Financing Opportunities are Available*)
   a. Keep investing in your growth team and hunting for new growth channels through continual experimentation.
   b. Look for pockets of possible target users that haven't adopted your product or service yet and try to uncover why they haven't and find ways to access them.

SECTION TWO: ESTABLISH YOUR TEAM TO SCALE YOUR BUSINESS

1. Attorney
   a. A corporate attorney with significant experience in corporate governance, corporate structure, and startup financing.
2. Accountant
   a. For the preparation and maintenance of consolidated, compiled, or audited financial statements.
   b. For assistance in tax strategy and determining the appropriate corporate structure.
3. Advisors

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   a. Mentors - An experienced and trusted advisor.
   b. Coaches - Someone who supports the growth and development of an organization.
   c. Entrepreneur - A person who organizes and operates a business/businesses.
   d. Experts - Someone who displays specialized knowledge from experience.

PART TWO: STARTUP FINANCING

SECTION ONE: TYPES OF INVESTORS

1. Friends & Family
2. Angel Investors
   a. Angel investors are high-net-worth individuals who provide financial backing for small startups or entrepreneurs, typically in exchange for equity in the company or debt.
   b. Super-Angel Investors
      i. Angel investors who have become full-time investors in early-stage startups and who often create their own venture capital (VC) funds allowing contacts in their personal networks to co-invest.
   c. Angel investors often bridge the gap between a friends and family round and venture capital and Series A rounds.
3. Venture Capital (VC)
   a. Venture capital is financing given to startup companies and small businesses that are seen as having the potential to generate high rates of growth and above-average returns, often fueled by innovation or by carving out a new industry niche.
   b. Venture capital funds usually provide investment capital, industry connections, and operational and strategic guidance to startups throughout their rapid stages of early growth.
4. Private Equity
   a. Private Equity is capital invested in a company or other entity that is not publicly listed or traded.
   b. It is a source of investment capital from high-net-worth individuals and firms. These investors buy shares of private companies.
   c. Large institutional investors dominate the private equity world, including pension funds and large private equity firms funded by a group of accredited investors.
5. Hedge Funds
   a. Hedge funds are a type of private investment fund that charges performance fees. Hedge funds are only open to a limited number of qualified accredited investors or qualified purchasers (QPs) and are largely exempt from regulation by the US securities laws and so may invest in riskier investments than would otherwise be permitted for other funds (such as mutual funds).

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6. Institutional Investors
    a. An institutional investor buys, sells, and manages stocks, bonds, and other investment securities on behalf of its clients, customers, members, or shareholders.
    b. Examples include mutual funds, pensions, and insurance companies.
7. Strategic Investors
    a. Companies investing in high-growth startups to complement their existing business lines

SECTION TWO: PRIVATE EQUITY VS. VENTURE CAPITAL

1. Key Differences
    a. Private equity firms mostly buy mature companies that are already established.
    b. Private equity firms mostly buy 100% ownership of the companies in which they invest.
    c. Venture capital firms mostly invest in startups with high growth potential.
    d. Venture capital firms invest in 50% or less of the equity of the companies. Most venture capital firms prefer to spread out their risk and invest in many different companies.

SECTION THREE: TYPES OF LENDERS

1. Private Lenders
    a. Friends, family, and private investors issuing debt instead of equity.
2. Institutional Lenders
    a. Traditional banks, credit unions, etc.

SECTION FOUR: SOURCES OF FUNDING

1. Self-funding - using your own money to get the business off the ground.
2. Crowdfunding (ex. Kickstarter and IndieGoGo) - does not usually generate large sums of capital.
    a. Equity Crowdfunding
        i. Allows startups to raise money from a large group through selling securities. However, each investment also means you're saying goodbye to equity.
    b. Debt Crowdfunding (*also known as microlending*)
        i. The crowd lends money to a business with the expectation the loan will be repaid with interest.
        ii. This is growing in popularity mainly because it may offer more favorable terms, lower interest rates, quicker approval times, and a simpler application process than other types of debt financing.
    c. Blend of Debt and Equity Crowdfunding

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        i. Using a mix of both strategies can allow for more favorable terms while also retaining more equity than simply using equity crowdfunding.

    d. Pre-selling Your Product/Service
        i. Allows businesses to raise the capital needed for a full launch while also testing the market response with lower initial risk.

3. Debt
    a. Line of Credit
        i. Business Line of Credit
            1. A business line of credit is a pool of money established by the lender with a maximum credit limit.
            2. Their advantages include its flexibility and accessibility for those with less-than-perfect credit.
            3. It may be drawn in whole or in part, and borrowers typically only pay interest on the amount of the line of credit that is used.
        ii. Personal Line of Credit
            1. A personal line of credit might be worth considering for entrepreneurs with very strong personal credit and a new business idea that you feel really good putting your own finances on the line for.
            2. Their advantages include being simple (basic personal loan) with lower interest and easier repayment terms.
            3. A major disadvantage is that the lender is entering into a contract with you as an individual—not with your business. You are fully and personally responsible for the repayment of the outstanding balance.
    b. Credit cards
        i. Issued by a bank or financial services company that allows cardholders to borrow funds with which to pay for goods and services with merchants that accept cards for payment.
        ii. They typically have substantially higher interest rates than other types of debt.
    c. Loan
        i. The lender (usually a corporation, financial institution, or government) advances a sum of money to the borrower. In return, the borrower agrees to a certain set of terms including any finance charges, interest, repayment date, and other conditions.
    d. Mortgage
        i. An agreement between you and a lender that gives the lender the right to take your property if you fail to repay the money you've borrowed plus interest.

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4. Raising Capital (*see below*)
5. Cost of Debt vs. Equity
    a. Typically, debt costs less than equity since giving up equity gives up a percentage of all future profits.
6. Joint Venture
    a. Establishing an agreement with a specific strategic company or individual that includes a contract or separate entity to contribute an agreed upon asset, investment, or resource in exchange for a percentage of the revenue or profits.

SECTION FIVE: RAISING CAPITAL

1. Seed Financing - The first round of financing that a startup completes is commonly referred to as a seed round.
    a. Friends and Family Round
        i. Most or all of the investors in a startup's seed round are close personal connections of the startup's founders.
    b. Series A Round
        i. The first financing round of a startup company led by a venture capital (VC) fund or other professional institutional investor. Series A financings typically have most or all of these characteristics:
            1. The company and the largest investor negotiate the terms of the financing and the pre-money valuation at arm's length.
            2. The largest investor is an institutional VC fund or strategic corporate investor.
            3. The largest investor conducts more legal, financial, commercial and technical due diligence than is typical in a seed financing round.
            4. The parties may use venture financing documents similar to the model documents published by the National Venture Capital Association (NVCA).
            5. The company raises at least $1,000,000, typically by issuing preferred equity securities convertible into common stock.
    c. Seed-Stage Companies Generally Issue:
        i. Convertible notes
            1. Pros:
                a. <u>Familiarity</u> - one of the most popular instruments for seed investments.
                b. <u>Simplicity</u> - tend to be short and have relatively few negotiated terms.
                c. <u>Cost</u> - cost advantages over preferred stock due to simplicity.

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d. 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.

2. Cons:
    a. Uncertainty - creates uncertainty for founders and investors related to the percentage of the company they each may eventually own once the notes convert into equity.
    b. Maturity and Interest - convertible notes eventually mature, potentially giving investors leverage to extract a better deal if the notes have not yet converted. Founders often view offering accruing interest as inconsistent with the notion that convertible notes are effectively deferred equity.
    c. Unintended Outcomes - can sometimes lead to unintended outcomes when compared with the market terms and conventions for seed equity.

ii. Simple Agreements for Future Equity (SAFEs)

1. Pros:
    a. Simplicity - SAFE documents tend to be even shorter than convertible notes.
    b. No Maturity or Interest - SAFEs never mature and the lack of interest saves the founders from additional dilution at conversion.
    c. Similarity to Convertible Notes - SAFEs are designed to have the same economics and mechanics as convertible notes, an instrument that most seed-stage investors are already familiar with.
    d. Cost - cost of documenting and closing a SAFE round is generally comparable, and in some cases slightly less expensive, with the cost of a convertible note financing.
    e. Equity Incentives - SAFEs may have an adverse effect on the fair market value of the company's common stock. 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.
2. Cons:
    a. Unfamiliarity - SAFEs are not as prevalent in some parts of the country, so investors who do not regularly invest in

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startup companies may not have familiarity with a SAFE, and may struggle to understand exactly how it works.

b. Uncertainty - same pricing uncertainty found in convertible notes.

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

d. Unintended Outcomes - same unintended outcomes as convertible notes.

e. Tax Treatment - market remains uncertain about the proper tax treatment of SAFEs.

iii. Convertible Preferred Stock (Series Seed)

1. Pros:

   a. Certainty for Investors - investors have control over the negotiation of the price and terms of the stock at the time of the investment.

   b. Certainty for Founders - allows founders to know exactly how much of the company they own immediately after the financing closes.

   c. Simplicity of Next Financing - next round of equity Financing is often more complex and more costly when notes or SAFEs are converted as part of the round. Companies can avoid this additional complexity when they structure their seed rounds using preferred stock.

   d. Familiarity - If a seed round consists mostly of sophisticated seed investors they are likely familiar and comfortable with preferred stock and its terms.

2. Cons:

   a. Complex Documents - financing documents tend to be longer and more complicated than convertible note or SAFE documents.

   b. Cost - preferred stock financings typically cost more in legal and filing fees than convertible note or SAFE financings.

   c. Equity Incentives - 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.

ii. Common Stock or Membership Interests

1. Pros:

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a. Simplicity - by far the simplest of the seed investment instruments.
b. Cost - documents that the founders used to acquire their common stock at the company's incorporation or membership interests for Limited Liability Companies (LLCs) can often be easily retooled for use with investors who are willing to purchase common stock or membership interests, creating savings on legal fees.
c. Equality - founders and investors receive the exact same security or membership interests. This closely aligns the incentives between the founders and their earliest investors.

2. Cons:
    a. Equality - investors prefer to have the additional rights, preferences, and privileges than later institutional investors that purchase preferred stock in future financing rounds receive.
    b. Equity incentives - 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.

2. Institutional Venture Financing
    a. Venture Capital Funds
    b. Corporate Venture Capital:
        i. in-house VC arms of large corporations; or
        ii. large corporations seeking to make strategic investments in high-growth businesses that may complement their existing lines of business.
    c. Growth-Focused Private Equity Funds
        i. Common types of private equity transactions include:
            a. Start-up or early stage venture capital.
            b. Late stage, growth equity minority investments in more mature companies.
            c. Leveraged buyouts, including going private transactions.
            d. Recapitalizations and distressed investments.
            e. Private investment in public equity (PIPEs)
    d. Hedge Funds, Mutual Funds, or Sovereign Wealth Funds.
    e. Venture Debt Lenders
3. Series A Financing
    a. Series A financings typically have the following characteristics:
        i. Amount raised - Companies usually raise between $3 million and $7 million.
        ii. Investors - Series A investors include venture capital funds focused on

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investing in early-stage companies and sometimes super-angels.

    iii. Instruments - Investors in VC-led Series A rounds purchase convertible preferred stock almost exclusively.

4. Later Series Financing
    a. Startups that have used the funds they raised in their Series A round to build scalable businesses generally continue to raise increasingly larger amounts of capital as they focus on pursuing rapid growth. The instruments used in these later stages mostly include convertible preferred stock.
    b. The negotiation generally focuses on:
        i. Whose approval is required for the company to take certain actions?
        ii. Who will serve on the board of directors or other governing body?
        iii. Which actions will require stockholder approval?
        iv. How much coverage and disclosure the company's representations and warranties should require?
        v. Whether founders and early employees should have an opportunity to sell a portion of their holdings?
5. Bridge Financings
    a. Convertible notes are frequently used as bridge financing for companies that need additional capital before being able to close their next round of equity financing or sell the company. In this context, they are often referred to as bridge notes.
        i. Bridge notes are functionally the same as the convertible notes used at the seed stage. While they contain all of the same key provisions as seed-stage convertible notes, the economic terms are often substantially different, reflecting the later stage and different circumstances in which bridge notes are most commonly used.
        ii. Bridge notes are also used as interim financing at a higher interest rate and shorter term of the loan (typically 12-18 months) that are intended to be replaced by term loans or lines of credit with a lower interest rate and longer maturity term from institutional lenders.
    b. There are two basic scenarios in which a later-stage company will need to use bridge notes:
        i. Bridge of Necessity
            1. The stockholders are left with no alternative to winding up operations and liquidating the business.
        ii. Bridge of Choice
            1. Happens when a startup is running low on cash but is otherwise doing quite well. With some extra time and a modest amount of capital, there is a good chance the company would be able to hit an important operational or financial milestone, allowing it to raise additional outside capital on attractive terms at a much higher

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valuation.

6. Venture Debt
    a. Early-stage startups are rarely candidates for commercial bank loans unless the founders are willing to give personal guarantees and have sufficient personal assets to pledge as collateral. However, once a startup has institutional VC investors, there are certain banks and venture lenders that offer commercial lending services.
7. Small Business Association (SBA) Loans
    a. For mature companies seeking private equity funding, they may also seek funding from the SBA, which can require at least three years of solid financials, a personal guarantee, and sufficient personal and/or business assets.

PART THREE: IMPACT ON CORPORATE STRUCTURE FOR STARTUP

1. Notes on the impact of certain funding strategies with respect to corporate structure decisions
    a. The primary difference between a Limited Liability Company (LLC) and a corporation is that a LLC can have different preferential rights between owners, one hundred percent of the membership interest in a LLC must be allocated at all times whereas a corporation may have ownership interests that are issued and outstanding. For this reason certain funding strategies require using a corporation as the entity structure rather than a LLC.
2. Certain funding strategies impact corporation structure options available.
    a. Convertible notes are only for corporations.
    b. Common and preferred stock is only for corporations.
    c. SAFEs are only for corporations.
3. Consult with an attorney and accountant to determine the best corporate structure based on the funding strategy.

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