CONVERTIBLE NOTES, "SAFES" AND "KISSES": A PRIMER FOR EARLY STAGE COMPANIES SEEKING OUTSIDE INVESTORS

It is a rare company that can fund its growth using only internal cash flow. Start-ups and early stage companies can be particularly challenged because they often do not have access to either bank financing or venture capital since both sources typically require several years of positive operating results before a company becomes a viable candidate for either.

CONVERTIBLE NOTES

If a company decides to seek outside investments from friends, family or other investors, the very first question the company will be asked is what percent of the company will I get for my investment. The answer to that question requires that the company and the investor agree on the current value of the company and that can be a difficult and time-consuming exercise. The reason convertible notes are so often used as the financing vehicle for start-ups and early stage companies is that they postpone the need to agree on the value of the company.

In a typical convertible note financing, the investor receives a convertible note, which provides for an annual interest rate and a maturity date of 18 months to 3 years. Principal and sometimes interest are typically paid in a single installment at maturity. However, the note is automatically converted to the class of shares issued to new equity investors in an equity financing that closes on or before the maturity date, at the same price and terms (or sometimes at a discounted price) as those offered to the new equity investors. If the company does not close on an equity financing before the maturity date of the note, the note becomes due, just like a normal loan.

The concept is that the company uses the proceeds of the convertible note financing to get the company up and running. Once it is generating cash flow, the valuation is less subjective and an equity financing (typically called an "A round") is far more likely to be successful.

"SAFEs" and "KISSes"

SAFEs (which stands for Simple Agreement for Future Equity) and KISSes (an acronym for Keep It Simple Security) are relatively new alternative investment vehicles which have been developed over the last few years by Y-Combinator and 500 Startups, respectively. Both of these are West Coast accelerators. A great deal has been written about SAFEs and KISSes and sample legal documents are available online. Both have been billed as alternatives to more traditional convertible notes. While it is probably worthwhile being familiar with the terms, the reality is that neither SAFEs nor KISSes have been widely used outside Silicon Valley, perhaps because they are less favorable to investors. Unlike convertible notes, among other things they typically have no maturity date and do not provide for payments of interest.

SOME PRACTICAL ADVICE

SAFEs and KISSes have very few disadvantages for early stage companies and have fewer terms to be negotiated than convertible notes. However, despite being around since 2013, they still have not gained wide acceptance, at least on the East Coast. Convertible notes are well known and widely accepted. Unless your prospective investors suggest a SAFE or KISS structure, most companies would be well advised to use the convertible note structure when seeking seed capital investments from friends and family.

If we can provide any further information, please contact your regular PLDO attorney or William F. Miller of our Corporate Group (wmiller@pldolaw.com).

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William F. Miller is a Partner with Pannone Lopes Devereaux & O'Gara LLC and a member of the Corporate & Business Law Team. He is a highly skilled attorney with more than 30 years of experience who focuses his practice on corporate and business law matters, including mergers and acquisitions, angel, venture capital and private equity financing, commercial contract matters, intellectual property protection and licensing, and entity and investment fund formation. Mr. Miller frequently advises early stage technology companies, manufacturers, service and distribution companies as well as investors in such companies.

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