Founder Fundamentals

Securities Commonly Used in Startups

By Jared Schwass

When looking to raise money for a startup, entrepreneurs can structure investments using various types of securities. This article discusses the most common types of securities used when startups look for funding.

The term "security" has a very broad definition that encompasses various types of investments into startups. A security can represent an ownership position in a company, a creditor's relationship with a company, or the rights to an ownership position in a company. The two main securities offered by startups to investors are equity and debt, but there is also a growing trend toward using agreements for future equity such as the Simple Agreement for Future Equity (SAFE).

Debt

Convertible debt is the most common type of debt security used by startups. Convertible notes are the most common form of convertible debt, and are frequently used to fund early and seed stage startups. Convertible notes are regularly used when startups need an infusion of cash but are not ready to set their valuation, or expect their valuation to change.

Convertible notes accumulate interest, have a set maturity date and are issued with clearly defined terms. One common term that makes convertible notes attractive to investors is the discount rate, which allows the holder of the note to convert the note into equity at a discounted price. Another that startups often resist but sophisticated investors often request is a valuation cap, typically referred to as a "cap," at which value the notes will convert even if the valuation of the next equity round is higher. By providing a cap or discount rate, startups can entice investors to take larger risks by investing early.

While convertible notes will carry an interest rate, the interest is rarely paid. Rather, the interest incurred is added to the initial investment when the note is converted into equity. Securing a high interest rate is not as lucrative for investors as selecting the right company to fund, and securing a favorable cap/discount rate.

In addition to having an interest rate, convertible notes will typically carry an expiration or maturity date. That date will specify the time when the company has to pay back the note, but sometimes allows for the investment to convert to equity at that time. A startup should be careful to set the maturity date safely beyond the time needed to raise a round of equity funding, though investors frequently agree to extend the date if a valuation has not been established or if the startup is in the middle of funding rounds.

There is a risk with convertible notes that the investors might force the startup to repay the capital borrowed if the note has not converted by the maturity date. However, it is very unlikely investors will call their notes as doing so would typically force a cash-strapped startup to hand over the little cash it does have. Such a move would almost guarantee the startup's failure, so investors often work with a startup to restructure convertible notes. However, the investors will typically expect some sort of financial incentive to do so.

Equity

Equity is essentially ownership in a corporation. For startup investors, it consists of the percentage of a corporation's shares an investor would purchase for a specific amount of money. Startups typically conduct equity rounds

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to raise capital by offering investors ownership, or equity, in their company at a certain price per share. A startup's initial equity round (usually referred to as a "pre-seed" or "seed round") will often come from friends, family and other contacts. If all goes well, the startup will use those funds to get to a stage where the startup can attract new investors who will pay more per share if the company continues to progress and shows a potential for success. These later rounds are typically referred to as Series A, B, C, and so on.

When startups conduct equity rounds and accept money from investors, those investors will become part owners of the company. If the company makes a profit, the investor will receive returns proportionate to the amounat of equity they own and if the company fails, the investors may lose the money they invested.

If they choose to conduct an equity round, startups must determine what rights they are willing to grant investors who purchase equity. Investors will often drive the terms, especially in Series A and later rounds. Some rights that investors may demand from startups to protect themselves if the startup drops in value include a liquidation preference, pro rata rights, anti-dilution rights or other various rights and protections.

Agreements for Future Equity

One newer type of security is known as an agreement for future equity — the most common being a SAFE. A SAFE is similar to convertible debt. For instance, the standard SAFE documents function similarly to convertible notes; however, the investment amount will convert into equity upon the occurrence of future conditions, if they occur, and there is no expectation that the startup will repay the amount of the investment.

When a SAFE — or similar types of agreements such as Keep It Simple Securities (KISS) — is used, the investor receives the right to purchase stock worth the amount of their investment subject to the terms and conditions agreed upon in the SAFE agreement. SAFEs typically contain similar terms as a convertible note such as caps and discounts. However, these securities will not contain a maturity date or accrue interest.

SAFEs are often used for friends and family rounds, but a startup should do some research prior to presenting a SAFE offering to angel groups or other early-stage venture capital investors as some will not invest through a SAFE.

As a startup, it is important to understand your options when raising money. It is always advisable to retain counsel to properly structure the deal and to negotiate the terms with investors.

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