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This edition of EEC Perspectives focuses on seed round financings. We hope it will be an informative companion to our other publications devoted to Series A financings and Series B and later round financings. A large sample of reliable and consistent data concerning angel and seed financings is hard to find. Although there are a number of possible sources for this data, such as the Angel Capital Association and VentureSource™, the nature of these investments does not lend itself to easy aggregation because there are too many small investments that are funded by a great variety of possible investors. Seed and angel financings run the gamut from funding a Web-based retail business with the founder's credit cards (I know of at least one such business that now has over \$1 million in annual sales), to raising tens of thousands from friends and family (I have several clients who have raised well into the hundreds of thousands this way), to semi-formal private offerings aimed at wealthy individuals, to investments from formal angel groups, to small raises from so-called capital gap players, to seed loans from established VCs.

Having said that, there is one Web site, the Center for Venture Research at the Whittemore School of Business and Economics of the University of New Hampshire, that does attempt to follow these investments. The Web site, <http://www.wsbe.unh.edu/>, follows investments by sector such as software, healthcare, biotech, industrial/energy, retail and media. This Web site also tracks what it calls *yield rate*, which means the percentage of investment opportunities brought to investors that result in an actual investment. If numbers published by this group are correct, the yield rate has been trending down since 2005. The site also tracks rates of return, which it indicates tend to be in the 20%-40% range, although with a high rate of variability. For example, according to this site, 65% of angel exits were in merger and acquisition transactions and 27% were in bankruptcies. These investments also cover a wide variety of opportunities, many of which are not intended ever to be financed with venture money. According to this site, aggregate angel capital investments in 2007 were approximately \$27 billion. Without these types of investments many small companies would never get off the ground.

My experience is that many, but not all, venture financed companies start with some form of angel financing, even if it is just the personal investment of the

entrepreneur. I asked a VC with whom I am familiar how many of his firm's portfolio companies started with angel financing and if there were any differences based on industry. He said that almost all had some form of angel financing. Although one data point should never be mistaken for a trend, if this VC's reaction is representative, angel and seed financing clearly provide an important feeder to the VC community. So, I followed up with an obvious question about why the VC did not make really early stage investments directly. His answer was, of course, that in some cases they do. Many VCs have "starter" note programs pursuant to which they invest \$100,000 to \$200,000 or so to help the entrepreneur get started and flesh out his or her business plan, but he noted that, in many instances, VCs wanted to see some development beyond a plan before investing.

For this issue of EEC Perspectives, we have asked Ham Lord of Launchpad Venture Group to comment on seed rounds. We plan to bring you other points of view in future issues of *EEC Perspectives*.

We hope you will find this information useful in your financing efforts. In addition, we would like to hear from you if you have transactions or comments that might be interesting to others. Do not hesitate to send one of us at the EEC an email at [info@foleyhoag.com](mailto:info@foleyhoag.com). Also, please visit our Web site [emergingenterprisecenter.com](http://emergingenterprisecenter.com) and plan on attending some of the many networking and educational events we hold at the EEC. We hope you will find the EEC a valuable resource as you start and grow your company.

A handwritten signature in black ink that reads "Dave Broadwin". The signature is written in a cursive, slightly slanted style.

David A. Broadwin

## A Market Perspective

Ham Lord, Managing Director, Launchpad Ventures

Angel financing is more than just seed round financing for future venture capital deals. In fact, angels fund ten to twenty times more companies than venture firms do on an annual basis. This is because many angel deals will never need the type of large financing (\$10M+) that is typical of most venture deals. As venture capital firms increase the size of their funds, they are less able to fund capital efficient technology companies.

At Launchpad and other angel groups in New England, there is a strong desire to finance companies all the way from their seed round to an exit. This leads to an environment where angel groups are syndicating deals between groups in a geographic region such as New England. For the seed round, one or two angel groups will make a small investment of \$250K to \$1M and work with company management to achieve important milestones (e.g., moving from prototype to product, making initial customer sales, developing sales channels, and hiring key employees.) It is during the seed round that significant value for the company is created as a business moves from concept stage to established business.

After the seed round of financing, angel investors working with the management team will gain a better perspective on the future financing needs of the company. If the best path to exit requires a relatively large amount of capital, then angels will assist management in raising new funds from institutional investors such as VCs.

## Structuring A Seed Stage Investment

David A. Broadwin, Partner, Foley Hoag LLP

Many of the entrepreneurs who walk through our doors at the EEC are at the seed/angel stage and are looking for those kinds of investments as well as advice around how to structure the investments so as to (a) fund the early needs of the business and (b) not create barriers to a larger investment later in the life of the business.

True seed stage financing is always an issue because it can take a long time to find an investor and, for better or worse, investors, even at this stage, often want to see more than an idea. This is particularly true of investors who do not have a personal connection to the entrepreneur. As a result, for the very earliest stages, entrepreneurs are more or less constrained to fund ventures themselves or turn to friends and family, since no one else is likely to take a real flier without a material amount of time spent investigating the opportunity.

The next issue, of course, is what valuation to place on the business and what is fair to the entrepreneur and the investor. At the earliest stages, valuation is far more art than science. I typically advise clients to give away as little equity as possible. The reason for this advice may be obvious, nonetheless, it bears repeating. The more equity that is given away, the less equity there is for the entrepreneur. If you part with 50% of the business in the seed round, how much will you have after the “A” round? You should resist the urge to be extra generous with friends and family; you will pay for it later, especially since VCs are unlikely to increase the valuation of your business because you were “the good guy” in the past.

One popular way to structure investments to avoid this valuation issue is to raise funds using a promissory note that is convertible into the next round of financing at some discount to the per share price in that round. By way of example, an entrepreneur might raise \$10,000 by having her company issue a note to the investor, which note would convert into the Series A round at a per share price of 95% of the per share price in the Series A round. (Be aware that the note is usually issued by the company and is not a personal obligation of the entrepreneur. So, if the business fails (a) the entrepreneur does not have to pay the money back and (b) the investor is essentially taking equity risk.) If the company raises \$10,000,000 in a Series A round at \$1.00 per share of Series A stock, the note would convert into approximately 10,526 shares of Series A stock at the Series A closing. I say approximately, because this calculation does not account for interest. This arrangement also does not account for any negotiations that may take place with the preferred stock investor. Some VC investors resist having small angel type investors in their round but some do not. Also, angels are often tempted to ask for, and they often get, much larger discounts – 20%, for example. The larger the discount (and the larger the amount of angel money raised), the more likely a VC is to object and want to renegotiate. Nevertheless, this convertible note approach has the merit of putting off the valuation question and making the angel round proportional to the eventual VC financing.

### COMMENTARY:

**Amanda Vendig, Foley Hoag Lawyer**

“You should also keep in mind that angels may want the promissory note to address other contingencies, such as what happens if the next round of financing does not occur prior to the note’s maturity date or what happens if a sale of the company occurs prior to the next round of financing. To address the first scenario, you could include a provision in the note which would allow the note to convert into common stock, at the option of the angel investor, at some predetermined price if a financing has not occurred prior to the maturity date. In the case of a sale of the company, there are two common formulations that are used. First, you could agree to repay the principal amount of the note plus some premium amount immediately prior to a sale of the company. Alternatively, you could have the note automatically convert into common stock at some discount to the per share price at which shares of common stock are sold in the company sale. From the angels’ standpoint both of these formulations are intended to provide the angel with their investment back plus some premium which could range anywhere from 8% to 30%.”

There are, of course, other issues that have to be dealt with in connection with convertible notes such as what to do if there is no future round or if it is much later than contemplated or if other events such as major revenue producing contracts arise before conversion. Even after taking into account all the various items that have to be dealt with, the documentation for these types of seed investments can be simple, short and inexpensive compared to, for example, issuing some sort of preferred stock. One other word of caution: in this type of financing, as in any financing, you are issuing securities and your transaction must comply with federal and state securities laws. Aside from the fact that sales of securities that violate securities laws are illegal, they can result in all sorts of problems including, but not limited to, rescission rights for the purchaser (that is rights to undo the transaction and get his/her money back) and delays in your eventual Series A round.

COMMENTARY:

Carol Pratt, Foley Hoag Partner

“All issuances of securities – even a \$10,000 convertible promissory note – must either be registered with the SEC, or qualify for an exemption from registration. The SEC’s Regulation D provides various exemptions for private placements of securities. Financings that raise \$1,000,000 or less in any 12-month period generally qualify for the relatively painless Rule 504 exemption, which does not restrict investment to “accredited investors,” and does not require the delivery of any disclosure document. Of course, any information about your company that you do provide to prospective investors cannot be false or misleading, either directly or by omission. Just remember, to qualify for this exemption you cannot seek investors by advertising or generally soliciting the public. And you should also check state “blue sky” laws in the state(s) where your investors are located, to make sure you comply with those requirements. For example, in Massachusetts, you can offer securities in a Rule 504 offering to no more than 25 persons in any 12-month period (excluding certain institutional investors).”

If you have any questions about this publication or about the EEC and how we can help your entrepreneurial venture, please feel free to contact any of the following lawyers:

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