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Y Combinator's Post-Money SAFE: Risks for Founders[1]

U.S. TECH LAW UPDATE[2]

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Y Combinator, one of the most famed Silicon Valley startup accelerators, introduced the "Simple Agreement for Future Equity" (commonly referred to as the "SAFE")[3] in late 2013. Recognized within the early investment community for its efficiency, the SAFE serves as a prominent tool for early-stage financing in startups. As its name suggests, the SAFE empowers investors to secure ownership in a startup at a future date in exchange for a capital injection into the company at present. The number of shares investors will ultimately receive through a SAFE hinges on either the share price established in the company's next round of financing (referred to as an "Equity Financing") or a predetermined valuation cap agreed upon by the investor and the company, outlined in the SAFE itself as the "Valuation Cap".

Originally, Y Combinator's SAFE featured a "pre-money" Valuation Cap, aptly termed the "Pre-Money SAFE." However, a pivotal shift occurred in 2018 when Y Combinator altered its approach, embracing a "post-money" Valuation Cap in its model SAFE. This newer SAFE is referred to as a "Post-Money SAFE." This transition from the Pre-Money SAFE to the Post-Money SAFE carries potential ramification for founders who utilize the current Y Combinator Valuation Cap-only SAFE.

Under the Post-Money SAFE, when the company issues numerous SAFEs across various financing rounds, SAFE holders benefit from anti-dilution protection, which shields them from the dilutive impact of any subsequent SAFEs or other convertibles issued prior to an Equity Financing. This protective mechanism, while advantageous for SAFE holders, may lead to a significant reduction in ownership percentage for the founders.

This legal update briefly reviews the drafting history of Y Combinator's SAFE, explains its core mechanisms, and underscores how Y Combinator's shift to the Post-Money SAFE can lead to anti-dilution protection to SAFE holders at the expense of founder ownership. Founders may not always fully grasp the potential pitfalls associated with Y Combinator's Post-Money SAFE, as the SAFE's nuances are embedded in a standard document frequently signed without legal counsel.

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[1] This U.S. Tech Law Update is adapted from Greg Pilarowski's presentation on the Term Sheet Walk-Through: Simple Agreement for Future Equity (SAFE) during the Angel Advanced Investing Bootcamp, held by Harvard Business School Alumni Angels Association on October 10, 2023. We extend special thanks to Alexa McCulloch and Sameera Bazaz for organizing the event and providing their comments on the presentation. Notwithstanding their gracious attention and knowledgeable insight, any errors or oversights in this legal update are Pillar Legal's own.

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[3] The latest SAFE is available at http://ycombinator.com/documents.

I. Introduction to Y Combinator's SAFE

Founded in March 2005, Y Combinator plays a crucial role in the startup ecosystem. With a remarkable track record of helping launch over 4,000 companies, it has fostered illustrious successes such as Airbnb and Dropbox. The combined valuation of companies launched by Y Combinator stands at a staggering $600 billion, a testament to Y Combinator's influence and impact.[4]

In the nascent stages of a startup, fundraising often involves the direct purchase of equity. However, this approach introduces the intricate challenge of determining the company's valuation, a complex task early in a startup's lifecycle. Additionally, a conventional direct equity purchase necessitates an array of extensive, often complex documentation and legal guidance, a financial burden that can prove challenging for fledgling companies grappling with limited resources.

Within the landscape of equity financing documents, two prevailing sets of forms emerged. The first, supplied by the National Venture Capital Association ("NVCA"), and spans over 200 pages. The second, primarily reserved for a company's initial Equity Financing rounds, is the Series Seed forms, encompassing nearly 38 pages.[5] In stark contrast, the SAFE is a concise document with only five pages of substantive terms.

Convertible notes (a term describing instruments expected to turn into equity at a future date) offer substantial advantages as an alternative to a traditional Equity Financing. By reducing the onerous legal expenses and documentation associated with an Equity Financing, convertible notes allow startups to efficiently raise funds while deferring complex valuation discussions. This remains true even when some convertible notes establish a maximum valuation through a Valuation Cap. Convertible notes may also incorporate elements such as a maturity date and interest rate, which can exert pressure on founders, compelling them to either repay the investment amount with accrued interest or convert the note before its maturity date. However, the absence of a widely accepted market standard necessitated legal counsel for meticulous review of each convertible note, often consuming the precious time and resources of early-stage companies.

Considering the complexities linked to traditional Equity Financing and capitalizing on the potential advantages of a convertible note fundraising model, Y Combinator introduced the SAFE in 2013. The SAFE, as a standardized document, brought significant value to both the investment community and startups. Distinguished from traditional convertible notes, the SAFE stands out for its company-friendly nature. Unlike conventional notes, the company is not obliged to repay SAFE holders prior to a maturity date or with interest; instead, the SAFE seamlessly converts into preferred stock upon the occurrence of an Equity Financing, change of control, or an initial public offering. Y Combinator actively promoted the SAFE, making it accessible to its accelerator companies and providing comprehensive user guidelines on its website for the community's benefit.[6] Y Combinator's robust endorsement propelled the SAFE

[5] Available at https://www.seriesseed.com/
[6] See Jason Yeh, *When is a SAFE unsafe?* See also Y Combinator's SAFE forms at https://www.ycombinator.com/documents.

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to swift recognition and adoption, solidifying its status as a recognized standard in the startup sphere.

When it comes to curtailing a company's legal expenditures, the importance of contract standardization cannot be overstated. The SAFE offers relatively simplistic standardization to the startup investment community. Y Combinator offers three variants of SAFEs: the "Discount Only" SAFE, the "Valuation Cap Only" SAFE, and the "Most Favored Nation" (commonly referred to as "MFN") SAFE."[7] Leveraging the standard SAFE forms streamlines the fundraising process for early-stage companies, as it narrows down the decision-making to just one or two critical terms: the amount invested by the SAFE holder (called the "Purchase Amount"), the discount rate when using a Discount Only SAFE, and the Valuation Cap when using a Valuation Cap Only SAFE.

The subsequent sections of this legal update will primarily focus on Y Combinator's Valuation Cap Only SAFE, where the distinction between a pre-money and post-money SAFE is most evident. In the context of a Pre-Money SAFE, the shares allocated to the SAFE holder are determined before factoring in additional funding, as the "pre-money" moniker implies. However, following Y Combinator's 2018 change to its SAFEs, the method for calculating the SAFE holder's shares takes into account the additional funds injected into the company, altering the dynamics of ownership and investment value.

II. Pre- vs Post- Money SAFE Comparison

A "pre-money valuation" refers to the company's valuation before an investor invests new money into the company, whereas a "post-money valuation" represents the pre-money valuation *plus* the amount the investor invests. As such, an investor investing $1 million at a $4 million pre-money valuation is equivalent to the investor investing $1 million at a $5 million post-money valuation. In both cases, the investor acquires 20% of the company. So, what is the difference between the two?

The distinction lies in how the "Company Capitalization," a number representing a sum of certain shares of the company, is calculated under the Pre-Money SAFE and Post-Money SAFE. A SAFE entitles a holder to a certain number of the company's shares in an Equity Financing. The exact number of company shares converted from a SAFE is determined by dividing the Purchase Amount by the SAFE's conversion price (the "SAFE Price"). For a "Valuation Cap Only" SAFE, the formula for calculating the SAFE Price is:

SAFE Price = Valuation Cap/Company Capitalization

The larger the Company Capitalization number, the lower the SAFE Price becomes, resulting in more shares for the SAFE holder. In the Pre-Money SAFE, the Company Capitalization number does not account for shares converted from SAFEs or convertible notes. However, in the 2018 Post-Money SAFE, the Company Capitalization number *does* include shares issued upon conversion of all of company's SAFEs and convertible notes. This crucial

[7] See Y Combinator's SAFE forms at https://www.ycombinator.com/documents.

difference means that the Company Capitalization under a Post-Money SAFE represents a greater number of shares, consequently resulting in a reduced SAFE Price and a higher share allocation for the SAFE holder.

The below table demonstrates the different inclusions in the Company Capitalization number under a Pre-Money SAFE and Post-Money SAFE:[8]

Company Capitalization Number	**Pre-Money SAFE**	**Post-Money SAFE**
Outstanding shares of Capital Stock	Included	Included
Outstanding Options	Included	Included
Promised Options	Included	Included
Unissued Option Pool	Included	Included
Option Pool Increase	Included	Excluded [9]
SAFEs, convertible notes and other similar convertibles	**Excluded**	**Included**

III. Hidden Implications: Anti-Dilution Protection for SAFE Holders

Y Combinator asserts that the shift from offering a Pre-Money SAFE to a Post-Money SAFE was primarily driven by the pursuit of clarity. The rationale, as explained by Y Combinator, is that under a Post-Money SAFE, calculating the ultimate ownership percentage sold to the investor is more straightforward, enhancing transparency for both investors and founders.[10] This argument undoubtedly has its merits. In theory, under a Post-Money SAFE, the parties can simply divide the Purchase Amount by the Valuation Cap to ascertain the exact percentage of ownership the investor will obtain after conversion of the SAFE.

However, Y Combinator fails to highlight one other implication of the change to the Post-Money SAFE: an inherent advantage to investors over the common stockholders of the company. The Post-Money SAFE provides anti-dilution protection to the SAFE holder from other SAFEs or convertible notes. This means the holders of common stock (in early-stage companies, typically only the founders) will bear the entirety of dilution from other SAFE or convertible note rounds until an Equity Financing takes place.[11] Comparatively, under the Pre-Money SAFE both common stockholders and SAFE holders were equally diluted by other SAFEs or convertible notes.

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[8] The summary table is from Y Combinator's *Quick Start Guide*. For more detailed definitions of "Company Capitalization", please check form SAFE on Y Combinator website here.

[9] Another change from the Pre-Money SAFE is the Post-Money SAFE Company Capitalization number does not include the new or increased option pool adopted as part of the Equity Financing, but the options promised by the company before the Equity Financing are still included. This means SAFE holders are not diluted by the options increased following the SAFE but prior to the Equity Financing. Y Combinator's explanation for this is that the money injected into the company from the SAFE helps the company hire employees by granting options before an Equity Financing, but Y Combinator also argues that SAFE holders should be diluted by a new or increased option pool in connection with the Equity Financing. Otherwise, the founders are forced to absorb the dilution from two hiring rounds instead of just one, even though SAFE holders only supplied sufficient funds for one round of hiring. See Y Combinator's *Quick Start Guide*.

[10] See Y Combinator's *Quick Start Guide*.

[11] See José Ancer, *Why Startups shouldn't use YC's Post-Money SAFE*, SILICON HILLS LAWYER (May 1, 2019).

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Founders, often grappling with limited resources, might opt to download the Post-Money SAFE from Y Combinator's website and proceed with its execution without seeking advice from advisors. After all, such is the appeal of using this standardized document. However, when multiple SAFEs are issued across various funding rounds, founders could face significant ownership dilution. This implication of the anti-dilution protection offered to SAFE holders under the Post-Money SAFE may not be immediately apparent.

Should founders encounter an unexpected magnitude of dilution in their company, the consequences may impact their leadership motivation and compel challenging renegotiations with investors. In turn, this can strain both company dynamics and investor-founder relationships. Unmotivated founders often leads to equally dissatisfied investors.

Below are two approaches aimed at mitigating these potentially substantial dilutive effects on founders. These approaches make slight modifications to the Y Combinator Post-Money SAFE "Company Capitalization" definition. The proposed modifications seek to provide a measure of protection against the risks associated with the Post-Money SAFE and promote a more equitable distribution of dilution among all company stakeholders.

A. <u>Approach 1: Excluding Future Convertibles with Different Valuation Caps</u>

The first approach is to exclude future converting securities with different Valuation Caps (the "<u>Excluding Future Convertibles with Different Valuation Caps</u>" approach). The rationale behind this approach is to treat each round of SAFEs with the same Valuation Cap as its own financing round. Thus, prior and current rounds of SAFEs do not dilute the SAFE holders, but subsequent rounds of SAFEs with a higher Valuation Caps do. This puts founders and common stockholders on more equal footing with SAFE holders. Below are some suggested edits, with additions to the Post Money SAFE's original text in <u>underline</u> and deletions from the original text in ~~strikethrough~~:[12]

"Company Capitalization" is calculated as of immediately prior to the Equity Financing and (without double-counting, in each case calculated on an as-converted to Common Stock basis):

- *Includes all shares of Capital Stock issued and outstanding;*
- *Includes all Converting Securities <u>outstanding as of the final closing of the SAFE financing in which this SAFE is issued, but expressly excludes subsequently issued Converting Securities with different valuation caps</u>;*
- *Includes all (i) issued and outstanding Options and (ii) Promised Options; and*
- *Includes the Unissued Option Pool, except that any increase to the Unissued Option Pool in connection with the Equity Financing shall only be included to the extent that*

[12] This approach was first suggested by José Ancer. See José Ancer's article *Why Startups shouldn't use YC's Post-Money SAFE* and listen to his discussion on the SAFE on Gary J. Ross' podcast episode *Capital Raising Considerations for Emerging Companies with Jose Ancer, author of Silicon Hills Lawyer and partner at Optimal Counsel* (Oct. 31, 2022).

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the number of Promised Options exceeds the Unissued Option Pool prior to such increase.

B. Approach 2: Excluding All Convertibles

The second approach is to exclude all the SAFEs and convertible notes from the Company Capitalization definition. (the "Excluding All Convertibles" approach). The Excluding All Convertibles approach has even less of a dilutive effect on founders and common stockholders than the Excluding Future Convertibles with Different Valuation Caps approach. Under the Excluding All Convertibles approach, founders and SAFE holders are proportionally diluted by other investments. Below are some suggested edits, with additions to the Post-Money SAFE's original text in underline and deletions from the original text in ~~strikethrough~~:

"Company Capitalization" is calculated as of immediately prior to the Equity Financing and (without double-counting, in each case calculated on an as-converted to Common Stock basis):

- *Includes all shares of Capital Stock issued and outstanding;*
- ~~*Includes all Converting Securities;*~~
- *Includes all (i) issued and outstanding Options and (ii) Promised Options;*
- *Includes the Unissued Option Pool, except that any increase to the Unissued Option Pool in connection with the Equity Financing shall only be included to the extent that the number of Promised Options exceeds the Unissued Option Pool prior to such increase; and*
- *Excludes all Converting Securities."*

C. Impact of Post-Money SAFE Modifications

The below example demonstrates the dilution effects under each of (i) Y Combinator's Post-Money SAFE, (ii) the Excluding Future Convertibles with Different Valuation Cap approach, and (iii) the Excluding All Convertibles approach. Assume the following conditions:

Founders	Own 900,000 common stock shares
Employee Stock Option Pool	Comprised of 100,000 common stock shares
SAFE Holder 1	Invests $200,000 with a Post-Money Valuation Cap of $8 million
SAFE Holder 2	Invests $800,000 with a Post-Money Valuation Cap of $16 million
New Investor	Invests $6,000,000 with a pre-money valuation $20,000,000

As demonstrated in the pie charts reflecting each party's ownership of the company below, when the company does not have many outstanding SAFEs, the impact on the founders' ownership is relatively minor when the SAFEs convert during an Equity Financing. The left pie chart, which represents ownership under the Post-Money SAFE, shows the founders' ownership at 64.04% of the company. In contrast, the right pie chart, representing the Excluding All Convertibles approach, the founders' ownership is at 64.40%. This small difference may not be meaningful to founders trying to fundraise capital quickly.

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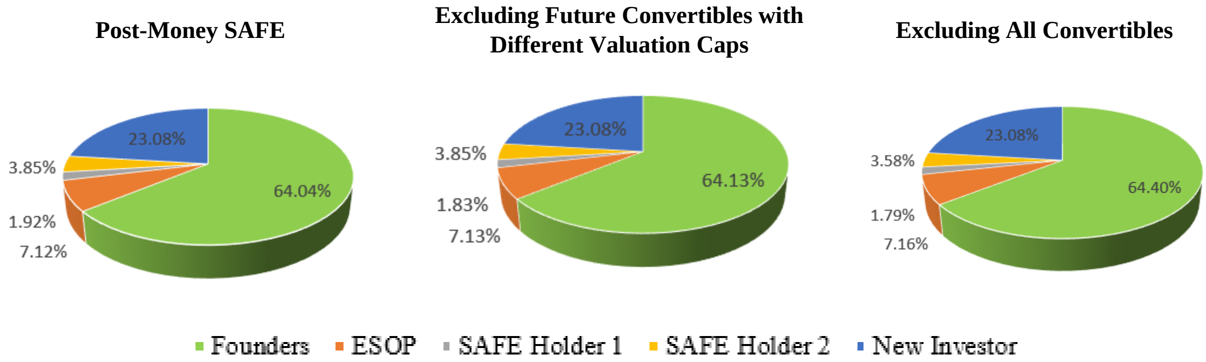
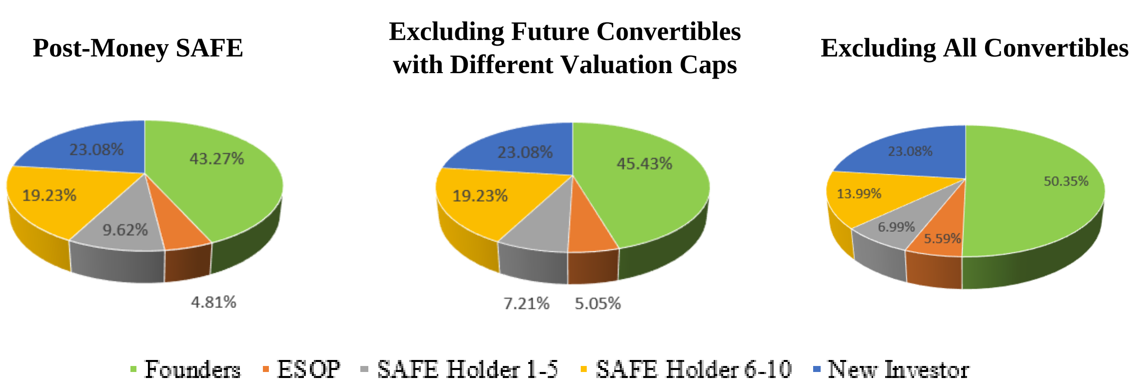


However, if the assumptions are adjusted to reflect a scenario where the company has more SAFE holders with different Valuation Caps, the founders' dilution is more noticeable. In this scenario, assume the company has a total of ten SAFE holders. Five of those SAFE holders each invest $200,000 using a SAFE with a post-money valuation cap of $8 million, and the other five SAFE holders each invest $800,000 using a SAFE with a post-money valuation cap of $16 million.

Founders	Own 900,000 common stock
Employee Stock Option Pool	Comprised of 100,000 common stock
SAFE Holder 1-5	**Each** invests $200,000 with a Post-Money Valuation Cap of $8 million
SAFE Holder 6-10	**Each** invests $800,000 with a Post-Money Valuation Cap of $16 million
New Investor	Invests $6,000,000 with a pre-money valuation $20,000,000

In this scenario, upon conversion of the SAFEs at the company's next Equity Financing, using an unmodified version of Y Combinator's Post Money SAFE nets the founders 43.27% ownership of the company. In contrast, opting for the Excluding All Convertibles approach secures founders a significantly greater portion of ownership with 50.35% of the company, as demonstrated by the right pie chart. This simple adjustment results in a 7.08% increase in founder ownership, a figure more closely aligned with what founders might typically expect under a Pre-Money SAFE. This substantial disparity underscores one of the risks founders face when utilizing Y Combinator's Post-Money SAFE for fundraising.



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Due to the founder dilution risks associated with Y Combinator's Post Money SAFE, it is advisable for all parties involved to explore the above modifications to the SAFE. In cases where investors are hesitant to endorse these changes, founders are encouraged to conduct a thorough analysis of cap table figures and conversion scenarios of the SAFE utilized. This practical approach can give founders a clear understanding of the potential dilution impact on their ownership, should they choose to retain the Post-Money SAFE without the above-suggested modifications.

IV. Final Tip: Use a Consistent SAFE Form

Whether founders and investors can reach a consensus on the discussed modifications or not, founders should strive for consistency when using a convertible instrument in order to simplify conversion calculations. Ideally, all company SAFEs use the same form. Using inconsistent SAFEs can introduce complex conversion mathematics that can potentially escalate legal costs for startups.

Avoid mixing-and-matching convertible notes. Different convertible notes often feature distinct Company Capitalization definitions, a divergence that holds true even between Pre-Money and Post-Money SAFEs.[13] When each instrument contains a distinct Company Capitalization number, it typically necessitates advanced calculation techniques and a proficiency in Excel or other spreadsheet programs.[14] Consequently, fundraising using a combination of SAFEs, convertible notes, and other convertible instruments can lead to complexities during the calculation of ownership allocation during an Equity Financing, potentially causing delays.

In addition to slowing down an Equity Financing, using different convertible note forms can quickly increase a company's legal expenditures where legal professionals are enlisted to confirm ownership percentages for all parties involved. The intricate calculations can extend the time devoted by company and investor legal teams to due diligence and Equity Financing preparation, as well as lengthen the negotiation process. To avoid heightened legal costs and streamline an Equity Financing, companies should prioritize consistency by adopting a uniform SAFE for their early-stage fundraising endeavors.

[13] Y Combinator also acknowledges that combining SAFE forms can result in "cap table uncertainty" which requires the company to "commit to careful cap table modeling by running the conversion calculations for all outstanding SAFEs." See Y Combinator *Quick Start Guide*.
[14] For example, "Goal Seek", a "What-If Analysis" tool in Excel.

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