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You're probably familiar with SAFE notes if you're an early stage Founder or Investor.

But did you know that later stage Investors and Founders are also using SAFE notes?

And have you figured out that later stage SAFEs can create real downstream problems for a startup? 🧵👇

Background

A SAFE note is a "Simple Agreement for Future Equity" and it was created by Y Combinator in 2013. It was designed to reduce the cost and complexity of the legal paperwork associated with equity deals for very young companies.

Another important goal was to create a standard for the industry so Founders didn't get surprised or swindled by terms they didn't understand.

What Are They?

A SAFE note is an agreement for an Investor to exchange cash today for shares in a Company at a predetermined discount to its next priced equity round.

SAFE notes are simple because there's no need to negotiate valuation caps, interest payments or maturity dates.

Market Standard

SAFEs have become the market standard with Y Combinator companies being the early adopters.

✅ SAFE notes were used in 50%+ of Y Combinator deals in 2015 and 70%+ in 2016

✅ SAFE notes were used in 80%+ of Y Combinator deals between 2017 and 2023

Problem: They're Not Debt

A SAFE note is NOT a debt instrument. It does NOT lock in a maturity date or interest rate nor does it have protections if a new equity round doesn't materialize.

As a result, there's no time pressure for a Company to convert SAFE notes into equity.

Problem: No Voting Rights

While the notes are outstanding the voting and ownership dynamics of a company stay fixed in time.

SAFEs receive voting rights when they convert into actual equity. This allows Founders to delay important conversations around control and governance.

Problem: Ability to Stack

Since SAFEs aren't debt they don't require the traditional Board approvals that Investors negotiated for in their deal docs. Founders can stack SAFEs without seeking "permission" from equity or debt holders.

Because there's less oversight and not all capital comes from "sophisticated Investors", some Founders have been able to use stacked SAFEs to raise more capital than their company should be taking on given their progress.

When this happens, the stack becomes a major deterrent for any rational downstream Investor to price a round in anything but a true rocket ship scenario.

Talk to any new Investor digging into a company with a mountain of SAFEs and you'll hear nothing but horror in their voice.

Problem: Misaligned Incentives

Incentives become misaligned when SAFE notes are outstanding for any significant time because value creation HURTS an Investor's ownership.

SAFEs don't have a valuation cap so Investors own less when a company does well than if it performs poorly.
So while SAFE notes work well for "first capital in" situations, they are increasingly being used in ways that "kick the can" and set up mid-stage Companies for major downstream issues.

SAFE notes are going to be the cause of death of some mid-stage companies.

Y Combinator would be applauded if they revisited the structure of SAFE notes to protect against the many unintended consequences. The startup ecosystem consists of participants with different levels of sophistication so fixing issues with SAFEs will improve everyone's lives.

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