

SAFEs and Convertible Notes

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An angel investment can take the form of convertible debt, convertible equity (e.g. a Simple Agreement for Future Equity, more commonly known as a SAFE) or equity (such as stock or membership units in a priced round). A convertible instrument does not provide the investor with immediate ownership upon investing but may be converted into equity in the first (or next) sale of stock by the company in which the Company's valuation is established. Because a sale of stock necessarily requires that a price per share be stated (thereby establishing a valuation of the company), stock sales are often referred to as priced rounds, whereas convertible debt or equity are unpriced rounds.

For a variety of reasons, most angel financings are structured as convertible debt, SAFEs or similar instruments. There are, however, subtle differences in each of these types of instruments that can have a significant impact on the company and/or the investors. Discussed below are major features of SAFEs and convertible notes.

1. Pre-money vs Post Money. As originally conceived, the standard form of SAFE was "pre-money", meaning the valuation cap at which the SAFE converted into stock was based on the company's capitalization immediately prior to the event triggering such conversion (usually an equity financing resulting in proceeds to the company at or above a specified dollar amount). Because investors cannot know a company's future capitalization until after the next financing has occurred, they also would not know until after the financing occurred what percent of the company they own after conversion of their pre-money SAFEs. Thus, investors sometimes use a form of SAFE with the valuation cap based on the company's post money valuation. In this case, the SAFE conversion price would be based on the valuation cap divided by the company's capitalization on a fully diluted basis immediately after the financing ("post money"). In the post money scenario, the investor always knows what their percent of the company will be after the financing.

There are some significant differences between pre and post money SAFEs. In the pre-money scenario, if the Company sells additional SAFEs, the investor and founder both share that dilution. In the post money scenario, only the founder is diluted. Generally, the pre-money SAFE favors the company and its existing stakeholders while the post money SAFE favors the investor by protecting the investor against dilution.

2. Discounts. Investors that provide early money usually receive a discount to the preferred stock price in the equity financing that triggers conversion of the convertible debt or equity. The discount usually ranges from 10% to 30% and is often 20%. This means that every \$80 of investment in the form of a convertible promissory note or SAFE would buy \$100 of stock in the priced round.
3. Valuation Caps. Since convertible promissory notes and SAFEs convert in the future, at a time when the company's value is likely to be higher (or much higher) than its value at the time of the investment, the note or SAFE holder would receive proportionately less stock than

they would have received had they initially purchased stock instead of convertible debt or equity. To deal with that problem, convertible notes and SAFEs usually contain a valuation cap, meaning the convertible instrument converts at a conversion price based on the company's valuation that will be capped at a specified maximum. For example, if a note had a valuation cap of \$10 million, and the company did not do a financing until the company was worth \$20 million, the note investor would receive stock at a price per share based on a valuation of the company equal to \$10 million rather than \$20 million. Almost all convertible instruments today contain a valuation cap.

4. Convertible Note Interest and Maturity Date. Convertible promissory notes are technically debt and accrue interest. More significantly, a feature of debt is that it has a maturity date. Due to state banking and finance laws, most promissory notes have a relatively short term (1 to 2 years). If the company does not conclude its financing in that amount of time, the notes would become due and, if not repaid, in default. SAFEs have neither an interest component nor a maturity date and are therefore more attractive to issuers than convertible debt.
5. Shadow Preferred. In the past, convertible instruments frequently converted into the same preferred stock that was being issued to new investors in the next equity financing, where the preferred stock's liquidation preference was equal to the issue price paid by new investors rather than the discounted conversion price pursuant to which the convertible instruments were converted to stock. This meant that holders of convertible instruments received a windfall since they received stock with a liquidation price in excess of the conversion price paid to convert their notes or SAFEs. For example, if the preferred stock price and corresponding liquidation preference is \$1 per share, and a SAFE or convertible debt converts at \$.80 per share, the investor would receive \$1 in liquidation proceeds for every \$.80 invested. To address this windfall, well drafted convertible instruments now oblige the holders to convert the instrument into a shadow series of stock (ie., Series A-1 instead of Series A) that has the same rights, preferences and privileges as the preferred stock issued to new equity investors, except the per share liquidation preference equals the discounted conversion price of the note or SAFE (eliminating the prior windfall). Price-based antidilution protection and dividend rights are also based on the discounted conversion price rather than the full price paid by new investors.
6. Pro Rata Rights. A pro rata right is a right of the investor to purchase additional stock on a pro rata basis if the company raises another round. The pro rata right is usually expressed in a side letter and typically refers to a financing round after the current round in which the note or SAFE converts. For example, if the note or SAFE converts in the Series A round, the pro rata right would apply at the next financing round (presumably Series B).
7. Most Favored Nation (MFN). An MFN clause protects the investor from a later more favorable sale of convertible promissory notes or SAFEs. Under an MFN clause, if the company subsequently issues a convertible promissory note or SAFE with provisions that are more advantageous to subsequent investors (such as a lower valuation cap or a more deeply discounted conversion price), the currently outstanding convertible instrument (of the same type) is amended to reflect the more favorable terms. Typically, the more favorable terms must be set forth in the same type of instrument in order for the MFN clause to apply, so a subsequent issuance of SAFE's with more favorable terms would not trigger amendment of previously issued convertible promissory notes, and vice versa, unless the MFN clause is drafted broadly enough to cover more favorable terms set forth in different types of convertible

instruments.

8. Conversion. SAFEs and convertible promissory notes will convert to stock in the next round of financing that meets certain conditions, such as an equity financing of a certain size (a “qualified financing”). In the case of a note, that qualified financing must occur before the maturity date of the note to trigger an automatic conversion. Often the investor will also have the right to convert (an optional conversion) in the event of a financing that does not meet the criteria for a qualified financing. The note or SAFE may also convert if there is a sale of the company prior to a financing (a liquidation event).

In the case of a conversion on a liquidation event, a note or SAFE may provide that it (a) converts to common stock at a conversion price based on a specified valuation of the company (the valuation cap, for example) or at the valuation specified by the buyer in the liquidation event, (b) is to be repaid in full, or (c) is to be repaid at a multiple of the principal amount of the note or purchase price of the SAFE in connection with the closing of the liquidation event. Such alternatives may be at the option of the holder (as is often the case for SAFEs) or mandatory (more common for promissory notes).

9. Dissolution. The note or SAFE will typically become payable in full if the company ceases business operations or enters into a liquidation or insolvency proceeding.
10. Representations. Investors tend to do less diligence in convertible bridge investments than they do in priced rounds. Nevertheless, basic representations will be made by both the company and the investor. The company will represent as to its corporate status, power and authority, no violation of applicable laws or other instruments or agreements by which the company is bound, no consents required, and sometimes (but not always) ownership of the company’s IP. The investor will make representations as to its power and authority to enter into the agreement as well as securities related representations. In particular, the investors will almost always be required to represent that they are accredited under US securities laws.
11. Other Rights. Sometimes investors ask for additional rights to be contained in side letters. An investor may ask for a board seat (which is rare at this early stage) or a board observer right, which means the investor’s designated representative would be allowed to attend board meetings but would not have a vote. The investor might also ask for rights related to the company’s financial information and reporting, as well as inspection or consultation rights.
12. Securities Laws. Convertible promissory notes and SAFEs are securities, the sale of which must comply with US federal and state securities laws. A broadly worded exemption from registration under section 4(a)(2) of the Securities Act of 1933, as amended, is available for private placements involving no public offering and has no related filing obligations. Another exemption from federal registration that companies frequently rely on is Regulation D promulgated under the Securities Act, which is a safe harbor that generally requires the investors to represent that they are accredited. A federal Form D filing is required under this exemption and must also be filed at the state level if so required by state securities regulators. The states of residence of the investors may also have notice filing requirements.
13. Tax. For tax purposes, most SAFEs are probably treated as a prepaid forward contract, meaning that it is a right to buy stock in the company at a later date. Some drafters attempt to treat SAFEs as stock for qualified small business stock (QSBS) purposes, but the IRS has not ruled on this issue. Convertible notes are generally treated as debt, so the company can

deduct the interest paid or accrued to the investor. A taxpayer's holding period for capital gains and QSBS should start when the SAFE is converted to stock. In the case of a convertible note, the holding period for stock issued on conversion of the note should tack back to the date of issuance of the note for capital gains purposes but not for QSBS (the holding period for which starts only when the promissory note is converted to stock).