



SAFEs, Notes, & Series Seed

Tech Coast Angels
March 3, 2021

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

- \$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

A photograph of a person sitting on a rocky cliff overlooking the ocean. The cliff is made of reddish-brown rock, and the ocean is visible in the background under a clear sky.

IRC 1202

- 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
Up			
MFN	✗	✓	✓
Pro Rata	✗ Unless Side Letter	✗	✓
Ownership Clarity ("Shuffle")	✓ Post-Money SAFE	✗	✓
Change in Control Min Return	✗	✓	✓ Veto Voting
Down	✗	✓	✓
Liquidation Pref or Priority			
What's Going On	✗	✗	✓
Reps and Warranties	✗	✗	✓
Board Seat	✗	✗	✓
Information Rights	✗	✗	✓
Protective Provisions - Veto			
Tax	✗	✗	✓
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				
Total	16,788,486	100.00%	\$50,000,000				
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				
Total	17,202,825	100.00%	\$50,000,000				
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				
Total	16,875,000	100.00%	\$50,000,000				

“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

