

## SAFE PRIMER

A safe is a *Simple Agreement for Future Equity*. An investor makes a cash investment in a company, but gets company stock at a later date, in connection with a specific event. **A safe is not a debt instrument**, but is intended to be an alternative to convertible notes that is beneficial for both companies and investors.

### Why

1. 1. Debt instruments have requirements – including regulations, interest accrual, maturity dates, the threat of insolvency and in some cases, security interests and subordination agreements. These requirements can have unintended negative consequences.

2. 2. A safe is intended to be simple for both companies and investors, with the usual path to agreement requiring the negotiation of only one item – the “valuation cap.”

3. 3. A simple equity security has the potential to become standardized, and a standardized form has the benefits of certainty and speed, which in turn results in lower (or zero) transaction costs for companies and investors.

### When

Most startups need to raise money soon after formation in order to fund operations, and the safe can be a vehicle for investors to fund companies at that very early stage. Unlike the sale of equity in traditional priced rounds of financing, a company can issue a safe quickly and efficiently, without multiple documents and the necessity of a charter amendment. As a flexible, one-document security, without numerous terms to negotiate, the safe should save companies and investors money and time.

### How

The investor and the company agree on the valuation cap, mutually date and sign a safe and the investor sends the company the investment amount. What happens next? Nothing, until the occurrence of one of the specific events described in a safe. In the meantime, an outstanding safe would be referenced on the company’s cap table like any other convertible security (such as a warrant or an option).

### Q & A

•  *Does a safe convert at a round of equity financing?* Yes, when the company decides to sell shares of preferred stock in a priced round, an outstanding safe will convert into shares of preferred stock. There is no threshold amount that the company must raise to trigger the conversion.

•  *What if the pre-money valuation of the company in the financing is higher than the Valuation Cap in a safe?* The holder of a safe gets a number of shares of preferred stock calculated using the Valuation Cap, not the higher pre-money valuation. However, **the preferred stock that a safe holder is issued will have a liquidation preference that is equal to the original safe investment amount, rather than based on the price of the shares issued to the investors of new money in the**

**financing.** This feature means that the liquidation preference for safe holders does not exceed the original investment amount (a 1x preference). For example, if the company issues Series A preferred stock in the financing, a safe holder would be issued Series A-1 preferred stock, the only difference being the name and the share price attributable to that series. See [Example 1](#) in Appendix II.

- *What is the difference between Safe Preferred Stock and Standard Preferred Stock?* Safe Preferred Stock will be a separate series of preferred stock issued in the Equity Financing, commonly referred to as “shadow preferred” or “sub-series” preferred stock. Safe Preferred Stock will have the same rights, privileges, preferences and obligations as Standard Preferred Stock, but the liquidation preference, conversion price, and dividend rate will be calculated based on the price per share of the Safe Preferred Stock. The price per share of Safe Preferred Stock is determined by dividing the Valuation Cap in a safe by the company’s fully diluted outstanding capitalization (the “Company Capitalization,” described below). See [Example 1](#) in Appendix II.

- *What if the pre-money valuation of the company in the Equity Financing is lower than the Valuation Cap in a safe?* The Valuation Cap is inapplicable in this situation. A safe holder gets the same preferred stock, at the same price, with the same liquidation preference, as the other investors of new money in the financing. See [Example 2](#) in Appendix II.

- *Do safe holders get pro rata rights?* Yes, when they become stockholders of the company. As holders of preferred stock, former safe holders will have a pre-emptive right to purchase more shares if and when the company raises another round of financing. This pro rata right must be in either the Equity Financing documents or a side letter. **Please consider this pro rata right carefully.** There is no dollar threshold on this right – even an investor putting the smallest amount of money into your company will get pro rata rights. If it is not acceptable to you to have every investor holding pro rata rights going forward, consider adding a dollar threshold. See Appendix I for sample language.

- *Does a safe holder have a choice about converting a safe in an equity financing?* No, conversion in an Equity Financing is automatic and the safe then terminates. A safe is intended to turn safe holders into stockholders.

- *What happens to a safe if a company is acquired or merges with another company?* In a “change of control” transaction, a safe holder can convert a safe into shares of common stock, calculated based on the Valuation Cap, or have its investment returned. A safe holder will decide which of these two options is more advantageous, depending on the terms of the merger or acquisition. See [Example 4](#) and [Example 5](#) in Appendix II.

- *What is the difference between Company Capitalization and Liquidity Capitalization?* “Company Capitalization” is the company’s fully diluted outstanding capital stock as calculated at the time of an Equity Financing. If a company intends to adopt an equity incentive plan in connection with the Equity Financing, Company Capitalization includes the shares allocated to that plan. If a company has already adopted an equity incentive plan, Company Capitalization includes all shares reserved under that plan, as well as any plan increases contemplated in connection with the Equity Financing. “Liquidity Capitalization” is a company’s fully diluted outstanding capitalization as calculated at the time of a Liquidity Event. This calculation includes outstanding options (vested and unvested) under an equity incentive plan, but excludes all unissued shares in the plan.

- ☐ *What happens to a safe if the company goes public?* If a company goes public, a safe will convert into shares of common stock calculated based on the Valuation Cap (or the safe holder can cash out the safe).

- ☐ *Does a safe ever expire?* A safe has no maturity date. A safe is designed to expire and terminate only when a safe holder has received stock or cash, in an equity financing, change of control transaction, IPO or dissolution – whichever occurs first. In theory, a safe could remain outstanding for a long time without the need to “extend” any dates or time periods. A safe can be amended by the company and the safe holder, if necessary. See Example 6 in Appendix II.

- ☐ *What happens to a safe if the company shuts down and goes out of business?* In a dissolution, any money that the company has to distribute would be distributed to safe holders before any money is allocated to holders of common stock.

- ☐ *Can a safe have a discount, or a “Most Favored Nation” provision?* Yes. This Primer describes a safe with a Valuation Cap only (a “**Standard Safe**”). Other versions of the safe are described in Appendix I.

## **Appendix I**

### **Alternative Versions of a Safe**

(“Standard” version of a safe is Valuation Cap only)

#### **1. 1. Cap and Discount**

- This is a safe with a negotiated Valuation Cap and Discount Rate. Either the Valuation Cap or the Discount Rate applies when converting this safe into shares of Safe Preferred Stock.
- The Discount Rate applies to the price per share of the Standard Preferred Stock sold in the Equity Financing. If this calculation results in a greater number of shares of Safe Preferred Stock for the investor, the price per share based on the Valuation Cap is disregarded (and vice versa). See Example 7 in Appendix II.
- The conversion of this safe in a Liquidity Event is the same as a Standard Safe.

#### **2. Discount, No Cap**

- This is a safe with a negotiated Discount Rate, e.g., a 20% discount off the price per share of the Standard Preferred Stock, applied to the conversion of this safe into shares of Safe Preferred Stock. See Example 8 in Appendix II.
- If the safe is converting in a Liquidity Event, the investor could elect to have the Purchase Amount repaid, or to convert the safe into shares of common stock, based on the fair market value of the common stock at the time of the Liquidity Event with the Discount Rate applied to the common stock price.

#### **3. No Cap or Discount, MFN Provision**

- This is a safe with no Valuation Cap and no Discount Rate. If the company subsequently issues safes with provisions that are advantageous to the investors holding this safe (such as a valuation cap and/or a discount rate), this safe can be amended to reflect the terms of the later-issued safes. The amendment term is the so-called “MFN Provision.” Note that, unless the later safes include an MFN, the MFN of the original safe is amended away once the safe holder decides the MFN is triggered. In other words, the MFN provision typically provides only one opportunity to amend the original safe, not multiple opportunities as the company continues to issue additional safes.
- If there is an Equity Financing before this safe is amended pursuant to the MFN Provision, the investor would receive the same shares of preferred stock as the investors of new money in the Equity Financing, at the same price. However,

this safe does not automatically convert into shares of preferred stock unless the amount of new money raised in the Equity Financing is at least \$250,000. This threshold amount provides the investor with some protection against an insignificant equity round raised at an artificially high valuation.

- If there is a Liquidity Event before this safe is amended by the MFN Provision, the investor could elect to have the Purchase Amount repaid, or to convert the safe into shares of common stock, based on the fair market value of the common stock at the time of the Liquidity Event.

### **Notes about the Pro Rata Right**

- If all of your prospective investors want pro rata rights and you agree to give each such investor pro rata rights, use the safe as-is – no changes are required to the template. If this is your decision, be aware that changing your mind about giving these rights at the time of the Equity Financing is not fair to these early investors.
- If you only want to give pro rata rights to certain investors, you can revise the template safe. If you want to use the exact same form of safe for every investor, put in a threshold in the definition of “**Pro Rata Rights Agreement**” in Section 2 as follows:

“**Pro Rata Rights Agreement**” means a written agreement between the Company and the Investor (and holders of other Safes, as appropriate), **provided the Purchase Amount of this instrument is not less than [\$ \_\_\_\_\_]**, giving the Investor a right to purchase its *pro rata* share of private placements of securities by the Company **occurring after the Equity Financing**, subject to customary exceptions. *Pro rata* for purposes of the Pro Rata Rights Agreement will be calculated based on the ratio of (1) the number of shares of Capital Stock owned by the Investor immediately prior to the issuance of the securities to (2) the total number of shares of outstanding Capital Stock on a fully diluted basis, calculated as of immediately prior to the issuance of the securities.

- If you want to create a tailored safe for each investor, for any investor to whom you will NOT be giving pro rata rights, edit the template safe to (1) remove Section 1(a)(ii) entirely and (2) remove the definition of Pro Rata Rights Agreement from Section 2. Section 1(a) should look as follows (subsection (i) can be collapsed into subsection (a)):

(a) **Equity Financing**. If there is an Equity Financing before the expiration or termination of this instrument, the Company will automatically issue to the Investor either: (1) a number of shares of Standard Preferred Stock equal to the Purchase Amount divided by the price per share of the Standard Preferred Stock, if the pre-money valuation is less than or equal to the Valuation Cap; or (2) a number of shares of Safe Preferred Stock equal to the Purchase Amount divided by the Safe Price, if the pre-money valuation is greater than the Valuation Cap. In connection with the issuance of Standard Preferred Stock or Safe Preferred Stock, as applicable, by the Company to the Investor pursuant to this Section 1(a), the Investor will execute and deliver to the Company all transaction documents related to the Equity Financing; *provided*, that such documents are the same documents to be entered into with the purchasers of Standard Preferred Stock, with appropriate variations for the Safe Preferred Stock if applicable, and *provided further*, that such documents have customary exceptions to any drag-along applicable to the Investor, including, without limitation, limited representations and warranties and limited liability and indemnification obligations on the part of the Investor.

## Appendix II

***\*\*Please note that many of the numbers discussed below are rounded\*\****

### Example 1

- Investor has purchased a safe for \$100,000. The Valuation Cap is \$5,000,000.
- The company negotiates with investors to sell \$1,000,000 worth of Series A Preferred Stock at a \$10,000,000 pre-money valuation. The company's fully-diluted outstanding capital stock immediately prior to the financing, including a 1,000,000 share option pool to be adopted in connection with the financing, is 11,000,000 shares.

The company will issue and sell 1,100,110 shares of Series A Preferred at \$0.909 per share to the new investors. The company will issue and sell 220,022 shares of Series A-1 Preferred to the safe holder, at \$0.4545 per share.

In the safe, the Series A Preferred is referred to as "Standard Preferred Stock" and the Series A-1 Preferred is referred to as "Safe Preferred Stock." The table below sets forth a comparison between the Standard Preferred and the Safe Preferred, as each would be described in the company's certificate of incorporation:

	<b>Standard Preferred Stock</b>	<b>Safe Preferred Stock</b>
Liquidation preference on a per share basis:	\$0.90	\$0.4545
Aggregate payout in a change of control transaction (each series pari passu with the other):	\$1,000,000	\$100,000
Conversion price and original issuance price at the time of the Series A Preferred financing:	\$0.90 (initially converts into 1,100,110 shares of common stock)	\$0.4545 (initially converts into 220,022 shares of common stock)
Dividend Rate per share (based on an 8% dividend):	\$0.072	\$0.036

### Example 2

- Investor has purchased a safe for \$100,000. The Valuation Cap is \$4,000,000.
- The company negotiates with investors to sell \$600,000 worth of Series AA Preferred Stock at a \$3,000,000 pre-money valuation. The company's fully-diluted outstanding capital stock immediately prior to the financing, including a 500,000 share option pool to be adopted in connection with the financing, is 12,500,000 shares.

The company will issue and sell 2,500,000 shares of Series AA Preferred at \$0.24 per share to the new investors. The Company will issue and sell an additional 416,666 shares of Series AA Preferred to the safe holder at the same price per share. There is no difference between the Series AA Preferred issued to the new investors and the Series AA Preferred issued to the safe holder, and the references to “Safe Preferred Stock” in this case are inapplicable.

### Example 3

- ☐ Investor has purchased a safe for \$100,000. The Valuation Cap is \$8,000,000.
- ☐ The company negotiates with investors to sell \$2,000,000 worth of Series A Preferred Stock at an \$8,000,000 pre-money valuation. The company’s fully-diluted outstanding capital stock immediately prior to the financing, including a 1,500,000 share option pool to be adopted in connection with the financing, is 11,500,000 shares.

The company will issue and sell 2,875,215 shares of Series A Preferred at \$0.6956 per share to the new investors. The company will issue and sell an additional 143,760 shares of Series A Preferred to the safe holder at the same price per share. As in Example 2, there is no difference between the Series A Preferred issued to the new investors and the Series A Preferred issued to the safe holder.

### Example 4

- ☐ Investor has purchased a safe for \$100,000. The Valuation Cap is \$10,000,000.
- ☐ Another entity proposes to acquire the company for cash consideration of \$50,000,000. The company’s fully-diluted outstanding capital stock immediately prior to the acquisition, including 1,500,000 outstanding options but excluding any unallocated shares in the option pool, is 11,500,000 shares.

The investor can choose to have the safe purchase amount returned, or convert the safe into shares of common stock and receive the cash consideration with the other common stockholders. The safe would convert into 115,008 shares of common stock, based on the “Liquidity Price” of \$0.8695 per share (the Liquidity Price is calculated by dividing 10,000,000 by 11,500,000). When the \$50,000,000 deal consideration is allocated pro rata among all of the common stockholders, including the investor (and assuming the outstanding options are all exercised), the investor would receive approximately \$495,074. Since this amount is considerably more than the \$100,000 purchase amount, the investor would elect to convert the safe.

### Example 5

- ☐ Investor has purchased a safe for \$100,000. The Valuation Cap is \$6,000,000.
- ☐ Another entity proposes to acquire the company for cash consideration of \$200,000. The company’s fully-diluted outstanding capital stock immediately prior to the acquisition, including 795,000 outstanding options but excluding any unallocated shares in the option pool, is 10,795,000 shares.

The investor can choose to have the safe purchase amount returned, or convert the safe into shares of common stock and participate pro rata in the cash consideration with the other common stockholders. The safe would convert into 179,920 shares of common stock, based on the “Liquidity Price” of \$0.5558 per share (the Liquidity Price is calculated by dividing 6,000,000 by 10,795,000). When the \$200,000 deal consideration is allocated pro rata among all of the common stockholders, including the investor (and assuming: (1) the outstanding options are all exercised; (2) there is no outstanding debt; and (3) for purposes of this example, there is only the one outstanding safe), the investor would receive approximately \$3,274. This dollar amount is calculated by dividing the \$200,000 deal consideration among 10,974,920 shares of outstanding common stock, resulting in \$0.0182 per share (179,920 shares multiplied by \$0.0182 = \$3,274.54). Since this amount is considerably less than the \$100,000 purchase amount, the investor would elect to cash out the safe in connection with the transaction.

#### Example 6

- Investor has purchased a safe for \$100,000. The Valuation Cap is \$7,000,000.
- The company grows, generates revenue and becomes cash flow positive, and therefore does not need to raise outside capital. The company has no acquisition offers and no plans to go public.

The safe will remain outstanding until the company has a liquidity event, even if that liquidity event doesn’t happen for years after the original date of purchase.

#### Example 7

- Investor has purchased a safe for \$100,000. The Valuation Cap is \$8,000,000 and the Discount Rate is 85%.
- The company has negotiated with investors to sell \$1,000,000 worth of Series A Preferred Stock at a \$10,000,000 pre-money valuation. The company’s fully-diluted outstanding capital stock immediately prior to the financing, including a 1,000,000 share option pool to be adopted in connection with the financing, is 11,000,000 shares.

The company will issue and sell 1,100,110 shares of Series A Preferred at \$0.909 per share to the new investors. The company will issue Series A-1 Preferred to the safe holder, based on the Valuation Cap or the Discount Rate, whichever results in a lower price per share. The 15% discount applied to the per share price of the Series A Preferred is \$0.77265. The Valuation Cap results in a price per share of \$0.72727. Accordingly, the company will issue 137,500 shares of Series A-1 Preferred to the safe holder, at \$0.72727 per share. The Discount Rate does not apply in this case.

#### Example 8

- Investor has purchased a safe for \$20,000. The Discount Rate is 80%.
- The company has negotiated with investors to sell \$400,000 worth of Series AA Preferred Stock at a \$2,000,000 pre-money valuation. The company’s fully-diluted

outstanding capital stock immediately prior to the financing is 10,500,000 shares.

The company will issue and sell 2,105,263 shares of Series AA Preferred at \$0.19 per share to the new investors. The 20% discount applied to the per share price of the Series AA Preferred is \$0.152. Accordingly, the company will issue 131,578 shares of Series AA-1 Preferred to the safe holder, at \$0.152 per share.