Equity Crowdfunding Securities

SAFE: Simple Agreement for Future Equity

With an emphasis on *simple*, this new equity security works for seed-stage startups

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Y Combinator [www.ycombinator.com], a well-known tech accelerator, created the SAFE (simple agreement for future equity) in 2013, and uses it to fund most of the seed-stage startups that participate in its three-month development sessions. Since 2005, Y Combinator has funded over 1,000 startups, including Dropbox, Reddit, WePay, AirBnB, and InstaCart.

The SAFE is something like a warrant entitling investors to shares in the company, typically preferred stock, if and when there is a future valuation event, i.e., if and when the company next raises "priced" equity capital, or is acquired, or files an IPO.

Outside of Y Combinator, the SAFE is being scrutinized and utilized by startups in the equity crowdfunding markets. Since 2013, the SAFE was used in perhaps 1 or 2 percent of equity offerings on Regulation D platforms under Rule 506(c), also known as equity crowdfunding for accredited investors. In the period from 9/23/13 to 9/23/15, among the Rule 506(c) offerings tracked by Crowdnetic [http://www.crowdnetic.com/reports/sep-2015-report], 69 percent used straight equity (e.g., preferred stock), 20 percent used convertible debt, 9 percent used straight debt, etc.

The SAFE may have found its ideal niche in Title III offerings, also known as equity crowdfunding for all investors – although we won't know how effective it really is for several years. Upon the launch of Title III (under Regulation CF) on May 16, 2016, a majority of the 20 equity offerings listed on Wefunder [http://www.wefunder.com], the dominant Title III portal, use the SAFE.

Founders Love It

SAFEs are attractive to founders, especially at the pre-revenue stage, for two reasons. First, they're very simple. The founders don't have to hire a lawyer to draft the agreement (although I wouldn't discourage them from getting good legal advice). Y Combinator released four basic versions of the agreement [http://www.ycombinator.com/documents/] in December 2013, all of them five pages plus signatures, which issuers can adapt. Simplicity is attractive to inexperienced angel investors too.

Second, like convertible debt, there is no need for issuers and investors to agree on a current valuation or share price – those numbers are fixed at a later date, in a liquidity event, presumably when the company has more revenue, and presumably in a priced funding round with more sophisticated venture investors, or in an acquisition or IPO.

Also like convertible debt, the SAFE deal terms can include valuation caps and share-price discounts, to give early (CF) investors a lower price per share than later (VC) investors or acquirers get in that liquidity event. That's justice, because earlier investors take more risk than later investors in pursuit of the same equity.

Unlike convertible debt, there is no debt with a SAFE. There is no maturity date either, which means investors have to wait an unspecified amount of time before they can get their hands on the equity they bought, if that ever happens.

Investor Protection

On the surface, it appears that the SAFE offers investors less protection than convertible debt. For such a sacrifice, investors should be very generously rewarded, right? It seems the magnitude of the reward depends entirely on low caps and/or high discounts, since those are the only variable terms – a feature of the SAFE's exquisite simplicity.

Experienced angel investors are skeptical about whether issuers are willing to offer sufficiently generous discounts in particular. Of the 11 issuers that use SAFEs for their offerings on Wefunder, all include valuation caps (ranging from $2 million to $20 million) but only two include discounts (10 and 15 percent). Considering the much greater level of risk that seed-stage investors take on compared to later-stage investors, 15 percent might not seem like much of a reward to sophisticated angel investors. Try 50 percent, which would represent a 2x valuation jump from the CF round to the liquidity event, quite reasonable when the time between events is indefinite.

But crowdfunding investors under Title III will be more socially motivated than traditional angels whose primary motivation is ROI. Average Title III investors (a) will gravitate to simplicity, (b) might not be able to judge whether the valuation cap makes any sense whatsoever, and (c) will often settle for a half-decent discount on share price just to get in on the ground floor of an exciting startup – a privilege that was largely unavailable to them before Title III of the Jumpstart Our Business Startups Act of 2012 was implemented this year.

In fact, even some experienced angel investors care less about deal terms than about the brilliance of the business concept, the ability of the founders to execute their plan, and the growth potential of the market for the company's product or service. Paul Graham, one of America's premier angel investors and a founder of Y Combinator, wrote this [http://www.paulgraham.com/angelinvesting.html] in 2009:

> Don't spend much time worrying about the details of deal terms, especially when you start angel investing. That's not how you win at this game. When you hear people talking about a successful angel investor, they're not saying, "He got a 4x liquidation preference." They're saying, "He invested in Google."

> When angels make a lot of money from a deal, it's not because they invested at a valuation of $1.5 million instead of $3 million. It's because the company was really successful.

Again, many experienced angels may disagree with that approach, because they *must* maximize return on investment *every time* in order to be successful – that's their full-time job. Graham's advice is better suited to part-time angels whose primary motivation is to help entrepreneurs they admire, support community development, own a piece of their favorite hangout or brand, or simply have as much fun as those "Shark Tank" investors seem to have.

Drilling into SAFE Terms

The SAFE was originally drafted by Carolynn Levy, a lawyer and Y Combinator partner. Here are the most important terms that are featured in the SAFE:

- Along with valuation and share price, many terms of the equity agreement – including distribution preferences, anti-dilution mechanisms, conversion from preferred to common stock, protective provisions, and other details – are deferred to the future liquidation event.
- If the issuer is unsuccessful and dissolves the business before there is a liquidity event, SAFE holders may receive their investment back (without interest) prior to any distribution to company stockholders, if cash is available for that purpose.
- Often the SAFE holder's liquidation preference is 1x (equal to the original SAFE investment) even if later investors get a higher liquidation preference for the same preferred stock equity. For this reason, SAFEs are said to convert into "shadow preferred" stock.
- Some SAFES provide that in the event of a merger, acquisition, or IPO, a SAFE holder may convert the SAFE into shares of common stock rather than preferred, calculated based on the valuation cap; or opt to get the original investment refunded.

Resources

Here are some authoritative articles that cover the basics of SAFEs:

- Y Combinator's Startup Documents page, which introduces the SAFE, with links to four different versions of the document (with or without caps and discounts).

- The "SAFE Primer," published by the Cooley law firm. (Click on the "Safe Primer" link from the "Documents Generator" page.)

- "Better SAFE than Sorry?" published in January 2015 by the McCarter & English law firm.

- An April 2015 *Wall Street Journal* article.

- A 2016 *National Law Review* article by lawyers Stephanie Zeppa and Andrew Kreider.

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About the Author

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