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Simple Agreement for Future Equity — Are They Really That Safe?

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If you're involved in the start-up space, you've likely heard the term "safe". A Simple Agreement for Future Equity, more commonly referred to as a SAFE, was introduced by Y Combinator in 2013[2] as a cost-effective, simple and quick method for start-ups to raise capital. While SAFEs have yet to become as popular in Canada as they are south of the border, they are emerging as an alternative to more traditional forms of early-stage financing, such as convertible notes or preferred shares.

The Basics

A SAFE is a convertible security that typically does not have a debt component or an expiration/maturity date (*i.e.*, no obligation to repay). Investors who participate in a SAFE are acquiring an option to convert their investment into the company's shares at a later date when a pre-determined event occurs. This conversion event usually happens when the company completes an equity financing for a negotiated aggregate proceeds amount. To motivate investors to invest in a SAFE, their money will typically be converted at either, or the lesser of either, (a) a discount to the equity financing valuation, or (b) an agreed upon valuation cap. Due to this relatively simple structure and standard form documentation, negotiations between the parties generally focus on what the valuation discount or valuation cap will be, and whether the SAFE will include one or both features. Some modified SAFEs also try to entice investors by paying interest on invested capital, to be paid-in-kind on the equity conversion date (however, this is a relatively rare feature).

What Founders Should Know

One of the biggest draws to SAFEs for founders is the ability to close financing with an investor on an individual basis, rather than coordinating a single closing with multiple investors — often a stressful and costly process. This feature in effect creates a staggered equity raising process which allows founders to better manage how much equity should be offered (so they do not become diluted more than necessary) and ensures that the company does not become overcapitalized. A further benefit is that issuers will spend less on lawyers and save time negotiating given the lack of complex terms in the agreement compared with more traditional financing methods. Finally, given there are no maturity dates or equity financing deadlines,

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[2] https://www.ycombinator.com/documents/.

founders can focus on growing their business without the overhanging stress that debt or financing deadlines cause.

Despite the positives, there are some drawbacks of which founders should be aware. Often, founders will include a valuation cap in a SAFE and raise funds with the expectation they are diluting their ownership stake based on that valuation. It is important to remember that the valuation cap is not necessarily the valuation at which the capital is being raised. To illustrate, let's say a founder raised $500,000 of seed capital through a SAFE. The SAFE's conversion event is an equity round (commonly referred to as a Series A round) of $1M, and the equity converts at the lesser of either a $10M valuation cap or a 20% discount. If the company is forced to raise $1M at a $6M valuation due to a liquidity crunch or other market factors, the founders will have given up 27% of their company, compared with the 16% they would have anticipated at a $10M valuation.[3]

What Investors Should Know

Investors benefit from SAFEs for many of the same reasons as founders. The simplicity of the nature of the investment and the standard form paperwork reduces negotiation time and allows investors to make decisions quickly, while also reducing pressures to meet deadlines to participate in a formal equity round.

That said, there are also some negatives for investors. First, it is unclear what an investor actually owns when they purchase a SAFE. There are no expiration or maturity dates, so it may take years before a conversion to equity occurs or it may never happen. Second, an investor does not have any shareholder rights until the SAFE is converted to equity. Accordingly, a SAFE holder does not have the power to vote in an election of the board of directors or to participate in dividends. Third, on a dissolution of the company, SAFEs rank junior to outstanding debt and creditor claims (but generally are senior to payments to common shares).

Takeaways

A SAFE is a useful tool for start-ups looking to raise capital without incurring the higher costs and protracted negotiations associated with more traditional methods of financing. Nevertheless, it is important for founders to carefully consider how much equity they are willing to give up, and for investors, to keep in mind that they have no shareholder rights and lack recourse in the event a conversion to equity does not occur.

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[3] $10M Valuation: [SAFE dilution + Series A Dilution] = (500,000 / 8,000,000) + (1,000,000 / 10,000,000) = 16% $6M Valuation: [SAFE dilution + Series A Dilution] = (500,000 / 4,800,000) + (1,000,000 / 8,000,000) = 27%