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Commonplace Funding Issues for Early-Stage Companies: Prevalent Investment Structures

Introduction

Obtaining initial financing can be a major issue for early-stage and startup companies. However, there are now a range of investment structures available when raising capital through an angel or seed round of financing. This article provides an overview of five generally accepted and increasingly recognized structures available to companies and investors in the U.K. market: (i) the convertible note; (ii) the Simple Agreement for Future Equity, or 'SAFE'; (iii) the Keep It Simple Security, or 'KISS'; (iv) the Advance Subscription Agreement, or 'ASA'; and (v) the Series Seed Equity Round.

Convertible Debt Investment

Convertible Notes

Convertible notes are the instrument that have traditionally been used in the U.S. to raise capital at the seed stage of financing. A convertible note is a debt instrument that has the ability to convert into equity upon certain specified events, such as a preferred equity financing, an IPO, and/or change of control event, or a maturity date. There is no universally recognized form of seed stage convertible note. However, our experience is that most seed stage convertible notes have a 2-8% interest rate and a maturity date of 18-24 months. Furthermore, the current market trend is that most convertible notes include both a conversion discount[1] and valuation cap[2], and convert at the lesser of the two. A convertible note is typically used as a bridge financing to fill the needs for capital before the company is able to put together a later equity round, but it can be used by early investors as a form of preliminary financing when the parties are not ready or able to address company valuations, or the amount being raised is small enough such that it does not warrant expending resources on preparing more complicated documents that are usually associated with equity financings. The advantages of the convertible note include, *inter alia*, that: (i) the explicit question of company valuation is delayed until a future point in time; and (ii) most serial early-stage investors are familiar with document terms because convertible debt has been around in the market for longer than the convertible equity investment instruments described below. The disadvantages include, *inter alia*, that: (i) there is not a standard form convertible note so transaction expenses can be higher; (ii) convertible debt does not qualify for the tax benefits under the U.K.'s Seed Enterprise Investment Scheme (SEIS) and Enterprise Investment Scheme (EIS) programmes, which is why convertible debt has not typically been used in a U.K. context; and (iii) the maturity date and interest accrual on the notes can result in risk to the company if further funding has not been received.

Convertible Equity Investment

SAFE (Simple Agreement for Future Equity)

The SAFE documents were created in late 2013 by the prominent West Coast startup accelerator Y-Combinator. The SAFE documents were originally drafted for use by U.S. companies, but can be modified to be used by U.K. companies as well. The purported goal of the SAFE documents was to create a standardized set of basic funding terms between startups and investors. The SAFE appears in four forms:

[1] A 'conversion discount' is a mechanism to reward investors for their investment risk by granting to them the right to convert the amount of the investment at a reduced price (in percentage terms) to the purchase price paid by the Series A investors.

[2] A 'valuation cap' is another mechanism to reward investors for their investment risk by setting a ceiling on the value of the startup for purposes of determining the conversion price of the investment — which (like a discount) thereby permits investors to convert their investment at a lower price than the purchase price paid by the Series A investors.

(i) SAFE Cap. No Discount; (ii) SAFE Discount. No Cap; (iii) SAFE Cap and Discount; and (iv) SAFE MFN. No Cap. No Discount. The SAFE is an agreement through which an investor pre-pays for shares that will be allocated to them upon certain specified events, such as a preferred equity financing, an IPO, and/or change of control event. The main difference between the SAFE and the convertible note is that the SAFE has no interest rate and no requirement to repay the amount within a set period of time. The main advantage of the SAFE documents is that they are simplistic, efficient, and easy to transact. In addition, the SAFE documents permit the Company to raise capital without incurring debt by removing maturity and interest features from a convertible note. The disadvantage of the SAFE documents from an investor perspective is that they lack certain forms of investor protections typically included in a convertible note.

KISS (Keep It Simple Security)

The KISS documents were created in mid-2014 by 500 Startups in the U.S. The KISS documents were originally drafted for U.S. companies, but they similarly can be modified to be used by U.K. companies. The KISS documents attempt to address some of the criticisms of the SAFE by providing more investor rights and protections. The KISS appears in two forms: KISS Equity; and KISS Debt. The KISS Equity instrument is an agreement through which an investor pre-pays for shares that will be allocated to them upon certain specified events, which events (unlike the SAFE) include a maturity date. The KISS Debt instrument has all of the same features of the KISS Equity instrument, except that it also includes an interest rate. There are several other differences between the KISS documents and the SAFE documents that should be noted. First, the KISS documents each include both a conversion discount and valuation cap. By contrast, the SAFE documents with their four different forms provide more flexibility if there is a preference to include only one of these investor-friendly conversion mechanisms. Second, the KISS securities automatically convert into equity at the next round of equity financing only if the financing is above a specified threshold amount. By contrast, the SAFE documents generally do not require a minimum financing amount (except the SAFE MFN. No Cap. No Discount form). Finally, the KISS documents also have some more investor-friendly terms, such as information rights and participation rights for KISS holders, that are not present in the SAFE documents and typically only given to shareholders.

ASA (Advance Subscription Agreement)

The ASA was created in 2016 by Seedsummit, a group of more than 25 leading seed and early-stage investors who are working together to "create transparency in the Global startup ecosystem." Unlike the other convertible investment structures described above, the ASA was drafted specifically for U.K. companies and has become the industry standard and an accepted means for making investments of this nature in the U.K. The most well-recognized ASA is the version created by Seedcamp although there are several other versions. Among the aims of Seedsummit in creating the ASA was to facilitate a simpler funding process for early-stage companies while reducing transaction costs. The ASA is broadly speaking the U.K. equivalent of the U.S. SAFE (i.e., no maturity date, no interest rate, conversion discount and valuation cap) but there are certain differences to note. First, as required by SEIS and EIS, an ASA is a right to acquire ordinary shares (common equity) rather than preference shares. Second, the investment under an ASA (unlike a SAFE) automatically converts within a specified time period if there is no qualifying round during that period in order to meet an SEIS requirement. Third, similar to the KISS documents, the ASA also includes some more investor-friendly terms, such as information rights and participation rights.

Equity Investment

Series Seed Round

The Series Seed round of financing provides an alternative to the convertible investment structures described above, the traditional issuance of common stock or the issuance of a new class of preferred stock. The Series Seed is a class of preferred stock that has only streamlined preferential treatment over common stock by including a preferred return, voting rights, and the ability to convert the preferred stock into common stock. The advantage of the Series Seed from an investor perspective is that the investor has the

ability to control the term sheet and negotiations at the time of investment. The advantage of the Series Seed from a company perspective is that it generally does not involve all of the features of a true preferred round and the parties know the number of shares issued and the full impact of dilution at the time of closing (unlike ASAs, SAFEs, KISSes and convertible notes). However, the disadvantage of a Series Seed round for both parties is that it requires additional expenses due to heavier negotiations for additional investor protections, an increase in the complexity of the documents, and the need to file an amendment to the Articles of Association creating the Series Seed shares.

Conclusions

In conclusion, there are now several forms of investment structure available to companies seeking to secure early-stage investment. Investors may reasonably differ as to whether they prefer the convertible note, the SAFE, the KISS, the ASA, or whether to forgo these options altogether and pursue a Series Seed round. Curtis is well placed to assist both early-stage startups looking to raise capital, as well as angel or seed investors looking to make investments, and guide our clients through the various available investment options.

Questions, Comments, Suggestions?

If you have any comments or queries, please do not hesitate to get in touch with your usual Curtis contact, or one of the team members below.

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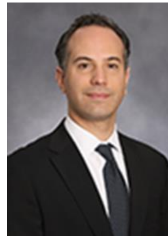

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