GUNDERSON DETTMER CATALYZE

Resource

January 2, 2024

Most companies will require outside sources of capital to build or grow their business, and financing events can be pivotal moments in a company's lifecycle. You've likely heard about financing rounds in the news or elsewhere in the startup universe—for example, a company "raising a seed round," "closing their Series A," or issuing SAFEs or notes as a bridge to its next priced equity round. This is really what the "VC" part of VC-backed companies is: selling equity securities, generally in the form of preferred shares (or instruments convertible into preferred shares), to investors, including VC funds.

These equity financings play a pivotal role as the main fundraising avenue in the venture capital ecosystem. In these transactions, investors (including VC funds) provide long-term capital to a company, free of immediate repayment obligations and restrictions. This distinguishes equity financings from venture debt financing—another customary and integral funding source for startups and VC-backed companies—which comes with a defined repayment schedule. In equity financing transactions, investors contribute capital and receive equity (i.e. ownership) in the company. The size of their ownership stake is determined by the amount of their investment in relation to the agreed upon valuation the company at the time of investment—a negotiated deal point that is key to the economic outcomes of the company and the investors. As that capital is put to use and value of the company (hopefully) grows, the investors’ ownership will likewise increase in value—largely aligning the goals and interests of the investors and the entrepreneurs running the company.

Types of investors who serve as common sources for emerging growth companies.

Friends and Family

Unless a company is born out of an incubator or accelerator, or is lucky enough to find a VC willing to provide “pre-seed” stage capital, founders starting new companies will often need to rely on sources of capital other than traditional VC funds. When self-funding (or “bootstrapping”) is no longer an option, founders generally turn to the people they know best: their friends and family.

“Friends and family financing” (or a “friends and family round”) is a term typically used to describe an early stage of financing for a new company, during which the founders lean heavily on personal contacts (as the name suggests) as sources of pre-seed or seed stage capital.

In a friends and family round, there are some key elements that will differ from what one can expect in a VC financing.

First, the investor syndicate is generally made up of friends, family, professional contacts and other acquaintances of the founder or founder team. Because this type of financing occurs most commonly in the early stages of the company’s life—before it has revenue, product-market fit, or even a fully developed idea—the investors are investing based on their belief and trust in the founder, rather than financial or technical considerations.

Further, because most of these contacts will be non-professional investors, the amount funded by each individual investor will usually be less than the investment that a VC fund might make. A company may need to gather together a larger number of friends and family investors to reach their target proceeds for the financing, resulting in rounds that typically contain many more investors than VC-led financings.

Finally, friends and family investments will often be in the form of a convertible security (either a convertible note or a SAFE) rather than a sale of preferred stock. This is because convertible securities typically involve fewer negotiated terms and less paperwork, making them cost-efficient for small, early rounds. Further, convertible securities do not require founders and investors to agree on a current valuation for the company (which can be very subjective for such early-stage companies), easing the pressure on founders to sell ownership in a highly-dilutive, low-valuation round.

Angel Investors

“Angels” are another common source of funds for early-stage companies. Angel investors are typically high-net-worth individuals who actively invest in startups with their own personal funds, and while they will invest in deals with founders from their own personal networks, they may also review and source deals in sectors or industries they are interested in by following a pitch process not unlike those used by VC firms.

Angel investors commonly (though not always) have some professional-level interest in the type of companies they invest in, and may be entrepreneurs themselves or have sector or industry expertise. They will often be able to invest in higher amounts than an investor in a friends and family financing, but often still not at the level of VC funds or other institutional investors. It is also common to have rounds made up of both angels and friends and family investors.

Given this profile, angel investors may take a somewhat more professional and/or savvy approach to their investments than friends and family. For example, transactions with angel investors usually include at least some additional level of due diligence, and a target company will likely need to show the angel investor information in more detail than what might be required by friends and family: things like financials, business projections and/or certain sales, revenue, or other metrics might be requested. Further, angels will often want to evaluate the product-market fit of the company’s products or services, the team and its business plan, as they aren’t solely relying on their relationship with the founder. The type of financing might also be more complicated in terms of the deal points . Angels will generally have some experience and savvy investing in similar companies in the past, and therefore have more familiarity with the deal documents and the included terms and conditions they may require or expect.

Some angels will look to have an ongoing support or oversight role with the company as well. These angel investors aim to develop relationships with their portfolio companies as mentors and advisors to the founders and executive team. They may even take positions on boards of directors or as board observers, with the goal of providing support to help the company (and their investment!) grow. Their experience can provide valuable know-how, guidance, industry connections and advice, and often can provide connections with potential future sources of capital, like VCs.

Strategic Investors

Strategic investors are another category of investor, although it is not the case that every company will have strategic investors on their cap table. Generally speaking, strategic investors provide capital to businesses that might be complementary or strategic to the investor's underlying business. So while the full focus of a VC Firm is investing capital into growing companies, strategic investors are often operating as part of larger businesses. For example, a large energy company might have a strategic fund that invests in new energy production and storage technologies, or an established car maker might have a strategic fund that invests in companies developing technologies relevant for autonomous vehicles.

This focus on business applications often results in differences in how VC and strategic investors structure their investments. While the VC is looking for cash returns, the strategic investor may value access to products or technologies, negotiated through licenses, development agreements or even rights of first refusal to ultimately acquire the business. Depending on the industry overlap between the strategic investor and its portfolio companies, strategic investors can be expert sources of market insight and technological expertise for new companies.

Venture Capital Funds

Generally speaking, venture capitalists are professional investors that collect capital from multiple sources, organize the money into funds and invest the capital into early-stage, growth-oriented companies in exchange for minority ownership interests in the companies. VCs typically stay involved in the development of portfolio companies by negotiating for board seats, approval rights for certain business decisions and/or mandatory information rights. In addition to capital, VCs can also provide early-stage companies with invaluable industry connections and business insight, given their involved position in the startup sector and experience in scaling businesses. A VC financing can be a positive market signal regarding the success and future prospects of a company, based on the conviction of a well-known, successful venture capitalist or VC firm. We'll talk more about the structure and investment focus of VC funds in the next section.

Basic terminology regarding the structure and focus of venture capital funds, including how funds categorize companies according to their need for capital across their phases of growth.

Below is a list of common terms you'll encounter in the VC financing space. While some of the terms, like "VC fund" and "VC firm," are often used interchangeably despite their distinct meanings, it is helpful to know the differences when discussing the industry with your internal stakeholders and when working on any proposed financings.

The VC Firm

A venture capital firm or "VC firm" is the company that manages venture capital funds. This company usually consists of investment professionals, including partners and analysts/associates, who will identify investments and then work closely with their portfolio companies to help them grow.

The VC Fund

The VC fund, or simply just a "fund," refers to a venture capital fund, which is a pool of capital that a VC firm manages. In short: it's the money. The capital in a particular VC fund is raised from institutional investors as well as high net worth individuals, and may also include contributions from the VC firm or the venture capitalists themselves. Each VC fund is generally structured as a limited partnership, with an entity created by the VC firm acting as the general partner, and the investors in the particular fund each as limited partners. The fund's strategy, sector, investment thesis, etc. will generally be outlined in the VC fund's governing documents or offering documents when the fund is being raised. A VC firm will generally raise (or at least aim to raise) multiple VC funds, with a new fund being raised every few years or so. The result is that most successful VC firms manage multiple VC funds at the same time. The makeup of the limited partners may change from fund to fund based on which investors choose to participate in each specific fund.

General Partner

The general partner(s) or "GP(s)" are responsible for the management of a VC Fund. This will typically include creating the fund, approaching investors to become LPs and "raising" the fund, making the various investment decisions with respect to deploying the VC fund's capital to target companies, and managing the operations of the VC fund. The GP also sets the investment strategy, negotiates the legal documents on behalf of the VC fund, and may work with portfolio companies to help them operate. The GP will receive a portion of the VC fund's profits as a management fee for compensation for its work.

Generally, a VC firm will create a managing entity (referred to as a management company) for each new fund when such fund is raised in order to handle these operational matters. Management fees are usually paid directly to this entity, and it in turn pays out operational expenses of running the fund.

Limited Partners

Limited partners or "LPs" are the investors in a VC fund. These typically will include institutional investors like pension funds, foundations, endowments or other professional investors or funds (known as a "fund of funds"), as well as high-net-worth individuals. The LPs commit capital to the VC fund and receive a share of profits from any returns generated by the VC fund's investments, but have limited control over the investment activity of the VC fund.

Venture Capitalist

This is an individual who works for the VC firm and reviews and evaluates new investments toward which to deploy capital from a VC fund. You've likely heard of many of these folks as successful investments and large profits in the VC industry have made celebrities out of some VCs – though most are simply investment professionals diligently running their funds on behalf of their LPs. Often, when a VC firm raises each new VC fund, the firm will name a particular VC or VCs as the manager(s) of the general partner entity for such fund. This way, the investors in the fund will know which specific person or persons retain decision-making authority in the GP, and therefore over the fund and its investments.

Target Company and Portfolio Company

A target company and a portfolio company differ in that these terms refer to distinct stages of the investment process for a VC firm.

A target company is a company the VC firm has identified and with which it is actively exploring a potential investment. The VC firm may be pursuing the opportunity in the company by conducting business and legal due diligence and/or negotiating the terms of the potential investment.

A portfolio company is a company that the VC firm has completed an investment in by providing capital from one of its VC funds. The VC firm has taken an equity stake or invested in a convertible security instrument and may have a seat (or seats) on the company's board of directors. The VC firm will typically be working with the company to help it achieve its goals and increase the value of the company, although the form and extent of the VC's involvement can vary. Not all of a VC firm's target companies will become portfolio companies, but all portfolio companies were at one time a target company of the VC firm.

Financing Stages

When seeking out target companies, rather than searching the entire universe of startups, VC firms will often focus their investment strategy for a particular VC fund toward companies that share similar characteristics like sector, industry, technology type, niche, etc. One such characteristic is the company's "stage" of financing, where a VC firm will evaluate potential target companies that are operating during a specific phase of their lifecycle.

Those "stages" of a startup's financing lifecycle can generally be broken down into the follow categories: pre-seed/accelerator stage, seed-stage, early-stage, later-stage/growth-stage. People within the VC industry may have their own terminology or lingo for these phases of a company's growth, and might reference additional or more detailed stages (for example, an "expansion" stage following the early stage, or a "pre-IPO stage" for companies looking to go public within a specific period of time). However, for our purposes, these stages refer to distinct timelines of a company's development that a VC firm may focus on:

Pre-Seed/Accelerator Stage

This refers to capital provided to startups—often provided to founders or entrepreneurs even before they have a company—to develop an idea, and instead of being strictly a cash investment may also take the shape of other support or resources (like physical office or meeting space, access to data, access to expertise, etc.). This is often the case when founders enter accelerators or "incubators" that provide services to help founders get their ideas off the ground and to connect them with other entrepreneurs and those in the venture capital community. Many startups will skip this stage and head straight for the seed stage. Founders "bootstrapping" their ideas with their own capital early in a company's lifecycle will also often get lumped into this category as well. VC funds and other institutional investors don't generally invest at this stage.

Seed Stage

The seed round is the earliest formal stage of funding and typically involves raising capital from individuals the founders know personally (the "friends and family" round), angel investors or early-stage VC funds. The goal of this round is generally to support the founders' development of an initial product, service or concept and to validate the startup's idea or thesis.

Many VC firms will raise "seed" funds that focus on making investments in these types of companies, and the investment size is generally smaller than for more developed companies. Initial seed rounds are often raised in the form of convertible securities like convertible promissory notes or SAFEs, though direct equity in the form of "Series Seed" preferred stock is also a common way to raise this capital. A company's "seed stage" need not be limited to a single financing transaction and may encompass multiple capital raises, such as the initial issuance of convertible securities followed later by a seed equity round.

Early Stage

The early-stage financing rounds are generally the first institutionally-led rounds of financing and typically involve the issuance of preferred stock to investors in a priced equity round. The typical naming convention uses letters, starting with "Series A." This nomenclature is not required and is mainly due to customary understanding in the industry. A single stage/letter can cover multiple rounds of financing (for example, Series A, Series A-1, Series A-2, etc.) and may also include rounds of convertible securities.

VC firms investing in early-stage companies at a Series A round are generally interested in taking their ownership stake prior to the startup's scaling and growth stages, but usually after an idea has been shown to have some level of product-market fit or the company has gained some initial traction. VC firms coming in at the later end of the early stage (think, a "Series B" round) may be looking to invest once initial milestones are met and further funding is generally required to move into the next phase of scaling the business. These rounds often are larger in terms of the amount capital raised than Series A rounds and may also include longer lists of investors, as syndicated rounds become more common.

Later Stage

As companies continue to develop, they often will require additional capital to support growth, expansion and scaling. These rounds (generally, "Series C" and later) are typically used for the company's later-stage growth initiatives, like rolling out new products or services, entering new markets, acquiring new assets or even acquiring other companies.

Many VC Firms will raise "growth" or "late-stage" funds aimed at companies in this phase of their life cycles, generally with the intention of taking an ownership stake while a company still has some room for growth that matches the fund's investment return goals. Often, startups will raise multiple rounds in their later stage, with "Series D", "E" and "F" all becoming more common as companies choose to stay private for longer periods of time or require additional capital infusions to keep and attract new talent, build out their products and services and meet their growth targets.

Types of equity and convertible security financing transactions commonly used by emerging growth companies raising money from investors.

When an investor invests in a startup, the investor's capital is used to buy an ownership stake, either through a direct purchase of equity securities (usually in the form of preferred stock) or by purchasing a convertible security (a note or SAFE—more on these below) that will convert into equity securities in the future.

The following will provide a general overview of the types of financing transactions that your company may have already completed or will seek to raise in the future. Your Gunderson team members are experts in these financing transactions and can walk you through each, whether you want the nitty gritty details or just the broad strokes. We're happy to help you understand each of these types of transactions and prepare you for whatever financing rounds you take on.

Equity Financing

An equity financing (for example, a Series A round) is the traditional form of VC financing where investors are issued shares of the company's equity securities in exchange for their capital investment. Upon such issuance, the investors become stockholders, thereby owning a portion of the company. The portion of the company owned is based on the amount of the investment made in comparison to the company's overall valuation, as agreed by the company and the investors at the time of the financing. From that point on, if the company's value increases, the shares are considered more valuable.

The vast majority of equity financings where a VC fund participates will be structured as a "preferred stock financing," in which the VC fund(s) and other investors purchase shares of the company's preferred stock. The shares in preferred stock financings are sold at a price per share that is based on a valuation of the company negotiated by and agreed between the company and the investors, with such negotiation generally led by a VC firm acting as a lead investor.

Shares of preferred stock, unlike common stock, have specific rights and preferences that will be negotiated by the VC firm on behalf of itself and other participating investors. These rights can include (among other things) liquidation preferences and priority in payment, dividend rights and the ability to convert into common stock. The preferred stock investors will also generally negotiate for certain voting rights in addition to those held by common stockholders (for example, control rights to the approval of certain corporate transactions) and may require that the investors be represented by a representative of the VC firm on the company's board of directors.

SAFE Financing

The SAFE (*S*imple *A*greement for *F*uture *E*quity) is a relatively new form of financing in the VC industry, dating back to 2013 when it was initially created by the tech startup accelerator Y Combinator. A SAFE is a contract between an investor and a company whereby the investor makes an immediate capital investment in exchange for the future right to receive equity upon the occurrence of certain events. Typically, the triggering event will be when the company completes its next preferred stock financing or consummates an exit event like a sale or merger.

As the SAFE instrument is solely a contract at the time the investment is made, it is not truly equity, and the holder does not immediately become a stockholder (and as such does not have stockholders' rights, including voting rights). Each SAFE holder will receive the type and amount of equity securities set forth in the SAFE when the SAFE converts. However, the SAFE is not quite debt either, as it (typically) neither accrues interest nor contains a specific maturity date at which the principal amount must be repaid. Some have referred to this instrument as "quasi-equity." A SAFE will often be referred to as a "convertible security," as it is issued with the intent of converting into shares of preferred stock in the future.

The SAFE was created with the goal of streamlining early investments by VC funds and other investors, making the process quicker and easier to close. As a result, SAFEs are commonly used in seed-stage financings as a way to quickly and efficiently raise capital, though they can be used at any time in a company's lifecycle.

One way the SAFE is designed to achieve its goal of streamlining the investment process is by using a standard form document—now well-known in the VC industry—that is shorter and uses less "legalese" and boilerplate language than documents used in other types of financings. Simplicity is achieved by removing many of the more complex negotiation points from the investment process and deferring them to a future time. Since the SAFE is generally intended to convert into preferred stock, the shares issued to the holder of a SAFE upon conversion will therefore be subject to the terms negotiated in the preferred stock financing. The result is that fewer deal points need to be included in the SAFE documentation, as they will be sorted out when the SAFE ultimately converts into shares.

This can be beneficial for various reasons, especially for early stage companies. For example, no valuation is needed to complete a SAFE financing, so companies can avoid a potentially lengthy process to try to determine and negotiate one. With simpler forms that are much shorter than those used in an equity financing (or even a convertible note financing), the company and investors can also avoid higher legal fees and longer closing timelines, allowing for less distractions.

While the goal of the SAFE is to reduce friction to closing funding, it's important to have expert legal counsel assist you in any SAFE financing transaction: among other things, the approvals process to close such a financing, the potential dilutive impacts of a SAFE upon its conversion (especially when multiple SAFEs are offered, and any associated rights the holders might negotiate, all need to be considered and addressed. Your Gunderson attorney team will guide you through the SAFE process in order to raise funding through a SAFE appropriately and assist you in structuring the investment with downstream impacts in mind.

Convertible Note Financing

In a convertible note financing (or "note financing"), a debt security in the form a promissory note is issued to an investor in exchange for an investment. However, instead of acting like a pure debt instrument, a key term of the promissory note is that the amount owed is convertible into the company's equity securities. Like a SAFE financing, a note financing is an investment made by a VC fund or other investors with the intention that the security issued will convert into preferred stock at some event in the future, typically the company's next equity financing.

The convertible note financing is a workhorse in the VC financing arena, pre-dating the SAFE by decades and still representing a large portion of VC financing transactions completed each year. Similar to a SAFE, the conversion terms negotiated in the note financing allow much of the more complex terms regarding preferred stock to be deferred until a preferred stock financing round is closed, so the overall process can be much simpler and can avoid needing a valuation of the company.

However, unlike a SAFE, the promissory notes are debt instruments held by the investors and as such, include typical debt terms like an interest rate and maturity date, as well as protections for the investors should the company not be able to raise equity or otherwise repay the notes. Given these terms, the documents for a note financing are generally longer and more complex than a SAFE; however they are still generally less complex than the documents used in an equity financing and can allow the investors and the company to complete a simpler, more streamlined investment process.

Reach out to your Gunderson team at any time to get more information on financing transactions and what to expect during the process. If your company is currently contemplating an equity, convertible security or note financing, or if you've received a term sheet, we're happy to get involved as soon as possible to guide you through the process.

Featured Insights

INSIGHTS

Client Insight: California SB 243: New Compliance Requirements for Operators of AI "Companion Chatbots"

INSIGHTS

Client Insight: California Raises the Bar: Groundbreaking Privacy Laws Bring Universal Opt-Out, Data Broker Transparency, and Health Data Protections

INSIGHTS

Client Insight: EDGAR NEXT Transition Deadline

INSIGHTS

Client Insight: CCPA Enforcement: Tractor Supply Hit With Record $1.35M Fine for Privacy Violations

INSIGHTS

Client Insight: SEC Opens the Door to Mandatory Shareholder Arbitration

Client Insight: SEC Opens the Door to Mandatory Shareholder Arbitration

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