Resource
March 4, 2025

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Key decisions

"Pre-Seed" typically refers to a company still developing an idea or prototype that has yet to hold any value. This article focuses on convertible debt issued to angel investors and pre-seed VC funds, but pre-seed companies may also obtain cash through accelerator or incubator programs.

Amount

Considering the company's stage and roadmap for launching the business, how much money does the company need, and over what period of time? A six-month "bridge" to a priced equity round may be structured differently than convertible debt raised for the purpose of funding the company for a year or more.

Type of security

The sale of **preferred stock** (*e.g.*, Series Seed Preferred, Series A Preferred) requires a company valuation to determine a price per share. Stock represents ownership in a company and investors typically enjoy voting and other rights under state corporate law. Lead investors often negotiate additional rights, preferences and controls in connection with their investment.

When a priced round is not available (*e.g.*, company valuation is undetermined) or beneficial (*e.g.*, company valuation is lower than desired), founders can raise needed funds by issuing **convertible securities**. Convertible securities offer a discount to a future stock purchase as an incentive for investors to fund a company at a very early stage and/or without an agreed-upon valuation. The transaction generally requires less time than a priced round, with the negotiation of most terms and controls postponed until the debt is converted into equity.

Convertible notes are debt securities that convert into equity upon the occurrence of certain events, such as when a company closes a *bona fide* equity financing. Convertible notes accrue interest, have maturity dates, and commonly convert at a discount or valuation cap. Convertible notes are debt obligations with remedies and creditor rights if not repaid or earlier converted.

SAFEs (Simple Agreement for Future Equity) were created as a simpler way to quickly invest in a start-up company, providing the holder with a future equity stake if a triggering event, such as a preferred stock financing, occurs. SAFEs are stand-alone, “off-the-shelf” agreements and typically are not heavily negotiated. SAFEs do not have a maturity date, have no accruing interest and no creditor rights. SAFEs can convert at a valuation cap or at a discount.

Convertible securities – common terminology

Pre-money / post-money SAFE. Simply put, it is two ways of framing the same valuation of a company but at different points in time, by determining how the shares issuable upon conversion of the SAFEs are factored into the calculation of the new money price per share.

The form of post-money SAFE is now the standard and developed from the original (pre-money) SAFE as SAFE-based financings began to look more like independent financing rounds than short-term “bridge” financings. With a post-money SAFE, the shares issuable upon conversion are treated the same as outstanding common and preferred stock, including that the issuance of preferred stock will dilute SAFEs in the same manner. Although the pro forma modeling of pre-money SAFEs and post-money SAFEs is different, the end result – the new money price per share – is essentially the same.

Discount / valuation cap. A discount is a reduction of the new money price per share by a set percentage – for instance, a 20% discount so that the purchase price for holders of outstanding convertible securities is 80% of the new money price per share. A valuation cap will result in a reduction of the new money price per share if the company's valuation at the time of a priced round is higher than the valuation cap. The larger the spread between a (lower) valuation cap and the actual valuation, the lower the purchase price for holders of outstanding convertible securities, resulting in more shares issued and more dilution to the company's existing cap table. Your Gunderson team can advise on appropriate valuation caps, taking into account (i) the expected time period between the issuance of the convertible securities and a preferred stock financing and (ii) the company's anticipated growth.

Major investor rights. Rights of first refusal and co-sale, rights to participate in future financings to maintain percentage ownership or on a *pro rata* basis, information rights, rights to approve or block certain corporate actions, board observer rights, rights to nominate one or more board members – are commonly associated with the purchase of preferred stock. Investors leading a priced financing round typically negotiate the rights and privileges of the preferred stock, and at times may require that certain rights given to pre-seed investors be revised or even revoked before agreeing to invest. Consult your Gunderson team before entering into any side letter giving – or agreeing to give – rights to pre-seed investors.

"Most Favored Nation" (MFN) clause. MFN generally means that if a company raises money with more favorable terms than what the MFN investor received, the company covenants to provide the MFN investor with the more favorable terms. Consult with your Gunderson team before agreeing to any MFN clause. There are times when an MFN clause may be appropriate but careful wording is critical to ensure the company is not promising more than it should.

Potential pitfalls

- Agreeing to financing terms before consulting with corporate counsel

    Your Gunderson team can identify what is market, explain why certain terms may potentially be harmful, and advise on negotiations. Unwinding previous agreements may be difficult and usually require the investor's consent.

- Negotiating different terms with different investors

    Although at times appropriate (e.g., investor status, size of investment), it is preferable to maintain uniform terms in a pre-seed financing. A variety of *valuation caps and discounts among convertible instruments can complicate pro forma modeling at the time of a priced round, adding time and cost. Additionally, it may become burdensome to keep track of multiple side letters giving different rights to different investors, and challenging to keep such letters confidential. Also see* major investor rights *above.*

- Publicizing the investment opportunity on social media

See comply with securities laws *below. The securities exemptions best suited for VC-backed companies limit the manner of offering, meaning that, among other things, the securities may not be sold by any form of general solicitation or general advertising. This includes a mention on Facebook, LinkedIn or other social media, meetings and informal get-togethers for the purpose of soliciting interest to invest. Your investors will generally be a small group known to you and the other founders and directors.*

- Paying someone to help find investors and sell company securities

Brokers (selling securities for the accounts of others) and dealers (buying and selling securities as part of a regular business) must register with the U.S. Securities and Exchange Commission (SEC) before selling unregistered securities. There is an exemption from this requirement for issuers and associated persons (officers, directors, employees) if (i) they are selling for the issuer's account only and (ii) are not compensated based directly or indirectly on securities transactions. Otherwise, company management cannot hire an employee or engage a consultant to find investors and sell the company's securities without violating securities laws unless that person is registered to do so.

- Neglecting to obtain board approval

A company's business is managed by its board of directors. The board has a duty to consider and approve (or not approve) company transactions, including a financing and its material terms, and the sale of securities (whether convertible debt or equity), even if there is only one director.

- Co-mingling funds

Open a corporate bank account and keep company accounts, books and records separate from personal finances.

Establish best practices

Prepare a term sheet

Establishing the terms of a pre-seed financing in advance will evidence thought, preparation and readiness for your first investors. Among other things, a written term sheet will specify the type of security to be issued and parameters such as the maximum amount to be raised and minimum investment (if any).

Comply with securities laws

The issuance of any security – stock, options, convertible notes, SAFEs – requires either the registration of the security with the SEC to sell in the public market or a valid exemption from such registration. The securities laws protect investors who may not be able to bear the risk of losing their entire investment; these rules and regulations ensure that a company provides investors with the information needed to make an informed decision about whether to purchase the company's securities. The securities laws apply to every entity issuing any security in any amount for any price.

To encourage and support capital formation, the SEC created exemptions from registration (an expensive and time consuming process) for private companies. These exemptions place limits on the offering, such as limits on solicitation and advertising, the number and type of investors, the amount raised and the length of the offering. As a company grows and certain limits are reached, the SEC may require additional disclosure to its investors or reliance on an alternate exemption.

CAUTION: This is basic information about a very complex topic. Consult with your Gunderson team before offering or issuing any security. Your Gunderson team can advise on compliance with federal and state securities laws, available exemptions, if an exemption requires one or more federal or state filings, and if those filings will be publicly available.

Keep securities laws in mind when fundraising

Can I sell securities to friends and family? The securities exemptions best suited for VC-backed companies require that either the investor be accredited (*e.g.*, a certain salary threshold or net worth supporting the ability to bear investment risk) or the company provide detailed disclosure materials.

How many investors is too many investors? There is no magic number but a large number of investors in an offering may begin to push its classification as a "limited" offering under the securities laws.

Can I publicize the investment opportunity on social media? Can I pay someone to help find investors and sell company securities? See potential pitfalls above.

Learn about the Corporate Transparency Act and required updates

(NOTE: *Check in with your Gunderson team as to current status and filing requirements*)

After a financing, a company may need to update beneficial ownership information, identify company applicants and/or collect FinCEN identifiers to simplify future reporting obligations.

Finalize and organize offering documentation

Finalize agreements (no blanks or brackets) and confirm they are dated and signed by all parties; incorrect or missing information may add time and cost to a priced financing round. Establish a records repository on a cloud file storage platform (*e.g.*, Box, Dropbox) to hold all offering documentation. Organization is key to an efficient diligence process at the time of a priced financing round.

Get to know your pre-seed investors

Investors diligence a company and get to know the founders; founders should do the same with potential investors. Stockholders may remain on the company's cap table for a long time, so be sure your investors are people who will support and encourage you as you grow the business.

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Related resources

Intro to Financing and the Venture Capital Ecosystem

Types of investors providing capital to startups, basic terminology regarding the structure and focus of venture capital investors and an overview of basic types of venture capital financings.

Preparing for a Venture Financing

Tips and insights on ways to prepare for an upcoming equity financing.

Featured Insights

FIRM NEWS

Gunderson Dettmer Launches Catalyze: An Exclusive Community Platform Built to Support and Empower Companies Throughout the Startup Journey

INSIGHTS

Gunderson Dettmer Releases 2025 Mid-Year Venture Capital Report

CLIENT NEWS

Gunderson Dettmer represented Statsig in its $1.1B acquisition by OpenAI

RESOURCE

Example Pre-Seed Due Diligence Checklist

RESOURCE

6 Startup Mistakes That Cost Founders Everything (And How to Avoid Them)

INSIGHTS

Ryan Purcell Guest-Authors “6 Startup Mistakes That Cost Founders Everything (And How to Avoid Them)” for Not Another CEO

INSIGHTS

Client Insight: Quarterly Employment Law Update – Summer 2025

INSIGHTS

Private Market Liquidity: A Review of Tender Offers

INSIGHTS

Client Insight: Eighth Circuit Vacates FTC's "Click-to-Cancel" Rule

INSIGHTS

Client Insight: One, Big, Beautiful Bill Enactment: Impacts To Qualified Small Business Stock

INSIGHTS

Client Insight: "Click to Cancel" Amendments to the FTC Negative Option Rule and California's Automatic Renewal Law

FIRM NEWS

Gunderson Dettmer Practice Areas and Partners Recognized by Chambers USA 2025 Guide