Now & Next
Emerging Companies Alert

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An overview of funding mechanisms for emerging companies

By Allan Cohen, Jason Chimon, and Marissa Espinoza Icochea

Convertible notes versus SAFEs—which mechanisms are preferred for emerging companies to raise capital from investors?

What's the impact?

- In the "seed funding" stage, the most common mechanisms through which emerging companies raise funds are convertible notes and simple agreements for future equity (SAFEs).
- Convertible notes and SAFEs delay the valuation discussion since there isn't a valuation upon issuance of the note or SAFE.
- A company should create a business plan and budget and raise sufficient funds to get it to its next inflection point, when it can then go out and raise additional funds for a more developed company on better terms.

One of the challenges that emerging companies face is how—and via what mechanism—to raise capital to fuel growth. In the early stages, companies may be self-funded or raise capital from friends and family or other angel investors, through business incubators, or through various state

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programs. In this "seed funding" stage, convertible notes and simple agreements for future equity (SAFEs) are the most common mechanisms used to raise funds.

In this article, we aim to give a broad overview of the two instruments and discuss some factors to consider when deciding which form of investment best suits the company's needs. Stay tuned for future articles, where we plan to delve into the nitty-gritty of convertible instruments, along with insights into the host of other issues early-stage companies might encounter.

What are convertible notes?

Convertible notes are considered a debt security. They can be issued individually to investors or as part of a series of notes to multiple investors. Like any debt security, they have a maturity date, typically at least one to two years from the date of issuance. Interest rates are often low relative to a bank loan, as early-stage investors with their priorities straight should be more interested in conversion into equity than earning interest. Specifically, convertible notes require the conversion of the principal of the note plus the accrued interest at the time of a "qualified" equity financing by the company. If such financing does not occur by the maturity date, the investor typically has the option to call the loan or convert it into common stock of the company. It's common to see either a discount or a cap in a note, meaning that when the note converts at the time of a qualified financing of the company, it converts either at a discounted price relative to the new investors (we see a 20% discount most frequently) or with an assumed "valuation cap" rather than the actual valuation used for the financing. Notes may also convert upon a sale of the company.

For example:

The note principal plus interest = $1 million. Say there is either a $5 million cap *or* a 20% discount.

Next, assume the Company has 10 million shares outstanding at the time of a qualified financing. For simplicity's sake, we assume the valuation cap is 'pre-money' (a bit of nitty-gritty to save for a rainy day), so these 10 million shares do not include any shares the investor receives when the note converts. Finally, let's say the company's capital raise is at a $10 million valuation and a price per share of $1.

- **With the cap**, the note converts to 2 million shares because a valuation cap of $5 million is used rather than $10 million ($1 million in principal + interest/$5 million valuation = 20% of the Company's 10 million shares or 2 million shares)
- **With the discount**, the note converts to 1.25 million shares because a price per share of $.80 is used rather than $1.00 ($1 million in principal + interest/$.80 = 1.25 million shares)
- **With neither**, the note would convert to 1 million shares ($1 million in principal + interest/$1.00 = 1 million shares)

What is a SAFE?

Unlike a convertible note, a SAFE is not considered a debt security but an agreement for the company to issue equity to the investor in the future. It is important to note that a SAFE is still a security and subject to federal and state securities laws. Since a SAFE is not a loan, there is no interest and no maturity date. SAFEs will convert into equity if the company closes a qualified financing. Like notes, the rate of conversion depends on whether there is a valuation cap or discount. Since SAFEs are not debt, SAFEs are paid after creditors but prior to common stock. Because of this, and because SAFEs do not accrue interest, they are viewed as more favorable to the company.

Convertible notes versus SAFEs — Which is best for my company?

Both notes and SAFEs delay the valuation discussion since there isn't a valuation upon issuance of the note or SAFE (although valuation may loosely be discussed if a valuation cap is to be agreed to). Delaying agreement on a valuation may provide emerging companies with more flexibility to keep the exercise price for options (based on the fair market value of the underlying stock) low, thereby making options more valuable as a tool to better attract talent. In addition, both convertible notes and SAFEs typically don't include a change to the board of directors beyond a significant holder being a board observer, and the holders will not be considered shareholders with voting or other shareholder rights.

Still, SAFEs offer a few additional advantages to the company relative to convertible notes. They do not accrue interest or have a maturity date, and because SAFEs are not debt, their holders are not creditors. SAFEs also benefit from having a few well-understood industry forms, which could help streamline negotiations over notes. As a result, in all cases, SAFEs are the preferred mechanism for companies. Of course, at the end of the day, the investor may insist on a convertible note, and a company's preference for a SAFE is only as good as the SAFE's ability to attract investors.

When to seek investments and how much

The decision to seek investments comes down to when outside capital would accelerate company growth and is largely a business decision. All emerging companies require cash at various points in order to grow. However, a company should create a business plan and budget and raise sufficient funds (perhaps building in a cushion) to get it to its next inflection point, when it can then go out and raise additional funds for a more developed company on better terms.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

Allan H. Cohen
516.832.7522
acohen@nixonpeabody.com

Jason Chimon
516.832.7574
jchimon@nixonpeabody.com

Marissa Espinoza Icochea
516.832.7536
mespinozaicochea@nixonpeabody.com