The SAFE alternative in funding startup ventures

by Gavin C. Grusd

Startup companies need a great idea and capable principals to execute their business vision. However, many startup founders lack the financial resources to implement their plan, and they would never be able to turn their concepts into successful businesses without investors willing to finance young and risky startup companies.

The first and often most vital round of financing for a startup company is known as the seed round. The **S**imple **A**greement for **F**uture **E**quity (or SAFE) is an alternative to issuing equity interests or convertible notes for raising capital at this stage. At the startup stage, it is challenging to determine how much equity a company needs to issue to investors for the amount of funding sought, because the funding amount will represent a percentage of the company's value. There may be no basis to establish valuation and often it is arbitrarily determined at a number on which the company and the investor may never reach agreement. Also, at the seed stage a company may be reluctant to issue debt for fear of reaching the maturity date before having funds to repay the debt. The SAFE instrument avoids these situations.

SAFEs provide for an investor to invest money now, and in return the investor will get the same type of equity that later investors will get in a future round of "qualified financing", based on the same valuation in the later round. A qualified financing is an equity financing (usually for preferred stock) by the company for least a stated aggregate investment amount that occurs in the future. The expectation is that given the further development of the company and the sophistication of the investors in that future transaction, the valuation and type of equity instrument to be issued will be established on an arms-length basis.

Because the SAFE investors come in and support the company at the early and more risky stage, the amount of equity that SAFE investors get is determined at a discount (typically 10–30%) to

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the valuation established via a qualified financing. As a result, early investors will get more equity for their SAFE investment than qualified financing investors receive for a similar level of investment at a later date.

SAFEs also provide a mechanism to convert or liquidate the SAFE if the company has a liquidity event such as a sale of the company or initial public offering, and never has a qualified financing, based on the valuation attributed to the company in that liquidity event.

A SAFE is neither equity or debt. Prior to a conversion, it has no attributes of equity (i.e. no voting or distribution rights), and no elements of debt (no maturity date, interest payments, principal repayment, or events of default).

If a qualified financing or liquidity event never occurs and the company fails, SAFE holders will sit below the company creditors but above the equity owners in the waterfall of distributions in liquidation, up to the amount of their SAFE investment, to the extent that funds are available.

The general terms and structure of SAFEs have become well-established in seed round financing, and as a result relatively little time and cost is expended in structuring SAFE deals compared to equity or debt financings. While the scope of this article only permits a basic overview of SAFEs, their terms may vary as the company and investors negotiate and agree individually.