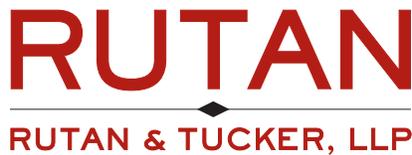


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Play It Safe or Kiss and Tell

Either Way, Seed Accelerators Continue Their Efforts to Standardize Startup Financing

by Garrett Sleichter, Partner, and Celeste Ahl, Associate, Rutan & Tucker, LLP

Startups come in different shapes and sizes, but they tend to share a common characteristic – need of capital. Startups are also typically difficult to value. Venture capital firms, which are the logical candidate to value and invest in a startup, have been more hesitant to make equity investments in pre-revenue companies since the 2008 financial crisis. Given a startup’s lack of operating history and little or no financeable assets, it is also difficult for them to secure traditional sources of debt funding. To meet this gap in the market, recent years have seen a trend of seed-round financing in the form of convertible notes, where the notes convert into equity once the startup closes a subsequent, more traditional round of equity financing. This structure allows the convertible note investor to receive stock once there is a more established basis for valuation. Plus, the noteholder is entitled to repayment upon maturity if a conversion event does not occur, just like with traditional debt (although the likelihood of a startup that fails to reach its first equity financing round having funds or assets to satisfy its convertible note obligations are typically remote at best).

To compensate investors for the increased risk of their early-stage investment, the convertible notes often feature a conversion discount, a valuation cap, or both. Advantages of this convertible note structure is that it does not require valuation of the startup and typically involves significantly less negotiation and drafting than a typical preferred stock financing.

But there are some down sides. Since the convertible note is a debt instrument, the startup is required to carry the investment as a liability on its balance sheet and must repay the note if a future round of financing or sale of the business does not occur prior to the note’s maturity. Issuing debt can also potentially implicate certain regulatory issues depending on the startup’s industry. And while typically less complex than other financing structures, convertible notes require at least moderate negotiation and drafting and the terms and form of convertible note documents can vary significantly based on the investor and its counsel.

In the continuing evolution of early-stage financing, over the

past 14 months two Silicon Valley-based seed accelerators, Y Combinator and 500 Startups, have unveiled new forms of financing documents aimed at bringing more standardization to the structure and terms of seed financing.

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SAFE Financing

In December 2013, Y Combinator released a set of documents called SAFE (simple agreement for future equity). According to Y Combinator's website, "SAFE...is intended to replace convertible notes in most cases, and we [Y Combinator] think it addresses many of the problems with convertible notes while preserving their flexibility."

SAFE is not truly a debt structure, since it does not provide for interest and does not have a maturity date. Instead of these debt features, the SAFE documents contain a conversion feature that does not give fixed return, but still offers a liquidation preference similar to what investors might have in a customary preferred stock offering. As a result, Y Combinator and other commentators promote SAFE as a financing that, in contrast to a convertible note, is not carried on the startup's balance sheet as a liability. Y Combinator has made available to startups and investors four types of SAFE financing documents: 1) Cap with no discount; 2) Discount with no cap; 3) Both cap and discount; and 4) A most favored nation clause with neither cap nor discount.

While the SAFE documents and structure avoid some of the negative issues associated with convertible notes, they also tend to be startup-friendly compared to typical seed financing documents – with the result that a number of investor groups have expressed resistance in investing through a SAFE financing structure.

KISS Financing

In July 2014, 500 Startups released its KISS (Keep it Simple Security) financing documents. Like SAFE, KISS is aimed at bringing more standardization to the structure and terms of seed financing, albeit with more traditional, investor-friendly documents. According to 500 Startups, the KISS documents are derived from its research and compilation of the most frequently used versions of convertible notes. 500 Startups has made two types of KISS financing documents available: one for a convertible debt structure and one for an equity structure somewhat similar to SAFE. Based on the 500 Startups website, its KISS documents are designed to be "flexible without being overly customizable, simple while still including all of the necessary features, and balanced from both a company and investor standpoint."

KISS documents are available on the 500 Startups website or may be prepared through a number of automated online platforms, including Clerky (which is, somewhat ironically, a Y Combinator startup). When utilizing an automated platform, the KISS documents are personalized automatically as users answer questions about the startup and financing terms.

While the variable terms of the documents change somewhat based on the particular internet platform from which they are accessed, the KISS convertible debt instrument typically is pre-populated with an annual interest rate of 4% or 5% and matures in 18 months. The note converts to preferred stock upon a financing round of at least \$1 million. If there is a change in control, the debt holder can cash out at 2X or convert into common stock. All of the rates, thresholds and multiples are fairly simple to modify from the pre-populated amounts as necessary to reflect the terms of a particular financing. If the security never reaches a conversion event and the company does not want to (or is unable to) pay the note balance in cash, the balance can be converted into common stock along standardized terms or the maturity of the note can be extended, at the note holder's option. KISS investors receive most favored nation treatment and investors who invest a specified minimum amount are guaranteed the right to participate in future rounds.

The KISS equity document is almost identical to the convertible debt, except that there is no interest feature. However, unlike SAFE, it matures after a pre-populated term of 18 months.

Conclusion

Any attempt to standardize and increase efficiencies in the structuring and documentation of startup seed financing should be appreciated by startups, investors and their respective counsel alike. Generally speaking, nobody wins when a startup is burdened by unnecessary time and expense negotiating and documenting early-stage financing. In this vein, enthusiasm for the SAFE and KISS documents appears to be growing.

However, while both SAFE and KISS documents are effectively formatted for self-use through completing the open information and blank deal terms in their respective form documents, both startups and investors are well advised to consult with experienced counsel in their preparation and review of SAFE or KISS documents. The KISS documents in particular are fairly robust and contain a number of legal and financing concepts (and corresponding consequences) that may be unfamiliar or otherwise not fully appreciated by your average founder or occasional angel investor. In addition, both SAFE and KISS financings are subject to compliance with applicable federal and state securities law. All said, however, both SAFE and KISS provide a valuable foundation to create greater efficiencies and standardization in the seed financing markets.