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Good Seed; Bad Seed (Preferred That Is)

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At the risk of fighting the last war, I am going to come back to the idea (and in some cases reality) of "standard" open source seed preferred documents.

To be clear:

> (1) A note that converts at a discount into the next round of equity financing is probably the best deal an entrepreneur can hope to get. Now he or she may not be able to actually get such a deal (and certainly won't get it from many VC investors). Why is this the best deal an entrepreneur can hope to get? Because it limits the investor's upside. Why do VC (and other) investors hate these notes? Because the notes limit their upside.
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> (2) A convertible note with a cap may be the worst deal an entrepreneur can get. Why? Because, she is selling equity at the lower of two prices. One price is a fixed valuation and the other is something less. If you are going to set a valuation, you might as well just take that.
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> (3) The seed preferred is probably the investor's best friend because it sets a valuation on the closing date. And, it starts the capital gains clock ticking so that in the case of an early exit, there is some hope for capital gains tax treatment.

It is hard to object to a fair valuation. Of course, if it is fair, then so be it. Unfortunately, experience suggests that valuations at the seed stage are chronically too low, with the result that after the first VC round, founder equity is diluted to the point where it is hard to see how (in the absence of a spectacular exit) the founder pay day will be all that good.

Of course, the black magic of valuation is the special provenance of VCs. So that last paragraph was just an observation from the peanut gallery. Unfortunately, I have seen this show more than a few times, and it doesn't change much over time.

But here is one that is more in the provenance of lawyers: Sometimes seed preferred docs carry in them the germ of a most favored nation clause. That is the clause that says something like: **The Series Seed will be given the same rights as the next series of Preferred Stock (with appropriate adjustments for economic terms).**

In effect, your seed investor has gotten today's valuation (the low one) and tomorrow's terms (the good ones that the VCs negotiate). If you are an entrepreneur and you believe, as I am told some people do, that investment negotiations sometimes involve a trade off between price and terms, then you just lost on two counts.

Ah, but what did you get? A nice, simple, clean deal (that give the investor what he wants low price and good terms) at a low transaction cost (whatever fixed fee you agree to with the lawyers).

Unfortunately, many seed investors won't stop at a simple deal. They have loads of their own requirements. But that will be the subject of another post.

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In addition to being a Partner at Foley Hoag and a member of the Firm's Executive Committee, David heads the Emerging Enterprise Center. He focuses on representation of venture financed technology companies as well as buyers and sellers of public and private companies.

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Full Bio

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