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Raising Capital for Your Start-Up

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Raising capital is a precarious process navigated by many start-ups. This article gives an overview of capital-raising structures, available securities exemptions, and some of the pitfalls to avoid in the process.

The following chart summarizes the most common capital structures. Be aware that there are tax and securities consequences for all options, and we encourage you to engage experienced legal counsel along with accounting and tax assistance.

Capital Structures	
Equity/Equity Hybrid	
SAFE	**SUMMARY:** Convertible security forms that have some combination of valuation cap, discount rate, and/or MFN clause. **PROS:** More issuer friendly than convertible note because it has no maturity date or interest. **CONS:** Tax uncertainty – IRS has not settled whether a SAFE is debt or equity.
KISS Equity	**SUMMARY:** Convertible security form that has a valuation cap and discount rate. **PROS:** More issuer friendly than a convertible note because it has no interest or repayment. **CONS:** Tax uncertainty – IRS has not settled whether a SAFE is debt or equity; automatic conversion to preferred stock at maturity using Series Seed Documents; more investor rights.
Preferred Stock	**SUMMARY:** Selling part of your company on more investor-favorable terms than common stock, such as liquidation, conversion, and voting. **PROS:** No-debt financing (though usually carries a dividend). **CONS:** Dilutive and comes with more investor rights; higher legal fees and the investor(s) and founders must agree on valuation.
Common Equity	**SUMMARY:** Selling part of your company. **PROS:** No-debt financing; unlike preferred stock, no senior liquidation preference. **CONS:** Dilutive, may change control of company; investor(s) and founders must agree on valuation.

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Debt/Debt Hybrid	
Senior Debt (Revolving Loans/ Term Loans)	**SUMMARY:** Collateralized by tangible assets, has an interest rate, short-term maturity date, and strict amortization. **PROS:** Retain ownership in your company. **CONS:** Restrictive covenants and usually requires guarantees by founders.
Mezzanine Debt	**SUMMARY:** 2nd lien term loans. **PROS:** Retain ownership in your company and limited or no amortization; more flexible covenants. **CONS:** Requires positive cash flows, warrants, high interest rates.
Convertible Note	**SUMMARY:** Debt (accrues interest and has maturity date) but is set to convert to equity for a discounted price (15%+) in the future. **PROS:** Avoids the valuation issues associated with the sale of stock and has lower transaction costs. **CONS:** If the note does not convert to equity before the maturity date, the note will have to be paid back plus interest or you may default.
KISS Debt	**SUMMARY:** Convertible security form that has a valuation cap, discount rate, accrues interest, and has a maturity date. **PROS:** Founders and investors should be able to agree to the form and then only need to agree on valuation cap and discount rate. **CONS:** Tax uncertainty and more investor friendly terms including information rights and automatic conversion at maturity date.

Selling stock or some debt instruments will implicate state and federal securities laws. The following chart summarizes the most common securities exemptions.

Securities Exemptions		
No General Solicitation Allowed		
Reg. D Rule 506(b)	**Offering Limit (12 mo.):** None	**SEC Filing:** Yes, Form D
	Investors: Unlimited accredited and up to 35 sophisticated	
§4(a)(2)	**Offering Limit (12 mo.):** None	**SEC Filing:** No, but state specific filings
	Investors: Must not involve any public offering or distribution	
General Solicitation Allowed		
Reg D, Rule 506(c)	**Offering Limit (12 mo.):** None	**SEC Filing:** Yes, Form D
	Investors: Unlimited accredited investors and certain due diligence is required	
Rule 504	**Offering Limit (12 mo.):** $10 Million	**SEC Filing:** Yes
	Investors: Must follow in-state securities laws for issuer and investor(s)	

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Reg A, Tier 1	**Offering Limit (12 mo.):** $20 Million	**SEC Filing:** Yes
	Investors: Accredited or non-accredited	
Reg A, Tier 2	**Offering Limit (12 mo.):** $75 Million	**SEC Filing:** Yes
	Investors: Accredited and limited non-accredited	
Regulation CF (crowdfunding)	**Offering Limit (12 mo.):** $5 Million	**SEC Filing:** Yes
	Investors: Non-accredited; subject to strict investment limits on regulated platforms	
Intrastate Rules, §3(a)(11), Rule 147, Rule 147A	**Offering Limit (12 mo.):** State Specific	**SEC Filing:** No, but state specific filings
	Investors: Must follow in-state securities laws for issuer and investor(s)	

Some of the most common pitfalls are the failure to consider tax and securities consequences, giving up board control, agreeing to a non-dilution clause, saddling the start-up with debt without a clean exit, or agreeing to an investor's modification of standard forms without seeking legal advice.

A word on valuation: You may have heard the terms "pre-money" and "post-money" valuation. Here is a simple formula:

$$\text{post-money valuation} = \frac{\text{dollars raised}}{\text{\% equity ownership}}$$

So, if you raise $1 million for your business, and the investor receives 10% of the stock in your company the "post-money valuation" is as follows:

$$\frac{\$1 \text{ million}}{.01} = \$10 \text{ million}$$

The "pre-money" valuation is simply the "post-money" valuation minus the dollars raised, or in this case, $10 million - $1 million = $9 million.

If you have questions, please contact a member of Kutak Rock's Scottsdale Corporate & Securities Practice Group. You may also visit us at www.KutakRock.com.

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