Is a SAFE, well, um… Safe?

SAFE stands for "Simple Agreement for Future Equity" and is a creation of the ubiquitous start-up accelerator, Y Combinator. SAFEs look like convertible notes, but have some material differences that you should understand.

How does a SAFE work?

Much like a convertible note, a SAFE is an instrument that gives an investor a right to acquire equity in a company upon the occurrence of certain events ("qualifying events"), including preferred equity financings ("financing") and/or sales of the company ("sale of the company"). At a SAFE closing, the investor delivers the SAFE funds to the company. Upon a qualifying event, the SAFE is converted to equity.

If the qualifying event is a financing, an investor's SAFE will convert to the preferred stock issued in the financing (with the exception of the "shadow" preferred concept, as discussed below), at a discounted price based upon either: (i) a discount percentage (for instance, 20%) of the price per share paid by the new investors in the financing, or (ii) a "valuation cap," regardless of the price per share the new investors pay in the financing. With respect to the former, if the price per share in the financing is $1.00, the SAFE would convert at $0.80 per share. With respect to the latter, the price per share paid by the SAFE holders would be the valuation cap (i.e., a pre-money valuation ceiling) divided by the pre-money, fully-diluted capitalization, regardless of the valuation in financing. Valuation caps can lead to steep discounts if the valuation in the financing greatly exceeds the valuation cap. Some SAFEs also include a conversion feature stating that the SAFE converts at either the discount price, or the valuation cap price, whichever leads to a lower price per share for the SAFE investor. This ensures that the SAFE investor will always convert at a lower price than the price in the financing, regardless of the valuation.

If the qualifying event is a sale of the company, the holder of the SAFE usually has an option of converting to equity prior to the transaction with similar mechanics as described above (i.e., at the price per share based upon: (i) the discount rate (as applied to the purchase price in connection with the sale), or (ii) the valuation cap), or getting paid back his or her SAFE investment.

If the company closes its doors, SAFE holders would typically be entitled to any liquidation distributions prior to any company equity holders.

What are the Differences?

SAFEs are similar to convertible notes, but there are some important differences.

First, SAFEs are not "debt," so there is no interest rate or maturity date. In that respect, SAFEs act more like a warrant or an option (and are similarly reflected on the capitalization table) than convertible debt. The fact that SAFEs are not debt instruments allows issuers to avoid regulations typically associated with debt, such as term limitations and interest rate limitations.

Second, SAFEs generally include language that prevents what has been coined a "liquidation overhang." A liquidation overhang occurs when a SAFE holder coverts to equity at a discount, but gets a liquidation preference based on the full price of the stock in the financing. For example, if SAFE holders convert to preferred stock at a 50% discount, and the preferred stock has a 2x liquidation preference based upon the price in the financing, the SAFE holders are really getting a 4x liquidation preference (because they paid half price). SAFEs generally include language to avoid this sometimes unintended result by stating that the SAFEs convert to "shadow" preferred stock. The "shadow" preferred stock is identical to the preferred stock that the new investors receive, except that the "shadow" preferred stock dividend and liquidation preference rights are based

on the SAFE conversion price, rather than the price in the financing.

Third, SAFEs are generally less expensive to implement because there are fewer terms to negotiate. Valuation caps and discounts are generally the only points of real contention. As I mentioned above, interest and term are no longer issues to negotiate. The folks at Y Combinator have also effectively combined the purchase agreement and the separate investment instrument (which you normally see in a convertible note transaction) into one document. So, there is less paper. People generally like that.

Finally, the interest on convertible notes can make conversion complicated, and the fact that the debt has a fixed term can cause extra work for both parties when the term has to be extended. SAFEs avoid both of these complications.

Should I Utilize a SAFE When Raising Funds?

As with everything in the law, it depends, of course! It depends on how much money you want to raise, how much leverage you have, and the composition of your target investors. That being said, this tool is more appropriate for rounds typically described as “seed” or “angel” and would not likely work in a typical “Series A,” VC-backed round. In early rounds, investors are more likely to go with a SAFE because it’s an efficient way to get the capital to the Company, has a low transaction cost, and gives the investors a chance to own some of the feature-rich, preferred stock that gets issued down the road. At the end of the day, if you are raising a seed or angel round, and are considering a convertible note transaction, it’s likely that a SAFE could be an excellent alternative.

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