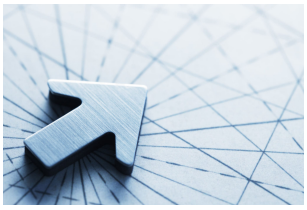

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Categories:

Blogs
QSBS Fundamentals
Qualified Small Business Stock (QSBS)
Tax Law Defined™ Blog

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How to Use SAFE Preferred Stock in Early Funding Rounds

The Simple Agreement for Future Equity (SAFE) was introduced in 2013 by startup accelerator Y Combinator as a convertible notes alternative.[1] The idea was to cretae a simple—as the name suggests—solution for early-state startups and investors.

Neither a full stock offering, with its concomitant negotiations, nor a convertible note, with its debt implications, a SAFE allows an investor to pay in full up-front for the right to receive a variable number of shares of preferred stock as part of the corporation's first equity round.[2] SAFEs automatically convert into preferred stock in connection with a corporation's first priced round, typically at a discount and sometimes with a valuation cap.[3] A SAFE is typically subordinate to debt, on an equal footing with preferred stock, and ahead of common stock.

Understanding the Benefits and Drawbacks of SAFEs

The Y Combinator website noted in its 2013 introduction to SAFEs that while both SAFEs and convertible debt allow for faster and cheaper fundraising than issuing preferred stock, SAFEs were specifically engineered to avoid the complicated regulatory and tax issues associated with debt. Since their introduction, many start-ups have relied on SAFEs to raise capital quickly and avoid the often involved and costly process of issuing preferred stock.

As discussed in our ***Guide to the Federal Income Tax Treatment of SAFEs***, many examples of SAFEs have a predominance of features that point towards treatment of the instrument as "stock" for federal income tax purposes. Unfortunately, no tax authorities have confirmed that treatment, and the treatment of an instrument as stock for federal income tax purposes is a requirement for investors looking to take advantage of the favorable benefits of Sections 1202 and 1045.

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How SAFE Preferred Stock Can Clarify Taxation Gray

In our guide to taxing SAFEs, we suggest that issuing "SAFE Preferred Stock" might be a viable alternative to either taking a risk regarding the SAFE's tax treatment or foregoing altogether the benefits of the SAFE. The introduction of SAFE Preferred Stock is intended to take advantage of the best features of the SAFE while adding additional certainty regarding tax treatment.

Since SAFE Preferred Stock is actually a series of preferred stock included in the Certificate of Incorporation and on the corporation's cap table, its "form" is that of "stock" rather than a hybrid instrument/agreement (see the discussion in ***Guide to the Federal Income Tax Treatment of SAFEs***).

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What Startups Can Do to Offer SAFE Preferred Stock

Our definition of SAFE Preferred Stock is included as the initial series of preferred stock in a Delaware corporation's Certificate of Incorporation. The typical corporation will first issue founder common stock and then SAFE Preferred Stock.

The Certificate of Incorporation also includes the concept of "blank-check preferred," allowing the Board of Directors to adopt, without the vote of holders of SAFE Preferred Stock, the terms of the corporation's first priced round of preferred stock in a certificate of designations that is filed with the Delaware Secretary of State's office once the terms of the preferred to be issued in the priced round are determined. The concept of blank-check preferred stock can be avoided in situations where founders are okay with holders of SAFE Preferred Stock having voting rights with respect to amending the initial Certificate of Incorporation to incorporate the terms of the first priced round of preferred stock.

As a companion to this Users Guide, we have included a set of SAFE Preferred Stock documents as examples:[4]

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- An example of a Certificate of Incorporation that includes a class of SAFE Preferred Stock and incorporates Delaware "blank check preferred."[5]
- An example of a SAFE Preferred Stock Purchase Agreement.
- An example of a Certificate of Designations previously filed with the Delaware Secretary of State establishing a series of preferred stock.[6]

Unlike the SAFE examples on the Y Combinator website, which are often printed out by start-ups and used without modification, the Frost Brown Todd Certificate of Incorporation example combines provisions out of the Y Combinator SAFE with modifications to fit a particular start-up's needs. The terms of the SAFE Preferred Stock and the preferred stock terms in the Certificate of Designations example should be customized to fit a start-up's particular needs.

Tailoring SAFE Preferred Stock to Business Needs

The example Certificate of Incorporation for the SAFE Preferred Stock incorporates a modified version of a Y Combinator SAFE for purposes of illustrating how the SAFE can be transformed into a series or class of stock, while at the same time retaining the key features of a SAFE that have made it a popular alternative during the past decade to issuing convertible debt or a priced round of preferred stock.

In addition to the documents referenced above, stockholders (common and preferred) generally enter into a Stockholders Agreement addressing such matters as participation rights (pre-emptive rights to acquire stock, restrictions on transfer, drag-along rights, governance, issuing corporation covenants and registration rights).

More Information and SAFE Preferred Stock Help

We understand that founders and investors may want to know more about the features of SAFEs and how SAFE Preferred Stock functions. Interested parties will also want to create SAFE Preferred Stock that fits their specific needs. We recommend that interested parties review the "Safe User Guide" on the Y Combinator website.

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Frost Brown Todd's venture team, including Bill Strench and Zach Bahorik, are available to discuss the relative merits and features of SAFEs, SAFE Preferred Stock and other issues relevant to start-ups and equity and debt financing

Frost Brown Todd's tax planning team, including Scott Dolson and Brian Masterson, are available to discuss the tax issues associated with qualified small business stock (QSBS) and SAFEs, along with other tax planning issues.

Business owners and professionals interested in learning more about QSBS (Sections 1202 and 1045) planning opportunities are directed to our **QSBS & Tax Planning Services page**.

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[1] Wikipedia describes Y Combinator as an American technology startup accelerator launched in March 2005 which has been used to launch more than 4,000 companies. See the article Announcing the Safe, a Replacement for Convertible Notes (12/6/2013) at https://www.ycombinator.com/blog/announcing-the-safe-a-replacement-for-convertible-notes. Features of the SAFE instrument that are touted as favorable to start-ups include the absence of interest payments and maturity dates and that SAFE instruments generally do not provide for the repayment of principal.

[2] Since 2013, the SAFE templates have evolved on the Y Combinator website. While start-ups sometimes adopt the Y Combinator forms verbatim, a significant percentage of SAFE instruments undergo significant customization before use. There is currently a significant amount of debate over the relative virtues of pre-money versus post-money SAFEs. With a pre-money SAFE, the corporation's capitalization excludes all securities converting in the financing (such as SAFEs and convertible notes). In contrast, with the post-money SAFE, the corporation's capitalization includes the converting securities. The larger the corporation's capitalization, the lower the SAFE price will be, resulting in the issuance of more shares issued to the SAFE holders. With post-money SAFEs, the issuance of each additional SAFE lowers the post-money SAFE price, increasing the number of shares that are issued to the SAFE holders upon conversion. Issuing a substantial amount of post-money SAFEs can have the effect of dramatically reduce the founders'

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percentage ownership interest in the corporation.

[3] A valuation cap establishes the maximum valuation at which a SAFE will convert into the priced round of preferred stock, a feature that protects the holder by creating a floor for the SAFE's conversion.

[4] Neither Y Combinator nor Frost Brown Todd LLP assumes responsibility for the consequence of using any version of the Y Combinator SAFE or the SAFE Preferred Stock templates includes as companions to this User Guide. Frost Brown Todd LLP was not involved in the preparation of the Y Combinator SAFE and has incorporated many of the terms of a Y Combinator SAFE in our Certificate of Incorporation that includes SAFE Preferred Stock for the purpose of providing an example of how the terms of a SAFE illustrate how to create a class or series of stock will incorporating and preserving the desired features of the Y Combinator SAFE. Frost Brown Todd LLP does not necessarily endorse use of the Y Combinator SAFE terms either generally or in any specific instance. We recommend that readers obtain advice from a lawyer to help understand the legal, tax and business ramifications of using a SAFE or SAFE Preferred Stock and the meaning of the terms included in the various SAFEs available on the Y Combinator website and otherwise in the marketplace. Additional documents may be required for your contemplated transaction. You are responsible for ensuring that all necessary securities filings and/or other legally required filing, if any, are prepared and filed. No document or information provided on the Frost Brown Todd LLP website with respect to SAFEs or SAFE Preferred Stock constitutes or should be relied upon as legal advice.

[5] These SAFE Preferred Stock templates assume that the corporation will be organized in Delaware and be subject to the Delaware General Corporation Law.

[6] If a corporation's Certificate of Incorporation includes a provision giving the Board of Directors blank-check authority to adopt on or more series of preferred stock, the Board would adopt a resolution with the terms for the applicable series of preferred stock and file a Certificate of Designations with the Delaware

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Secretary of State.

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