Seed Financing Overview

This set of documents will provide you the knowledge and tools you need to successfully attract, negotiate, and secure seed level financing. This guide is designed for an arms-length transaction between third-party investors and an early-stage company, rather than for friends and family deals.

Capital raised by seed financing may be used to help you prove your concept in the marketplace and, hopefully, achieve growth and profitability. You will then be better positioned to attract larger amounts of capital and grow beyond a startup. For more information on whether or not your company is ready for seed financing, please see our Financing Alternatives Primer.

There are three parts to this document:

1 This overview with a pre-financing checklist;
2 A sample term sheet; and
3 A guide for the term sheet.

This overview provides an introduction to seed financing and a checklist of steps to take and documents to draft before approaching investors. The second document, the term sheet, is a barebones template of the most important terms, drafted with your best interest in mind. It is a negotiation tool, not a finished or executable document. The last document, the guide, explains terms contained in the term sheet and covers some additional terms you may consider adding or are likely to see in investors' drafts of such a term sheet.

Always keep your personal and business objectives in mind as you use these documents to guide you through seed financing.

Before Seeking Seed Financing, You Should:

Create a Business Plan. It is important to have a polished business plan to present to investors to demonstrate your thoughtfulness and professionalism. Investors want to see that you have thought about different aspects of the business and have done some preliminary forecasting about your future. Show the investors that that there is a viable way to execute your idea. For more information on how to create a business plan, please see: https://www.sba.gov/writing-business-plan.

Draft a Founders' Agreement. Similarly, having a Founders' Agreement demonstrates your preparation and willingness to discuss important business decisions among yourselves. It requires that you contemplate the different scenarios and issues that could occur during the startup phase, discuss how you will address those issues, and create procedures for resolving them. Investors are particularly concerned about potential deadlock or breaking up the company, so be sure to prepare for those scenarios. For more information on how to draft a Founders' Agreement, please see our Founders' Agreement Overview.

Form a Legal Entity. Investors will want you to form a legal entity, which will be party to the financing agreement. Forming a legal entity requires filling out some paper work and filing documents with various governmental agencies. Most of the work for forming the entity will be choosing which entity suits your business best. For help determining what entity to form, please see our Entity Choice Primer.

Prepare a Capitalization ("CAP") Table. A CAP table explains and details the various types of ownership in your company. Having a solid understanding of what a CAP table is and the related issues like dilution, option pools, discounts, and warranties, will help you understand how much money you need to raise and how that will affect the different owners' claims on your business. Additionally, your investors will likely want to see this table and attach it to the term sheet and financing agreement. Because of its importance, a brief overview on CAP tables is provided below this checklist.

Secure All Intellectual Property Rights. If you are not sure if your company has or needs intellectual property, read the Intellectual Property Primer to make a determination. Make sure that all intellectual property rights are properly transferred to the company as a legal entity and are not owned by individual founders or independent contractors. Also consider acquiring the relevant trademarks, patents, copyrights or domain names that correspond to your name, logo, or slogan, if you do not already have them.

Comply with Government Restrictions. If you are in a heavily regulated industry, make sure that you are in compliance or are prepared to comply with all applicable regulations. Even if regulations are not applicable at the early stage of your business, make sure you understand when and what you will need to do to comply in the future.

Rehearse Your Pitch. Investors will evaluate your venture based not only on your business idea and plan, but also on your presentation skills. Prepare diligently: rehearse several times in front of friends, family, and strangers; seek feedback on the presentation; and adjust as necessary. Investors want to see confident, knowledgeable, professional founders who they can trust and enjoy working with. You should have a 30-second, 2-minute, and 10-minute version of your pitch.

Consult Expert Advisors. Because seed financing is still early stage financing, investors are investing as much in the people behind the company as they are in the company itself. If you don't have all the necessary knowledge and experience within your founding team, try and find experts in your field that will join the company in an advisory role, lending you credibility.

Do Your Research. There are many different sources of seed financing: high net worth individuals, angel investor networks, and more. Know who you want money from and why. Maybe there is an angel with a particular interest in social impact ventures and your company fits the bill—that investor could be a great fit for you. Do your research to learn more about certain investors and develop a strategy for targeting your chosen investors.

Read this Document and Prepare a Term Sheet. Even though it is unlikely that the term sheet you prepare will be the final document signed in the deal, it is still valuable to go through the process of drafting. It will help you think through the important issues and serve as an anchor for future negotiations. It will also allow you to familiarize yourself with common terms and issues so that you will be prepared and knowledgeable when you negotiate with investors.

Disclaimer

These documents were created and vetted by students and supervising attorneys at the University of Pennsylvania Law School's Entrepreneurship Legal Clinic applying Pennsylvania law. They are intended to educate and inform the early stage start-up. As such, they are designed to be simple and accessible and may omit terms or language relevant to your specific circumstances. Please carefully read through the documents and any instructions and annotations included therein.

You acknowledge that your use of these documents does not create an attorney-client relationship between you and the Clinic or you and the individual members of the Clinic and does not constitute the provision of legal advice or other professional advice. You should seek advice from a licensed attorney before using or relying on these documents. Additionally, none of the documents created constitute tax advice. By using and relying on these documents, you assume all risk and liability that may result.

Capitalization ("CAP") Tables

A CAP table, typically created using Excel, displays the current and proposed ownership of a company. It is a very useful tool for startups to keep track of the different securities they have issued (convertible notes, common shares, preferred shares, etc.) throughout their different financing rounds (seed, series A, series B, etc.).

A company starting out may be quite simple, with only a few founders and maybe a small option pool of shares for future employees. When seed financing is acquired, the table must expand for a new investor and a new type of equity (see example below). Whenever new investors are acquired, the previous investors' and founders' ownership interests will likely be diluted (decreased).

A CAP table can be a useful forecasting tool if you can estimate how much you will need to raise in the subsequent few rounds of financing. You will be able to see what valuation at each round you will need to achieve to retain a certain ownership of your company.

Key Terms

Dilution. A reduction in the ownership interest of a share of stock caused by the issuance of new stock. (Ex. If you hold 5 of a total of 10 shares you own half the company, but if they issue 5 new shares you now only own 5/15, or 33.3%).

Option Pool. The option pool reflects the shares set aside for current and future employees. These option pools can dilute the founders' shares but are important to help attract bright talent early in the startups lifecycle.

Pro-Rata. A proportionate allocation. For example, if you own 1/3 of the shares of a company and the company issues $6 of dividends pro-rata, you will receive $2.

Seed Debt. Sometimes founders forget that if they have previously raised money with a convertible note, they need to account for its conversion on the CAP tables.

This short introduction into CAP tables only scratches the surface. Part of being an entrepreneur is constantly learning new things, so please familiarize yourself with CAP tables and seek help preparing one. There are several websites that offer free Excel templates to build your own CAP table, but you are ultimately responsible for making sure it is built properly. The sample

CAP table shows how a very simple seed round issuing preferred shares will affect each equity holders' ownership of the company.

Sample Capitalization Table for Seed Financing

Shareholder Name	Founding-Common Shares	Seed Round-Options	Seed Round-Preferred Shares	Fully Diluted Shares	Pro-forma Fully Diluted Ownership %
Founder - John	5,000,000	-	-	5,000,000	34.6%
Founder - Jane	5,000,000	-	-	5,000,000	34.6%
Founders Current Holdings	**10,000,000**	**-**	**-**	**10,000,000**	**69.2%**
Angel Investors	**-**	**-**	3,000,000	3,000,000	20.8%
Option pool	**-**	1,444,444	**-**	1,444,444	10.0%
Total Holdings	**10,000,000**	**1,444,444**	**3,000,000**	**14,444,444**	**100%**

Seed Financing Term Sheet
[Company Name]

The following is a summary of the principal terms with respect to the proposed seed round preferred stock financing of [__________], a [State] [entity] (the "Company"). This summary of terms does not constitute a legally binding obligation. The parties intend to enter into a legally binding obligation only pursuant to definitive agreements to be negotiated and executed by the parties.

Offering Terms

Type of Security to Issue	Shares of Seed Preferred Stock of the Company (the "Series Seed").
Amount of Investment	$[________]
Purchasers	[List all accredited and institutional investors approved by the Company] (the "Purchasers").
Price Per Share	Price per share (the "Original Issue Price"), based on a pre-money valuation of $[_________], including an available option pool of [___]%.
Liquidation Preference	[A multiple of] the Original Issue Price plus declared but unpaid dividends on each share of Series Seed. A merger, reorganization, or similar transaction will be treated as a liquidation.
Conversion	Convertible into one share of common stock in the Company (subject to proportional adjustments for stock splits, stock dividends and the like) at any time at the option of the holder.

Voting Rights	Votes together with the common stock on all matters on an as-converted basis. Approval of a majority of the preferred stock required to: i. adversely change rights of the preferred stock; ii. change the authorized number of shares; iii. authorize a new series of preferred stock having rights senior to or on parity with the preferred stock; iv. redeem or repurchase any shares (other than pursuant to employee or consultant agreements); v. declare or pay any dividend; vi. change the number of directors; or vii. liquidate or dissolve, including any change of control.
Participation Right	Purchasers who have invested $[_________] or more, will have the right to participate on a pro rata basis in subsequent issuances of equity securities.
Future Rights	The Series Seed will be entitled to terms and rights that are at least as favorable as those accorded to new issuances of preferred stock in subsequent rounds of financing (with appropriate adjustments for economic terms).
Confidentiality	The term sheet is confidential and may not be used to facilitate negotiations with third parties.

Company: [_________]	Purchasers: [_________]
______________________________	______________________________
Name: __________________________	Name: __________________________
Title: __________________________	Title: __________________________
Date: __________________________	Date: __________________________

Glossary

Founder Vesting. The investor might require that you earn ownership of your shares over a certain amount of years. This vesting procedure is meant to ensure that you stay with the company and do not pick up and leave immediately after securing financing. If you leave the company before all of your shares vest, you forfeit any unvested shares. For more information on different types of vesting, see our Founder's Agreements guide.

Board of Directors. You should not be surprised if the investor asks for a seat or seats on your company's board of directors. They want to ensure they have some control over your company. Balance how much control you want to give up with the potential value of having a strategic partner participate in board meetings and decisions.

Exclusivity. The investor may want you to negotiate exclusively with them during a period of negotiation for the term sheet. Good faith negotiations may be required through the use of a break-up fee if the deal does not go through. If the investors require this provision, try to negotiate the term down to as little as possible so that you can seek additional financing as soon as possible if the deal falls apart, and have the no-break-up fee apply only if negotiations are not conducted in good faith.

Discount or Stock Warrants. A discount reserves the investor's right to buy shares in a future round at a discounted price to be agreed upon by both parties. A stock warrant is a security issued to the investor that gives him the right to buy stock in the company at a fixed price. Similar to an option, warrants and discounts are meant to sweeten the deal and create incentives for the investor to provide financing.

Anti-Dilution Rights. These rights protect the value of the investor's shares by adjusting the conversion price of preferred stock if there is a new issuance at a lower price per share than what that investor paid. In general, this protection is the default rule for new issuances. You will want to negotiate with the investor about carve-outs, or situations in which this protection will not be triggered. Some example carve-outs include: common stock issued upon a dividend, stock issued upon a warrant or option, and stock issues pursuant to an equity compensation plan.

Redemption. Typical redemption ensures that the investor, after a period of years, has the right to force the company to buy out all of his shares at the original price per share. Remember that a redemption provision may give the investor the right to force a bankruptcy if there is not enough capital in the company to satisfy the buyout without liquidation. Investors want to ensure they have a viable exit strategy and may insist upon this provision.

Non-Disclosure. Both parties may want to protect their confidential information, including: financial statements, intellectual property rights, personal information of founders, etc., from being released to third parties. This provision requires both parties to keep this type of information confidential.

Co-Sale Rights. The investor may require that if anyone in the Company finds a buyer for their shares, that some or all classes of stockholders have the right to participate in the deal, as either co-buyers or co-sellers, at the new buyer's price. This provision ensures that the investor can benefit from a rise or drop in the price per share and that no third-party agreements to sell are made solely for the benefit of the common shareholders.

Management Information Rights. This provision requires the Company to deliver to investors—sometimes only to those with a large equity stake—certain management and financial information on a regular basis. It is not uncommon for investors to want updates; just be wary if they are required too often and if they are required to be audited, as this will greatly add to the costs.

Representations and Warranties. These are statements made by either party that will be relied on in making the deal. If they are not accurate, the party that made them could be liable to the other party for breach of the agreement.

Closing Conditions and Expenses. Some investors will insist that the company pay all legal fees relating to the transaction. Sometimes this is done through a fixed fee, or a cap on the legal costs. Try and negotiate this amount down as much as possible. After all, investors in the company should want it to have enough cash to succeed (rather than divert it to deal costs).