SAFEs vs. Convertible Notes – Which is Better for an Early-Stage Company?

By Eliza P. Shea, Andrea H. Vossler

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Our early-stage start-up clients often ask us about the difference between convertible notes and Simple Agreements for Future Equity (SAFEs). Each provides a way for companies to raise capital without the need to determine the value of the company, but they have different terms and implications for both the company and investors. In this article, we compare convertible notes to SAFEs as a fundraising mechanism for early-stage companies.

Convertible Notes

Convertible notes are debt instruments that may be converted into equity at a later date. They have a maturity date, an interest rate, and a conversion price that is typically set at an agreed upon discount to the valuation of the company in the next round of financing.

For early-stage companies, convertible notes can be an attractive option because they are relatively easy to prepare, and they offer a way to raise funds without determining an immediate valuation. Convertible Notes are also typically faster and cheaper to finalize than equity financing rounds, as they do not require as much due diligence, negotiation of terms, or paperwork.

A downside to using convertible notes is that they are debt instruments and, as a result, they come with a fixed interest rate that accrues and is either repaid or converted into equity along with the principal due under the Convertible Note upon conversion. Depending on when the notes convert, the accrued interest can be significant and result in sometimes substantial additional dilution to the existing shareholders. In addition, the conversion price of Convertible Notes is typically set at a discount to the valuation of the company in the next round of financing, which can further dilute the ownership of existing shareholders. As a result, we recommend that our clients do the “math” around convertibles notes before issuing them. The amount and type of interest (simple or compounding), the length of time that the notes remain outstanding (always be conservative, especially in these market conditions!), and the targeted valuation at which you anticipate their conversion (again, we recommend being conservative), will help you set reasonable terms that work for you and your investors.

Simple Agreement for Future Equity (SAFEs)

SAFEs are similar to convertible notes in that they are a type of financing instrument that allows companies to raise funds without determining an immediate valuation. However, SAFEs are not debt instruments and instead simply give investors the right to purchase equity at a discount to the valuation of the company at a future date, typically in the next round of financing.

One of the benefits of SAFEs with respect to companies is that they are simpler and more straightforward to prepare than convertible notes because the terms of SAFEs are fairly standardized across the industry. The SAFE was developed in late 2013 by Y Combinator, and, as a result, most companies raise capital using a SAFE use the Y Combinator SAFE, available at https://www.ycombinator.com/documents. They also do not come with a fixed interest rate that must be paid or converted into equity. As a result, they are less dilutive to existing shareholders at the time of conversion, as accrued interest does not need to be converted into additional shares. However, since SAFEs are not debt instruments, they may be less attractive to investors because they do not accrue interest and do not provide the same downside protections to investors as convertible notes. Because convertible notes are debt instruments, they rank above shareholders in terms of priority on liquidation, whereas SAFEs rank junior to convertible debt and other indebtedness, on par with other SAFEs and preferred stock, and senior to common stock.

The Bottom Line

Convertible notes and SAFEs are both popular options for early-stage companies looking to raise capital. Both offer simplicity, flexibility, and do not require an immediate valuation. However, they differ in their legal structure, conversion terms, and downside protection.

Ultimately, the choice will depend on the company's goals, the terms that can be negotiated, and the preferences of potential investors.

If you are an early-stage company seeking guidance on the benefits of convertible notes versus SAFEs for your fundraising needs, contact Lippes Mathias startups and venture capital team members Andrea H. Vossler (avossler@lippes.com) and Eliza P. Shea (eshea@lippes.com), who have extensive experience helping companies navigate the complexities of fundraising and can provide valuable insights tailored to your specific situation.

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