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# SAFEs, Notes, & Series Seed

Tech Coast Angels  
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# Convertible Notes

Pre-2005 Background



## “Bridge Notes”

### Bridge from Series X to Series Y

- Minimal reps and warranties
  - Often the same investors
  - Short duration < 1 year; relatively certain Series Y will occur
- No Board seat or information rights
- Low interest
- Warrants often issued rather than discounts
- Low risk about clarity on conversion
- No discount on conversion!
- No valuation cap!



# 2005 Bridge Notes “Converted” to Seed Financing

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- \$300k to \$750k could now significantly improve a startup providing a 12-18-month runway before a \$3M+ Series A
  - Less complex and quicker to negotiate than Series A
  - Maturity dates were no more than one year
  - More protection than Common Stock
  - Less costly than Series A
  - No valuation discussion – no valuations caps used yet
- Only other choice was Series A or Common Stock



# More Complex Over Time

- Discounts (~15-30%) soon replaced warrants
- Valuation caps; by 2012, 90% had caps
  - Valuation discussion
- Maturity dates extended to 1-3 years after an amendment to the CA Finance Lender's Law in 2014
  - IRC 1272 Original Issue Discount Tax applies
  - IRC 1202 Tax QSBS Exclusion from Gain doesn't apply
- Conversion to "shadow preferred" to avoid "liquidation overhang"
- "Equity" rights (board and info rights, reps and warranties, veto)
- Conversion terms to avoid the "shuffle"



# SAFEs

Late 2013

- Created by Y Combinator in Late 2013
- Not a debt instrument
  - No maturity date
  - No interest
- Short, standardized 6-page document, not meant to be negotiated
- Treated like preferred stock in liquidation, i.e., paid after debt, but before common stock
- Be careful with the newer “Post-Money” version



# Series Seed Preferred Stock

2008-2010



# Why Series Seed

- Simple Way to Buy Preferred Stock
  - 2-3 documents (Term Sheet, COI, Investment Agreement)
  - Important protections are included
- Commitment to Valuation
  - Notes and SAFEs don't avoid valuation with valuation cap.
- Cost – Investor Counsel
  - Not significantly different from Notes versus value
- Tax
  - IRC 1202 QSBS Exclusion of Gain applies
  - IRC 1272 Original Issue Discount N/A

# IRC 1202

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- Provides federal tax exclusion from income of gain recognized on the sale of QSBS held more than 5 years up to \$10M
  - IRC 1045: If held less than 5 years, you can rollover w/in 60 days
  - From 2010 – 2015 its long-term viability was uncertain
- December 2015/2016 the benefit was made permanent
- ❖ While Notes and SAFEs had developed in the absence of this long-term benefit, with it, equity is now much more important.



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|                               | SAFEs                | Convertible Notes | Series Seed   |
|-------------------------------|----------------------|-------------------|---------------|
| <b>Up</b>                     |                      |                   |               |
| MFN                           | ✗                    | ✓                 | ✓             |
| Pro Rata                      | ✗ Unless Side Letter | ✗                 | ✓             |
| Ownership Clarity ("Shuffle") | ✓ Post-Money SAFE    | ✗                 | ✓             |
| Change in Control Min Return  | ✗                    | ✓                 | ✓ Veto Voting |
| <b>Down</b>                   | ✗                    | ✓                 | ✓             |
| Liquidation Pref or Priority  |                      |                   |               |
| <b>What's Going On</b>        | ✗                    | ✗                 | ✓             |
| Reps and Warranties           | ✗                    | ✗                 | ✓             |
| Board Seat                    | ✗                    | ✗                 | ✓             |
| Information Rights            | ✗                    | ✗                 | ✓             |
| Protective Provisions - Veto  |                      |                   |               |
| <b>Tax</b>                    | ✗                    | ✗                 | ✓             |
| IRC 1202 or LTCG              |                      | ✗                 |               |
| Original Issue Discount Tax   | N/A                  |                   | N/A           |



# The Shuffle and the Tax

## Assumptions:

- Angel Round: \$1M on \$4M Pre or Cap; 20% Discount, 7% Interest
- Series A: 18 months post Angel; \$3M on \$12M Pre; Increase Option Pool
- Exit 5 ½ years post Angel; \$50M

| Convertible Notes Scenario 1  | Post Money        |                | Payout              | OID Tax  | LTCG Tax | Total Tax | Take Home |
|-------------------------------|-------------------|----------------|---------------------|----------|----------|-----------|-----------|
|                               | Shares            | %              |                     |          |          |           |           |
| Founders / Advisors / Options | 11,000,000        | 65.52%         | \$32,760,548        |          |          |           |           |
| Angel Investors - Notes       | 3,038,486         | 18.10%         | \$9,049,315         |          |          |           |           |
| > Each Angel at \$50k         | 151,924           | 0.90%          | \$452,466           | \$14,791 | \$90,493 | \$105,285 | \$347,181 |
| Series A Investors            | 2,750,000         | 16.38%         | \$8,190,137         |          |          |           |           |
| <b>Total</b>                  | <b>16,788,486</b> | <b>100.00%</b> | <b>\$50,000,000</b> |          |          |           |           |
| Convertible Notes "Shuffle"   | Post Money        |                | Payout              | OID Tax  | LTCG Tax | Tax Paid  | Take Home |
|                               | Shares            | %              |                     |          |          |           |           |
| Founders / Advisors / Options | 11,000,000        | 63.94%         | \$31,971,493        |          |          |           |           |
| Angel Investors - Notes       | 2,762,260         | 16.06%         | \$8,028,507         |          |          |           |           |
| > Each Angel at \$50k         | 138,113           | 0.80%          | \$401,425           | \$14,791 | \$80,285 | \$95,077  | \$306,349 |
| Series A Investors            | 3,440,565         | 20.00%         | \$10,000,000        |          |          |           |           |
| <b>Total</b>                  | <b>17,202,825</b> | <b>100.00%</b> | <b>\$50,000,000</b> |          |          |           |           |
| Series Seed Preferred Stock   | Post Money        |                | Payout              | OID Tax  | LTCG Tax | Tax Paid  | Take Home |
|                               | Shares            | %              |                     |          |          |           |           |
| Founders / Advisors / Options | 11,000,000        | 65.19%         | \$32,592,593        |          |          |           |           |
| Angel Investors - Seed        | 2,500,000         | 14.81%         | \$7,407,407         |          |          |           |           |
| > Each Angel at \$50k         | 125,000           | 0.74%          | \$370,370           | \$0      | \$0      | \$0       | \$370,370 |
| Series A Investors            | 3,375,000         | 20.00%         | \$10,000,000        |          |          |           |           |
| <b>Total</b>                  | <b>16,875,000</b> | <b>100.00%</b> | <b>\$50,000,000</b> |          |          |           |           |



“Over time, equity rounds have become cheaper to consummate, and the legal fees argument doesn’t carry much weight these days. In the end, the main force driving the use of convertible debt in early-stage companies is the parties’ desire to avoid setting a valuation.”

- Brad Feld, Jason Mendelson; Venture Deals

“Do priced equity rounds instead of notes. As I wrote seven years ago, the cost of doing a simple seed equity deal has come way down.... Honestly, I wish the whole scourge of notes would go away and we could go back to the way things were done for the first twenty years I was in the venture capital business.”

- Fred Wilson, AVC, March 12, 2017

