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A TECHPOINT RESOURCE FOR THE INDIANA FOUNDER'S NETWORK

Context, Benefits, and Tradeoffs of SAFE Notes

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BACKGROUND:

Simple Agreement for Future Equity (SAFE) notes are an investment vehicle created by Y Combinator to provide a simpler, faster, and cheaper way for startups to raise seed capital compared to convertible notes or equity financing. They are agreements that convert into equity during a future priced round.

BENEFITS:

SAFE notes are straightforward, with fewer terms compared to convertible notes, making them easier to understand and execute. They do not have a maturity date or interest rate, providing more flexibility to the startup. Unlike convertible notes, SAFEs are not considered debt, so there is no risk of default and legal costs are lower because of their simpler structure.

SAFE notes are beneficial for their simplicity and flexibility, making them suitable for early-stage funding with lower immediate costs and obligations.

NEGATIVE IMPLICATIONS:

Over time, multiple SAFEs with different terms can complicate the cap table, making it unclear how much equity is being given away. Investors may face uncertainty regarding their ownership percentage until the SAFE converts, potentially complicating valuation and equity stakes. If a conversion event does not occur, it leaves both founders and investors in a grey area regarding the equity conversion. There can be unclear tax implications where investors might struggle to claim losses due to the lack of clear SEC and IRS guidance.

Recommended Best Practices for Startups Using SAFE Notes

LIMIT STACKING:

Avoid stacking multiple SAFEs with different terms to prevent cap table complexity. If possible, consolidate SAFEs under similar terms.

CLEAR COMMUNICATION:

Ensure transparent communication with investors about the terms and potential implications of SAFEs.

LEGAL CONSULTATION:

Work with legal experts to tailor SAFEs to your specific needs and to understand the long-term impacts on the cap table and tax situation.

EDUCATION AND TRAINING:

Regularly educate your team and investors about SAFEs, their benefits, and potential risks. Consider mini-sessions or one-pagers to share best practices.

MONITOR MARKET PRACTICES:

Stay updated with market standards and practices regarding SAFEs to ensure alignment with investor expectations and regulatory changes. In 2024, there is more investor pressure to shift back to convertible notes.

PLAN FOR CONVERSION:

Have a clear plan for conversion events to avoid leaving SAFEs unconverted, which can lead to tax ambiguities and investor dissatisfaction.

How Much is Sold in a SAFE Round?

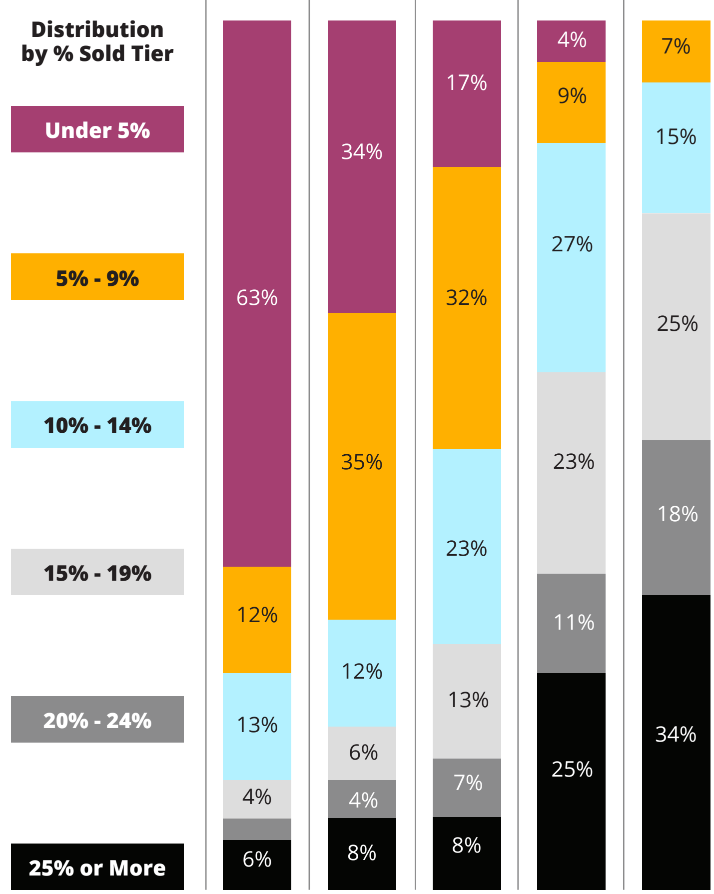
Dilution can sneak up on founders who raise multiple SAFE rounds

Data: 1,503 US companies raising on SAFEs before any priced round funding in H1 2024

Percent Sold by SAFE Round Size and Distribution

Post-money SAFEs Only

SAFE Round Size	Under $250K	$250K-$499K	$500K-$999K	$1M-$2.4M	$2.5M-$4.9M
Median % Sold	**3.0%**	**7.1%**	**11.2%**	**16.4%**	**21.4%**



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Comparing SAFEs to Convertible Notes

	SAFE NOTES	CONVERTIBLE NOTES
SIMPLICITY VS. STRUCTURE:	Simpler and faster to execute with fewer terms and no debt obligations.	More structured with defined terms, providing clarity on conversion but introducing debt obligations and interest accrual.
RISK FOR FOUNDERS:	No maturity date or interest, reducing immediate financial pressure but potentially complicating the cap table.	Can pressure the startup to raise additional funds or convert within a set timeframe, with the risk of debt obligations at maturity.
INVESTOR CONFIDENCE:	May create uncertainty for investors regarding their future equity stake until conversion.	Provide clearer terms and potential priority in liquidation, possibly offering more confidence to investors.
COST AND EFFICIENCY:	Generally cheaper and quicker to implement due to their simplicity.	May involve higher legal costs and more negotiation time due to their complexity.

Convertible notes are a form of short-term debt that converts into equity at a later date, typically when the startup raises a subsequent financing round.

Convertible notes typically have a maturity date and interest rate, providing clear terms for conversion and repayment. The maturity date encourages the startup to raise a subsequent round or reach a conversion event within a set timeframe. In the event of liquidation, convertible note holders are often given priority over equity holders.

As debt instruments, convertible notes can be called upon at maturity, creating financial pressure on the startup. The interest accrued on convertible notes can add to the financial burden and complexity. The additional terms (interest, maturity date, etc.) can make convertible notes more complex and harder to negotiate than SAFEs.

CONCLUSION

Both SAFE notes and convertible notes have their place in startup financing, offering distinct benefits and tradeoffs. SAFE notes are beneficial for their simplicity and flexibility, making them suitable for early-stage funding with lower immediate costs and obligations. Convertible notes, with their structured terms and potential liquidation preferences, can provide more certainty and security for investors but come with additional complexity and financial pressures.

Startups should carefully consider their specific needs, the stage of funding, and investor expectations when choosing between SAFE notes and convertible notes. By understanding the nuances and best practices associated with each, founders can make informed decisions that align with their long-term strategic goals.

OTHER RESOURCES

Y Combinator Safe Note Documents - https://www.ycombinator.com/documents

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