Published on *The National Law Review* https://natlawreview.com

SAFEs and KISSes Poised to Be the Next Generation of Startup Financing

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Overview

In late 2013, startup accelerator Y Combinator unveiled its Simple Agreement for Future Equity ("SAFE") investment instrument as an alternative to convertible debt. While SAFE templates appeared in different varieties, the purported goal was to create a standardized set of basic funding terms between startups and investors while deferring decisions about valuation, liquidation preferences and participation rights until later-stage rounds of financing. In mid-2014, another accelerator, 500 Startups, introduced a competing document, dubbed the Keep It Simple Security ("KISS"). Although investors were initially nervous about accepting either of the new investment forms, these alternatives to conventional notes ("note-alternatives") have become an increasingly popular tool for investing in early stage companies.

Note-Alternative Securities

Security instruments are contracts where companies take cash or other consideration in exchange for an equity interest in the company. Common stock is the most basic type of security and allows stockholders to manage the company generally on a one-vote-per-share basis. Preferred stock is similar to common stock except it grants its holders additional rights over and above the common shareholders such a preferred treatment at a set price in the event of a liquidation of the company. Options and warrants give their holders the ability to purchaseequity at a fixed price at a specified time in the future.

Unlike equity, convertible debt begins as a loan that the company is contractually obligated to repay, but may convert into equity such as preferred stock upon the occurrence of a specified event or events. Before conversion, convertible debt typically accrues interest and has a maturity date for repayment. As the maturity date for this type of debt approaches, illiquid companies may be faced with the paradoxical choice of renegotiating the instrument, seeking an alternative source of funding, or going out of business.

In a class of their own, note-alternatives are short and flexible security agreements that are designed

to be simple to understand, negotiate, and administer. Note-alternatives combine many features of the more traditional types of securities and are designed to give investors and entrepreneurs the benefits of traditional securities while attempting to remove their major frustrations. Note-alternatives are contractual rights to purchase the company's equity at a future date, similar to warrants, but the conversion price remains undetermined until a later date. Like convertible debt, note-alternatives are a quick and simple way of providing companies with cash in exchange for the promise of future equity. A major difference is that note-alternatives generally do not accrue interest and do not have stated maturity dates.

A note-alternative is an agreement that — when the company raises additional money, is sold or undergoes an IPO — the note-alternative will convert into an amount of preferred stock based on the value of the company as determined in the new round of financing. Although there are variations on the terms, most note-alternative securities convert into a special series of preferred (or "shadow preferred") that has the same features as the company's other preferred stock except for its conversion price, liquidation preference, and dividend rate.

A Typical terms that may vary include avaluation cap or anuncapped note alterative, discounts on conversion and the rights of the shadow preferred. Valuation caps and discounts are both pro-investor provisions. A valuation cap sets a maximum conversion price, and a discount gives early investors a percentage discount off of the valuation price.

Pros and Cons for the Company

Note-alternatives are short, simple agreements which makes them more readily understandable to entrepreneurs who are often not experts in law or finance. Note-alternatives typically do not accrue interest or have a maturity date, which reduces the risk of the company facing an insolvency problem. Sales of common stock by the company will not necessarily trigger the note-alternatives to convert, which gives the company added flexibility in its capital structure. Until the note-alternative converts into stock, note-alternative holders typically have no management rights and do not share in any dividends that are paid. But perhaps most importantly, note-alternatives are not treated as debt on the company's balance sheetNote-alternatives are also likely to receive similar tax treatment as convertible notes, but investors and business owners should consult their tax professional for individualized advice.

Despite their benefits, note-alternatives can also have drawbacks from the company's point of view. In particular, delaying valuation can be problematic for the company's founders because note-alternatives with a valuation cap have essentially the same effect as a full ratchet anti-dilution provision and may act as a ceiling to the next financing round. If the company is valued significantly lower in a future financing round than when the note-alternatives were issued, holders of the note-alternatives will be entitled to take a much greater percentage ownership upon converting. It is also unclear whether companies that raise money using note-alternatives would need 409A valuations, which govern certain deferred compensation to paid service providers.

Pros and Cons for the Investor

If a note-alternative includes both a valuation cap and a discount, the company's founders bear almost all pricing risk stemming from the agreement. If a later financing round is issued at a low price, the note-alternatives will convert into preferred shares based on that lower valuation, adjusted for any applicable discount. But if the later financing round is issued at a higher price, the note-alternatives will convert into preferred shares based on their own valuation cap, not the higher

valuation of the financing. Also, because most angels and venture capitalists are in the business of investing and not lending, investors may find psychological appeal in using note-alternatives instead of convertible debt.

However, note-alternatives also have several drawbacks for investors. The note-alternatives typically have no maturity date, so investors are unable to declare a default. Although the underlying purpose of convertible notes is that they will convert to equity, convertible noteholders still have some minimal comfort that they can declare a default if the company fails to raise an equity round of financing or pay off the loans as they come due. Note-alternative holders, on the other hand, have essentially no rights until a financing or sale takes place.

Implications

Note-alternatives are an entirely different type of security instrument, not a mere offshoot from the familiar forms of financing structures, and some investors may see note-alternatives as being too favorable to the company and providing too little protection for themselves. As a result, investors will need to be flexible and willing to learn the nuances of these new instruments if they are to continue using them as a regular part of their investment strategy.

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National Law Review, Volumess V, Number 126

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