

Early-Stage Funding for Life Sciences Businesses

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Early-stage life science businesses have several funding options available to them as they seek to raise capital to support research, development and commercialization efforts. Business owners should carefully evaluate the full spectrum of financing mechanisms, which typically include equity issuances, simple agreements for future equity (“SAFEs”), promissory notes and convertible promissory notes. Each of these instruments carries distinct legal, financial and strategic implications. The appropriate choice will depend on a variety of factors, including the company's current valuation, the stage of its technology or product development, the regulatory environment it faces, the founders' tolerance for dilution and the expectations and sophistication of prospective investors. Understanding the fundamental characteristics, advantages and risks of each option is essential for life science entrepreneurs seeking to structure their capital raises in a manner that supports long-term growth while preserving flexibility and protecting founder interests.

1. **Equity Issuances.** When funding an early-stage life science business through the issuance of equity, business owners should consider several key factors. First, issuing equity requires the company to establish a valuation, which can be particularly challenging for pre-revenue life science companies whose primary assets may consist of intellectual property, regulatory prospects and/or early-stage research data. Setting the valuation too low may result in excessive dilution of the founders' ownership, while setting it too high may deter investors or create complications in future financing rounds. Business owners should also consider the governance rights that equity investors may demand, including board representation, protective provisions, anti-dilution protections, information rights and participation rights in future rounds. Additionally, the type of equity issued—whether common equity or preferred equity—will have significant implications for the rights and preferences of investors relative to founders, particularly with respect to liquidation preferences, dividend rights and voting power. Compliance with federal and state securities laws, including applicable exemptions from registration, is also a critical consideration in any equity issuance.
2. **Simple Agreements for Future Equity (SAFEs).** When considering SAFEs as a funding mechanism for an early-stage life science business, owners should understand that a SAFE is not a debt instrument but rather a contractual right that entitles the investor to receive equity in the company upon the occurrence of certain triggering events, most commonly a future priced equity financing round. One of the primary advantages of a SAFE is that it allows the company to raise capital without establishing a valuation at the time of investment, thereby deferring that often difficult negotiation to a later date when the company may have more data, milestones or traction to support a fair price. However, business owners should be attentive to the terms of the SAFE, including the valuation cap, any discount rate and the definition of qualifying financing events that trigger conversion of the SAFE into equity. Founders should also be mindful that SAFEs can result in significant dilution if multiple SAFEs are issued at different caps, and the cumulative dilutive impact may not become fully apparent until a priced round occurs. Additionally, because SAFEs do not carry maturity dates or interest obligations, they offer less downside protection to investors than debt instruments,

which may limit their appeal to certain categories of investors in the life sciences space who are accustomed to more structured investments.

3. **Promissory Notes.** When funding an early-stage life science business through a promissory note, business owners should recognize that this instrument creates a traditional debtor-creditor relationship in which the company is obligated to repay the principal amount, together with any accrued interest, on or before a specified maturity date. Key considerations include the interest rate, repayment schedule, maturity date and any security or collateral that the lender may require. For life science companies, which often have limited tangible assets and may not generate revenue for extended periods, the obligation to repay debt on a fixed timeline can present significant financial risk, particularly if the company's research or regulatory milestones are delayed. Business owners should also consider whether the promissory note includes any covenants or restrictions that could limit the company's operational flexibility, such as restrictions on incurring additional indebtedness, making distributions or entering into certain transactions. Where a promissory note is secured, lenders may require a lien on the company's intellectual property or other key assets, which can limit the company's ability to use those assets as collateral in future financings and may complicate the company's strategic options in the event of default. The potential impact of debt obligations on the company's balance sheet and its attractiveness to future equity investors is another important consideration, as excessive debt may signal financial distress or limit the company's ability to raise additional capital on favorable terms.
4. **Convertible Promissory Notes.** When funding an early-stage life science business through a convertible promissory note, business owners should understand that this instrument combines features of traditional debt with the potential for conversion into equity upon the occurrence of specified events. Like a standard promissory note, a convertible note accrues interest and has a maturity date, but it also includes provisions allowing or requiring the outstanding principal and accrued interest to convert into equity, typically upon a qualified financing event, a change of control or at maturity. Key terms that business owners should carefully negotiate include the conversion discount, valuation cap, interest rate, maturity date and the definition of a qualifying financing event. Business owners should be aware that convertible notes can create misaligned incentives between the company and its noteholders, particularly as the maturity date approaches, since the company may face pressure to raise a priced round on terms that are not optimal simply to trigger conversion and avoid a repayment obligation. Additionally, the interaction between the conversion terms of multiple convertible notes issued at different times and on different terms can create complexity in the company's capitalization structure, making it important for founders to model the dilutive impact of conversion scenarios carefully before issuing such instruments.

Ultimately, the best funding option for an early-stage life science business will vary depending on the unique facts and circumstances of each company. Factors that may influence which instrument, or combination of instruments, is most appropriate include:

- The nature and stage of the company's technology or therapeutic candidate
- The regulatory pathway the company faces
- The amount of capital needed
- The timeline for anticipated revenue or liquidity events
- The founders' willingness to accept dilution and/or governance constraints
- Investor preferences and expectations

There is no one-size-fits-all answer, and business owners are advised to engage experienced legal and financial advisors who can help them evaluate the trade-offs associated with each option considering their specific objectives and constraints. A thoughtful and well-informed approach to early-stage financing can position a life science company for long-term success while preserving the flexibility needed to navigate the inherent uncertainties of bringing innovative products and therapies to market. Additionally, a life science business's choice of entity—whether organized as a corporation, limited liability company or limited partnership—may materially affect the structuring, tax treatment and investor appetite for each of the early-stage funding mechanisms discussed above. It is recommended that business owners consult with their legal advisors on these matters.