

# Series Seed Equity

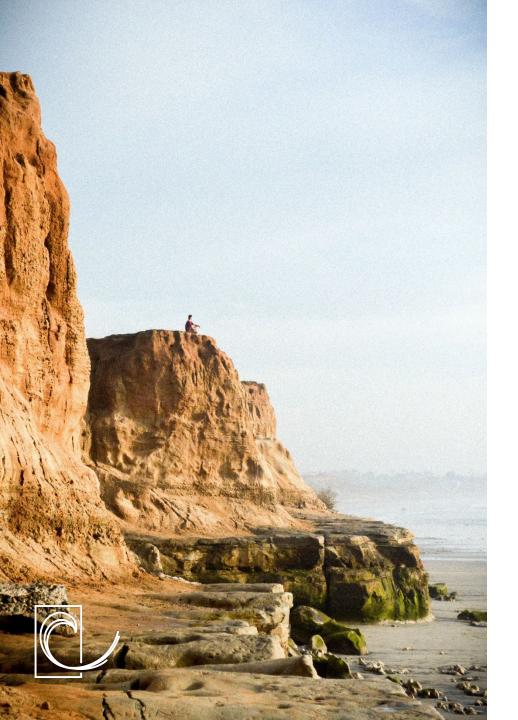
Tech Coast Angels October 1, 2021

#### Series Seed Preferred Stock

#### 2008-2010

Why Series Seed

- Simple Way to Buy Preferred Stock
  - 2-3 documents (Term Sheet, COI, Investment Agreement)
  - $\,\circ\,$  Important protections are included
- Commitment to Valuation
  - Notes and SAFEs don't avoid valuation with valuation cap.
- Cost Investor Counsel
  - Not significantly different from Notes versus value
- Tax
  - $\,\circ\,$  IRC 1202 QSBS Exclusion of Gain applies
  - o IRC 1272 Original Issue Discount N/A



## IRC 1202

- Provides federal tax exclusion from income of gain recognized on the sale of QSBS held more than 5 years up to \$10M
- IRC 1045: If held less than 5 years, you can rollover w/in 60 days
- From 2010 2015 its long-term viability was uncertain
- December 2015/2016 the benefit was made permanent
  - While Notes and SAFEs had developed in the absence of this long-term benefit, with it, equity is now much more important.

See John Harbison's email from 9.29.21 – write to your senators and congressional reps today.

	SAFEs	Convertible Notes	Series Seed	
Up				
MFN	×	$\checkmark$	$\checkmark$	
Pro Rata	X Unless Side Letter	×	$\checkmark$	
Ownership Clarity ("Shuffle")	Post-Money SAFE	×	$\checkmark$	
Change in Control Min Return	$\checkmark$	$\checkmark$	Veto Voting	
Down				
Liquidation Pref or Priority	×	<ul> <li>Image: A second s</li></ul>	$\checkmark$	
What's Going On				
Reps and Warranties	×	×	$\checkmark$	
Board Seat	×	×	$\checkmark$	
Information Rights	×	×	$\checkmark$	
Protective Provisions - Veto	×	×	$\checkmark$	
Ταχ				
IRC 1202 or LTCG	×	×	$\checkmark$	
Original Issue Discount Tax	N/A	×	N/A	







### A Potential Outcome

#### Assumptions:

- Angel Round: \$1M on \$4M Pre or Cap; 20% Discount, 7% Interest
- Series A: 18 months post Angel; \$3M on \$12M Pre; Increase Option Pool
- Exit 5 <sup>1</sup>/<sub>2</sub> years post Angel; \$50M
- OID Effective tax rate of 14.1% and LTCG rate of 20%
- > Note: this is federal tax only; state tax does not recognize IRC 1202

Convertible Notes	Post Money		Payout	OID Tax	LTCG Tax	Tax Paid	Take Home
	Shares	%					
Founders / Advisors / Options	11,000,000	63.94%	\$ <u>31,971,493.0</u> 5	$\frown$			
Angel Investors - Notes	2,762,260	16.06%	\$8,028,506.95	\$14,791.48	\$1,605,701.39	\$1,620,492.87	\$6,408,014.08
Series A Investors	3,440,565	20.00%	\$10,000,000.00			$\sim$	
Total	17,202,825	100.00%	\$50,000,000.00				
Series Seed Preferred Stock	Post Money		Payout	OID Tax	LTCG Tax	Tax Paid	Take Home
	Shares	%					
Founders / Advisors / Options	11,000,000	65.19%	\$32, <del>592,592</del> .59				
Angel Investors - Seed	2,500,000	14.81%	\$7,407,407.41	\$0.00	\$0.00	\$0.00	\$7,407,407.4
Series A Investors	3,375,000	20.00%	\$10,000,000.00				
Total	16,875,000	100.00%	\$50,000,000.00				\$999,393.33

"Over time, <u>equity rounds have become cheaper to consummate</u>, and the <u>legal fees argument doesn't carry much weight these days</u>. In the end, the main force driving the use of convertible debt in earlystage companies is the parties' desire to avoid setting a valuation."

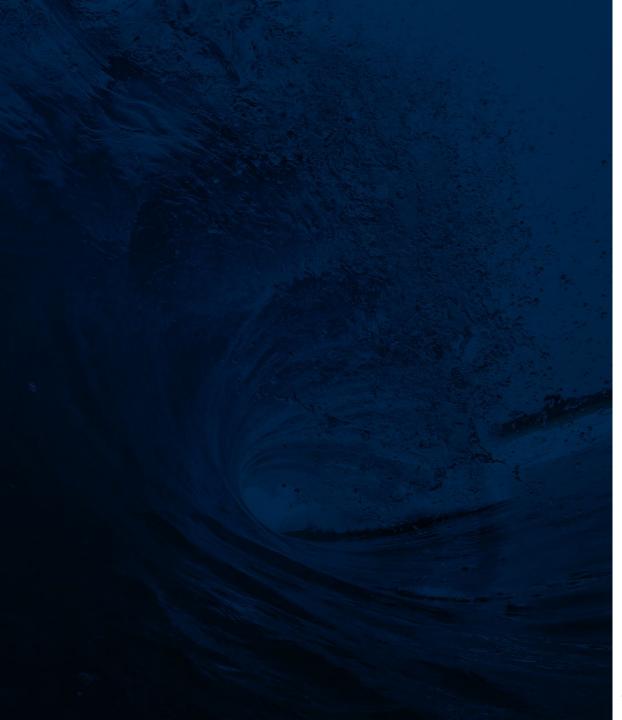
- Brad Feld, Jason Mendelson; Venture Deals

"Do priced equity rounds instead of notes. As I wrote seven years ago, the <u>cost of doing a simple seed equity deal has come way</u> <u>down</u>.... Honestly, I wish the whole scourge of notes would go away and we could go back to the way things were done for the first twenty years I was in the venture capital business."

- Fred Wilson, AVC, March 12, 2017







## **Talking Points**

- Saving a small amount on a \$1M+ investment doesn't carry much weight, especially when investors may save ~\$1M on taxes
- Simplified cap table eliminate SAFEs and Notes each converting at different prices
- No avoiding valuation with Notes and SAFEs
- Founders do not have threat of Note default
- Investors receive important assurances
  - More appropriate reps and warranties
  - $\circ\,$  Board seat
  - $\,\circ\,$  Information rights
  - Protective provisions/veto rights
  - o MFN
  - Pro Rata

© 2021 Coeptus Law, Inc.



Brian Dirkmaat Partner brian@coeptuslaw.com www.coeptuslaw.com (760) 283-0111