Nutter Emerging Companies Group

SAFEs ON THE EAST COAST

Slowly but surely, early stage investors and entrepreneurs on the East Coast are opting for financing mechanisms developed on the West Coast in lieu of traditional convertible notes. In particular, Simple Agreements for Future Equity, or "SAFEs," are becoming more popular and we have used them as both company and investor counsel to shorten transaction timing, reduce the costs of offerings, and get companies back to execution rather than financing.

Overview

SAFEs were developed by the folks at YCombinator, a prominent West Coast incubator, as an alternative to convertible notes. While investors and companies appreciated the way convertible notes allowed the parties to defer a valuation of the company's equity, some of the unintended consequences of convertible notes had started to create tension in the startup community. Both SAFEs and convertible notes require that investors provide cash to companies up front and only receive equity or repayment upon a financing, a sale, or the dissolution of the company. Unlike convertible notes, though, SAFEs are not debt instruments. They function more like prepaid warrants for equity to be issued at a later date. Consider the standard SAFE "trigger" events:

- **Subsequent Equity Financing**—In connection with a subsequent equity financing, holders of SAFEs are issued shares that are the same type as are being sold in the new round—most typically, preferred stock. The number of shares to be issued is usually determined by dividing the investment amount by the lower of a capped share price or the price of the new equity. Often times, SAFEs provide investors a discount on the per share price of the subsequent equity round in the same manner as would convertible notes.
- **Liquidity Event**—Upon a liquidity event (e.g., a sale of the company), SAFE holders will receive either their initial investment or an amount of common stock determined by dividing the investment amount by a capped per share price. As one might expect, this common stock is immediately sold, exchanged, or redeemed as part of the liquidity event and the SAFE holder is treated like any other common stockholder.
- **Dissolution**—In the unfortunate case that the company fails, SAFE holders are entitled to a return of their initial investment, subject, of course, to the availability of funds. Even if the company cannot repay the SAFEs, the holders have a contractual claim against the company and are in a position senior to the common stock holders upon distribution of the company's assets.

Advantages

No Maturity—SAFEs eliminate some of thorniest terms of convertible debt. For example, because a SAFE is not a loan, there is no maturity date and the company is spared the "gun to the head" moment if it does not have sufficient cash to repay a note. It might be assumed that all investors want this bargaining leverage. However, some investors in large syndicates have found that allowing other syndicate members to force the company into insolvency is not in their interest.

While the forced dissolution mechanism is rarely used, it is often the case that upon the maturity date, and the company's inability to pay the debt, investors will renegotiate and force a massive transfer of value from the management to the noteholders, usually by converting or capping the conversion at very low valuations.

No Interest—Because SAFEs are not debt instruments, they do not bear interest. This is beneficial to the founders by avoiding additional dilution. It also spares the company of having to report interest income. Similarly, while investors give up the additional equity purchasable with such interest, they are spared having to pay tax with out-of-pocket cash, on the accrued interest in the year it is earned.

Risk/Return Matching—The absence of typical note features such as maturity dates and interest reflect the position that SAFE holders are contracting for equity level upside and should be exposed to equity level risk. Many issuers believe that if investors want the protection and risk management mechanisms of interest, maturities and insolvency rights, then the cost of such capital should be reduced and capped similar to other forms of debt.

Balance Sheet Impact—One small advantage for startups is that SAFEs, by not being debt, do not interfere with other debt or collateral arrangements early stage companies may have made with equipment landlords, equipment lessors or lenders. This can save the company both administrative costs and unnecessary distractions in closing such deals.

Multiple Liquidation Preferences—SAFEs also eliminate the multiple liquidation preferences that result from convertible notes. Consider a typical convertible note structure, where an investor receives the number of preferred shares in the company's next qualified financing equal to its principal and interest divided by the discounted price per share of the next round. The total liquidation preference held by such investor will be significantly greater than the cash amount contributed. Contrast that with a SAFE investment, wherein the company creates both a "Series A" preferred and a "Series A SAFE Preferred" with differing liquidation preferences—one to reflect the actual cash invested by the SAFE holders and another to reflect the actual cash invested by purchasers in the qualified financing round.

High Velocity Financing—Another benefit to SAFEs for both parties is that each instrument is a direct contract between the company and the investor. Because each SAFE is a stand-alone instrument, companies may be able to close on individual investments faster than collectively-negotiated convertible notes. Theoretically, SAFEs also allow companies to craft unique deals depending upon the circumstances of the particular investor. In practice, however, most SAFEs in a financing process are issued at the same terms or contain "Most Favored Nations" clauses providing each investor with the best terms given to any subsequent SAFE investor.

Challenges

While SAFEs offer an elegant solution to some of the complications of a convertible note structure, they do come with certain challenges.

Investors Rights—Investors may not be comfortable that as a SAFE holder, their sole recourse against the company is a contract claim during the life of the company or as an unsecured creditor on the company's dissolution. Such investors would hold neither the rights of a lender nor the ongoing rights of a stockholder. Likewise, investors may be concerned that the lack of a maturity date provides insufficient pressure to the founders to drive value and close follow-on investments, although it is likely that founders are independently motivated to obtain such additional capital at favorable prices.

Taxation—A significant disadvantage of both SAFEs and convertible notes is that if an acquisition were to occur before a triggering financing, any net gains paid to the investors would be taxed as ordinary income or short term capital gain as opposed to long term capital gains. This increased tax burden will decrease actual investor returns.

Transaction Costs—SAFEs also present potential additional documentation costs over convertible notes at the time of a subsequent equity financing, particularly if differing SAFE deals force companies to have to issue a whole string of SAFE Preferred classes to match the relevant discounts or caps applied to each SAFE holder.

Disalignment—SAFEs , like convertible notes, do little to ease the tension around the incentives on follow-on financings. The floating price format sets up a dynamic where management would like the highest possible price for company equity in the follow on deal, but investors would prefer a lower price, because such lower price buys them more equity upon conversion. If the investors had purchased priced equity instead of a SAFE, they would be fully aligned with management to seek the highest possible price in each subsequent round. This dynamic can be particularly unsettling when early investors (whether holders of SAFEs or convertible notes) also act as the founders' key advisors and confidants.

Innovations

As SAFEs gain traction on the East Coast, it will be interesting to see whether they hybridize with other instruments to produce a SAFE that contains some of the investor-friendly information rights and negative covenants sometimes associated with convertible note deals.

SAFEs may morph to include "double down" options for investors to both convert their existing investment amount into the next round, and to exercise preemptive rights to buy a *pro rata* portion (or more) of the next round.

As SAFEs were originally drafted, upon an early sale, SAFE investors could choose between their original investment (1x) or common stock equal to the capped valuation divided by the then existing capitalization. Given that East Coast investors in convertible note deals have modeled this liquidity option at 1.5x–2x, it is unclear whether the base case terms for SAFEs will shift as well.

Many convertible note deals on the East Coast have adopted sliding discounts related to the span of time between the convertible note deal and the subsequent triggering financing. This more heavily rewards early investors and reduces over rewarding investors who took on little added risk. It is likely that savvy SAFE issuers will apply the same principles of sliding discount rates to their SAFE deals.

As the SAFE form documents were conceived prior to certain changes in the securities laws, it is also now prudent for investors and companies to require certain additional representations and warranties to comply with restrictions on general solicitation and bad actor disqualification rules.

What we know for certain is that innovative entrepreneurs and motivated investors will continue to find creative ways to balance their interests.

Conclusion

SAFEs provide an attractive way for companies and issuers to defer valuation negotiations and to provide early investors with equity returns, without creating the debt/equity hybrid that is economically and structurally confusing. We believe that in the months and years ahead more savvy entrepreneurs and early stage investors will seriously consider these instruments as the way to fund the next wave of amazing, high growth companies.

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