Startups Offer Unusual Reward for Investing

Insights
April 1, 2015
Originally published by: The Wall Street Journal

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When a young Boston entrepreneur sought half-a-million dollars to launch his startup last fall, he turned his back on today's usual tactics, such as selling equity stakes or issuing convertible notes.

Instead, Vinayak Ranade opted to use a largely untested way for entrepreneurs to raise funds known as a Simple Agreement for Future Equity.

The agreement provided investors in Drafted Inc., Mr. Ranade's fledging, four-employee company, no equity shares, and the investors weren't categorized as creditors.

Instead, the investors who bet more than $500,000 on Drafted got a warrant entitling them to shares in the company if and when it next raises investment capital, or is acquired, or has an IPO.

And if Drafted fails? Well, then the investors will get nothing.

Drafted is still developing its product, which enables users to refer friends to online job posters while it gathers a base of early users, said Mr. Ranade, who is its founder. He ruled out raising equity because he wanted to avoid the tricky task of setting a valuation for so nascent a company.

In addition, the 27-year-old was put off by the complexity of contracts and term sheets for deals to obtain funds by issuing convertible debt. “No matter how much I learned about convertible notes, I would never know as much about them as a seasoned investor,” he said.

The Simple Agreement for Future Equity is “a bit of a gimmick,” said Christopher Mirabile, the managing director of Launchpad Venture Group and chairman-elect of the Angel Capital Association. The deals look attractive to startup founders because they streamline the fundraising process at the earliest stages of building a new company. But “as an investor, you’re taking all the early risk without any upside.” He added that shifting more risk from entrepreneurs to investors is especially dangerous when soaring startup valuations are drawing a growing number of unsophisticated investors into the market.

In some ways, the new Simple Agreements for Future Equity are similar to convertible notes, which venture capitalists have used as bridge loans in later-stage startup financing deals since the mid-1990s, according to John Coyle, a professor at the University of North Carolina School of Law. “If you were running out of cash but were preparing for a Series B round, investors in your Series A round could loan you money,” using a convertible note, he said.

By the mid-2000s, many venture capitalists grew eager to invest in startups at earlier so-called “seed” stages. In order to get into these deals, they began using convertible notes rather than haggling over a valuation.

Yet, unlike convertible debt, the new Simple Agreements for Future Equity, or SAFEs, offer no maturity date and no interest rate. As a result, warrant holders can wait indefinitely for a “liquidity event”—such as a subsequent funding round or an acquisition—that will enable them to convert their capital into equity stakes.

Many early-stage investors recognize that the SAFE is short on investor protections. For instance, while equity and debt holders have a legal claim to a startup’s assets if the venture is forced to shut down and liquidate, warrant holders don’t.

Katherine O’Neill, director of the Jumpstart New Jersey Angel Network, said she has seen at least three startups offer Simple Agreements for Future Equity in the past year but has ignored all of them. The group sees as many as 600 startups pitching traditional equity or debt deals in a given year, she said. “We don’t like [SAFEs] because they don’t reward the early-stage investor for the large startup risk,” she said.

Mr. Ranade said the goal of seed investing should be to help get a startup up and running ahead of its first equity fundraising round. “If investors just want to get in early and flip their investment, we don’t want them as investors,” he said.

Carolynn Levy, an attorney at Y Combinator, a Silicon Valley accelerator known for helping to launch such technology startups as Airbnb Inc. and Dropbox Inc., developed the five-page Simple Agreement for Future Equity in December 2013. Ms. Levy said she created the agreement to help startups in the program raise seed funds.

So far, most of the 274 startups that have participated in the Y Combinator program since last year have used a SAFE to raise new money, it says.

Ms. Levy said she believes SAFEs more accurately represent what early-stage fundraising relationships should be. “I don’t think angels should be lenders,” she said. “They should be investors.”

She acknowledged she has seen pushback from some startup investors who are comfortable with convertible notes and don’t see any benefits from using the new alternative agreements. Y Combinator itself typically takes an equity stake of 7% for the $120,000 it invests in startups that participate in its program.

In any case, as early-stage investors pour money into startups, hoping to strike gold on the next Facebook or Uber, entrepreneurs are adopting more “founder-friendly” options like SAFEs, said some lawyers who work with startups.

Aaron King, the founder of SnapDocs in San Francisco, said using a SAFE “was incredibly quick and painless.” The typical SAFE agreement is only five pages long. “I can read a SAFE and understand what I’m getting into,” added Mr. King, whose company helps banks close mortgages throughout the country.

Mr. King has also been concerned about convertible notes being debt and accruing interest. “What it comes down to is... being comfortable with the documents,” he said. Plus, he added, “SAFEs were created by people who are more concerned with the founder experience.”

“The fact that we’re seeing more SAFEs being used has to do with the frothiness in the startup scene,” said Joseph Green, a lawyer at Gunderson Dettmer. If founders have “more leverage and lots of people who want to give them money,” he said, “there’s a good chance they’ll use a SAFE.”

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