Pillar Legal Tech Law Blog[1]
Startup Financing Legal Document Options

You have formed your company, perhaps you personally provided some funds to pay initial set-up costs, now it is time to raise external financing. What legal documents should you use?

Three Ways to Fund a Tech Startup
There are three primary legal document pathways to fund a tech startup:

1. Priced Equity Round
2. Convertible Note
3. Simple Agreement for Future Equity or SAFE

How to Choose? The Amount of Money Decides.
Each path has its own pros and cons, with the right path in any given situation generally determined by the amount of funds you will raise. If you are raising a lot, then a priced equity round is common. If you are raising a little, then use SAFEs. The SAFE is much more founder friendly than a convertible note, so founders will generally only use a convertible note if the investors insist. Otherwise, use SAFEs for smaller funding rounds.

I'm reluctant to put numbers here because I've seen the views on those numbers vary widely from region to region, both within the U.S. and across the world. This is very cost of living dependent – what is a lot in Cairo feels much less so in San Francisco.

Priced Equity Round

Valuation.
For a price equity round, founders and investors need to agree on a price – a valuation for the company. This is not an easy task for an early-stage company that might be pre-revenue and maybe even pre-product. To me, as the lawyer that often joins the discussion after this number has been agreed, it feels as if the valuation reflects the founder's story telling ability. Good story, lots of listeners, credible use of latest buzz words, all translates into a high valuation. Otherwise, not so high. Time to hone that investor pitch.

Paper, Lots of Paper.
The trouble with priced equity rounds, for everyone other than the lawyers, is the amount of paper involved. In the U.S. there are two sets of standard documents: the National Venture Capital Association ("NVCA") model legal documents and the Series Seed financing documents.

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The NVCA forms are over 200 pages long. The Series Seed are much shorter at nearly 40 pages, but I often see that page count grow if the investors' lawyers add back this and that from the longer NVCA forms rather than relying on the Series Seed "future rights" clause to obtain those same rights with the next financing round. Both sets of forms, and any forms that various law firms use, are the starting point for negotiation. If there is more than one new investor, and more than one pre-existing outside stockholder, these negotiations can take time, energy and increase legal costs.

Convertible Note

Postpone Valuation Discussion, Sort Of.
Convertible notes convert into equity at the next priced equity financing round. The amount of stock the noteholder receives is often determined by the valuation in that next equity round, with the noteholder receiving a discount off that future valuation. Sometimes, however, the convertible note includes a valuation cap, or a maximum valuation at which the note will convert irrespective of what the valuation is in the next equity financing round. In that case, the valuation discussion sneaks back in since the founders and investors need to agree on what the cap will be.

Debt Means Payback.
Convertible notes are a hybrid instrument – part debt, part equity. They have a maturity date and often accrue interest. If there isn't a qualified financing before the maturity date, the company is required to payback the principal amount of the note with all accrued interest. Thus, the clock is ticking with convertible notes, putting pressure on the founders to raise a priced equity round before that maturity date deadline.

Less Paper.
Convertible note financings normally involve less paper than priced equity financings. The main transaction document is the note purchase agreement, which looks like the stock purchase agreement in a price equity round. The key investment instrument is the convertible note itself. Because the convertible note starts as debt and not actual stock, many of the equity financing documents aren't needed, such as an update to the company charter or the various stockholder agreements. If the investors require a security interest in the company's assets to put them first in line for repayment in the event of insolvency, then more documents are needed. This is more common when times are not wonderful for the company, the company already has valuable assets (such as a patent portfolio), and investors want to reduce their downside risk.

No Standard.
Unlike the SAFE, there isn't a recognized market standard version of the convertible note. The conversion terms are intricate, which means that whoever prepares the initial draft, the lawyers for the other side will need to review it carefully. As a result, when compared with a SAFE, convertible notes have higher legal costs.

SAFE

The SAFE is indisputably the easiest, cheapest, and fastest way to fund a tech startup. Thank you Y Combinator. You don't even need a lawyer to use it. Opps, did I just say that out loud? But there is one lurking danger for founders – read about it here.

Postpone Valuation Again, Sort Of.
Like a convertible note, in the discount only version of the SAFE there is no need to discuss valuation. The number of shares that a SAFE holder will receive upon conversion of a discount SAFE will be determined by the valuation set in the next equity financing round. In the valuation cap version of the SAFE, however, the talk happens again – founders and investors must agree on the cap.

No Maturity, No Interest.
Unlike the convertible note, the SAFE does NOT have a maturity date and no interest accrues. This takes pressure off the founders and arguably recognizes the reality of early-stage investing – if the company doesn't close a priced equity financing round before running out of funds, there is generally very little for the SAFE holder or noteholder to recover. This element of the SAFE is one of the key reasons why the instrument is considered founder friendly.

Only Five Pages!
Well, seven pages really – but who counts the signature page or something with only three lines. You don't believe me? Have a look for yourself here.

Standardization is Beautiful.
Y Combinator ("YC") introduced the SAFE in 2013 and encouraged all its investee companies to use it. Thanks to YC's prominent position in the startup ecosystem, the SAFE become a standard document recognized across the industry. And standardization is the key way, perhaps the ONLY way, to reduce legal costs. To use a SAFE, you just need to:

1. Decide Version. Decide between the discount only or cap only versions.

2. Confirm No Changes. Compare whatever document has been provided to you against the relevant open-source document on the YC website to ensure no changes (you can do this in Word as described here).

3. Purchase Amount. Agree on the purchase amount, which is the amount the SAFE holder will invest.

4. Decide One Number. Agree on the discount percent (often 20%) if you are using a discount SAFE, or agree on the valuation cap if you are using a valuation cap SAFE.

5. Sign and Fund. DocuSign the SAFE, send your bank instructions to the investor and the investor wires the funds.

That is all there is to it. Standard, simple, beautiful. We love the SAFE, but do read about the anti-dilution risk to founders from stacking SAFEs here. If you don't modify the document to remove this risk, it is important to model out in a spreadsheet the dilution impact of each SAFE based on various future financing conversion scenarios.

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