What Startups Should Know about Series B Financings When Negotiating Series A

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Raising a Series B financing is a major milestone in the life of a company. However, from the negotiation of the term sheet to the closing process, you will face a set of issues that is unlike what you experienced in the Series A financing. Here are some issues to keep in mind about Series B financings, some of which are important to know when negotiating your Series A:

- Starting Point for Negotiation of Terms. By the time you raise a Series B financing, there is already at least one investor at the table who has received a set of rights in the prior financing, and these rights will need to be taken into account when negotiating the terms of Series B. This means that the appropriate starting point for negotiating the Series B term sheet is typically the Series A term sheet. You should understand that Series B investors will typically require *at least* all of the rights that Series A received. So, if you make significant concessions on terms in a Series A financing, you may be in effect conceding these terms to future investors as well.
- Specific Deal Terms. The general principle of having to account for both existing and new investors has implications for many of the specific Series B terms. To take one important example, a venture-backed company's certificate of incorporation will usually include provisions requiring a vote of the investors before the company can take certain major actions, such as selling the company or raising a new round of financing. One of the important questions in a Series B financing is whether these actions will now require a single combined vote of the Series A and Series B investors, or if the Series A and Series B investors must each approve these matters separately. It's typically to your advantage to have a single combined vote because this reduces the number of corporate hoops you need to jump through before taking action, but the Series A and Series B investors may want separate votes to ensure that they can protect their respective interests.
- Negotiation Process. Series A investment documents typically provide that you cannot raise a Series B financing without the consent of the Series A investors. This means that, even if the Series A investors aren't directly involved in the negotiations between you and the Series B investor, they may still want to review the Series B terms and documentation before approving the deal (or have their lawyers review them), which can lead to additional rounds of negotiation. Typically, the lead Series A investor will have a director on your board and would therefore be aware of the Series B terms, at least at a high level, well in advance of closing. However, if the Series A director has not been closely involved in the deal, or if there are multiple Series A investors who each need to approve the deal, then the financing could turn into a three (or more) ring circus, with you, the Series A investors, and the Series B investors trying to ensure their respective interests are protected. While every situation is different, it's generally advisable for you to figure out early which of the Series A investors will need to approve the Series B financing and get in front of this process, so as to avoid the prospect of a last-minute review and negotiation of documents by Series A investors. You should also factor the Series A investors' review and negotiation into your deal timeline and therefore into your planning as to when you need to start the Series B process to ensure you have enough runway to get to closing.

- Down Rounds. If you are raising a Series B financing at a lower valuation than the Series A, this raises an additional set of issues. While all the potential complexities of down rounds are beyond the scope of this article, a key point to be aware of is that Series A documents typically contain antidilution protections, which give the Series A investors the economic equivalent of additional shares if the company subsequently does a down round. This creates additional dilution for the founders on top of the direct dilution from the Series B investment, and is part of the true cost to the founders of doing a down round.

The above issues are relevant not only for your second round of funding, but also for preparing for Series A, since decisions made at the time of Series A may well have ramifications into Series B and beyond. By keeping the above issues in mind and planning accordingly, you can set yourself up for a successful Series A and Series B, and so position yourself for bigger and better achievements in the future.

Aaron's practice focuses on corporate law, including startup/venture capital and mergers and acquisitions. Aaron has represented venture-backed companies in early- and late-stage equity financings as well as debt financings. He has experience representing both buyers and sellers in M&A transactions.