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PERSPECTIVE

Common SAFE mistakes

By Murray Indick and Jesse Finfrock

Startup businesses continue to be created and financed globally at a rapid pace. Technology has made it easy and relatively cheap to incorporate a business and generate a "starter kit" of the key necessary documents to operate. Once formed, a business may need funding beyond the wherewithal of the typical founder. These "seed financing" rounds may raise anywhere from $100,000 to $1.5 million. The capital markets have generally standardized these early-stage financing documents, with options that are denominated as convertible notes and/or simple agreements for future equity (SAFEs).

By way of background, a convertible note is a debt instrument that either converts into equity or is repaid upon the occurrence of a certain event, such as a subsequent equity financing or the maturity of the note. If it converts, the debt generally converts into the class of equity issued in a qualified financing (i.e., the next round of funding subject to a baseline threshold funding amount). The note will convert at a discount built into the instrument to reward early investors, and such discount will be based on a negotiated upper limit on valuation at the conversion event (a so-called "valuation cap") or a percentage discount to the price per share of the equity securities sold in the qualified financing (e.g., 20 percent). Determining the correct conversion formula will depend on the pre–money valuation of the equity financing triggering the conversion.

Ultimately, the correct conversion formula will be the one that results in the noteholder receiving more shares. The note will also have a maturity date, an interest rate and other common features.

Pioneered by the startup accelerator Y Combinator, SAFEs are simple and short financing documents. At its core, a SAFE is a promise for future equity; it is not debt. But the mechanics of a SAFE are comparable to the type of note described above, except that in the case of a SAFE, there is no maturity date/repayment term and there is no interest rate. As with convertible notes, there likely will be a valuation cap, and there may be a discount to the price per share of the equity securities sold in the qualified financing.

Unfortunately, entrepreneurs and occasionally counsel are making common mistakes in documentation when raising capital during these seed financing rounds. Not only is this problematic when documentation does not sync with business expectations, but the errors imperil future financing rounds involving institutional capital. Here are two such mistakes that can and should be avoided.

Document the Discount Rate Properly

The first common mistake arises when a standard form of documentation is used. Bay Area startups and counsel now regularly rely on paperwork that involves filling in a blank on a defined term, the "discount rate." This key term is the percentage that may be discounted upon conversion to compensate earlier-stage investors. Today, we typically see a discount of 20 percent, but the discount rate needs to be papered properly. Drafters beware — entering 20 percent into the discount rate line would yield an untenable 80 percent discount. In other words, if the discount rate field is completed properly, a "20 percent discount" means that the discount rate used in the documents is 80 percent, or 100 percent minus the stated discount.

Distinguish between the Valuation Cap and the Discount Rate

Another common mistake arises when the startup business includes both a discount rate and valuation cap in its financing documents. We see too many mistakes when the documentation is described to potential investors. The most frequent error is the incorrect belief that the valuation cap is itself subject to the discount.

When the subsequent qualified financing occurs and conversion is triggered, the standard documentation, if it includes both a valuation cap and discount rate, dictates that the earlier investor gets the best result obtained by running the calculation in two ways (applying either the valuation cap or the discount) to determine the appropriate number of post-investment shares.

Take, for example, a convertible note or SAFE that has a valuation cap of $10 million and a 20 percent discount. The company would apply the discount up until the point at which doing so would yield fewer shares than applying the cap. In this case, that inflection point is a valuation of $12.5 million, since $10 million is 80 percent of $12.5 million. If the valuation of the company is $12 million, using the cap would mean that the price would only be reduced by roughly 16.7 percent, obviously less than the 20 percent discount. If the company's valuation is instead $13 million, using the cap yields a price reduced by roughly 23 percent and results for the investor superior to those of applying the discount.

The mistake we see is the assumption that the discount is made to the valuation cap itself. The valuation cap remains $10 million, with a 20 percent discount, as opposed to a valuation cap of $8 million. This is a particularly important mistake to avoid when investors are making seed investments into the business at different times but at the same stage.

Conclusion

These examples highlight the importance of careful drafting at the seed financing stage, as well as careful preparation of the spreadsheet modeling the note or SAFE conversion. While new tools make it easier than ever to prepare quick financing documents, they also require close attention to detail and complete understanding of the terms.

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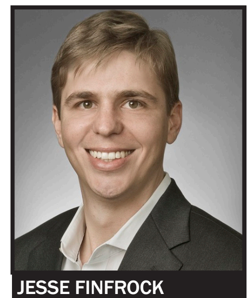
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