A safer option? - Y Combinator's alternative to convertible notes

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Last week, Y Combinator announced an alternative to convertible notes for early stage funding of their investee companies, dubbed "SAFE" ("Simple Agreement for Future Equity"). Paul Graham describes the new instrument having "*the advantages of convertible debt without some of the disadvantages*." You can read the announcement here.

Y Combinator began to advocate for the use of convertible notes in 2010, with the rationale being that it allowed for faster fundraising, on more flexible terms. In particular, a convertible note allowed the company and investors to defer the question of valuation until a later date, as the note would convert by reference to the valuation at a seed stage round. A convertible note also allowed companies to offer different prices to different investors, closing early rounds more quickly.

In New Zealand, we have seen some early stage investors switching to this form of funding (such as the Global from Day One Fund), particularly where the company is very young, and the business is still proving that it has a viable concept to bring to market.

From the company's perspective, there are still some things to be careful with in a convertible note. It is a loan, after all, and it will be repayable (sometimes "on demand") and bear interest. While some convertible notes provide for the holders to convert on whatever terms are negotiated by the next round of investors, others give the holders flexibility to determine when they convert, how much they convert, and what protective provisions they will get at the time. Not all convertible notes are as straightforward as they appear.

So, what about the SAFE?

Y Combinator says that they have introduced the SAFE because of some of the constraints around convertible notes being classified as debt. "*Debt instruments have maturity dates, are typically subject to certain regulations, create the threat of insolvency, and can include security interests and sometimes subordination agreements, all of which can have unintended negative consequences for startups*."

Money invested through a SAFE is not considered a loan, and it will not accrue interest. Instead, it is an agreement that when the company raises money in the next round, goes through a change of control, or undertakes an initial public offering, a SAFE holder will automatically be issued preference shares. The value of those shares will be determined by the value of the company at that time, subject to a "valuation cap", which can be agreed at the time the SAFE is entered into.

If, on the other hand, the company goes under, the amount invested under the SAFEs is paid out before any distribution to other shareholders.

The simplicity of the arrangement is attractive. SAFE holders have no special rights, and there is no need to take the time and expense of negotiating all the terms of the eventual equity investment at the outset. SAFE holders will get the benefit of any upside in valuation over the cap (and/or discount rate), and will receive a liquidation preference if things don't work out as planned.

There is, however, a little wrinkle.

Uncertainty exists as to how a SAFE holder should be taxed for New Zealand income tax purposes. There are several schools of thought as to the correct approach:

- A SAFE could be regarded simply as an option or agreement to acquire shares
- Alternatively, a SAFE could be viewed as a hybrid instrument.

The two approaches produce different income tax results for SAFE holders. For example, if the SAFE is treated as a hybrid instrument, the holder will have tax to pay prior to the shares being issued and may have further tax to pay at the time the shares are issued. By contrast if the SAFE is viewed simply as an option, then tax should only arise at the time the shares are issued.

One way to resolve this uncertainty may be to obtain a binding ruling from the IRD. However, this may not necessarily suit holders as it will involve significant cost and time. A more practical way to reduce the tax uncertainty may be to remove the entitlement of the holder to be repaid upon a liquidation event. While this may make the tax position a degree clearer, it may be a material change to the commercial acceptability of the SAFE to early stage investors.

Given the current focus on investor protection in even very early-stage investments made in New Zealand (including anti-dilution clauses and comprehensive protective provisions), it is unlikely that the SAFE will appeal to New Zealand investors unless very small amounts of money are at risk. However, for companies raising money for the first time and before they have a proven business model, a discussion around simpler, more flexible ways of raising capital should certainly be welcome.

Auckland

188 Quay Street
Auckland 1010

PO Box 1433
Auckland 1140
New Zealand

P: +64 9 358 2555
F: +64 9 358 2055

Wellington

Aon Centre
1 Willis Street
Wellington 6011

PO Box 2694
Wellington 6140
New Zealand

P: +64 4 499 4242
F: +64 4 499 4141

Christchurch

83 Victoria Street
Christchurch 8013

PO Box 322
Christchurch 8140
New Zealand

P: +64 3 379 1747
F: +64 3 379 5659