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Investing in startups: Is it SAFE to KISS?

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Two of your clients, both successful in brick-and-mortar businesses, ask for your advice on proposed investments in startups whose software, they believe, may revolutionize their industries. One sends you an agreement labeled "SAFE," the other sends one called "KISS." Each also sends a letter from the founder, urging a quick response, with assurances that the form and content of the agreements are standardized and blessed by prominent Silicon Valley accelerators and law firms.

A little googling reveals that, indeed, Y Combinator (creator of SAFE) and 500 Startups (creator of KISS) are respected Silicon Valley enterprises. You check their websites and, sure enough, your clients' SAFE and KISS agreements track the online versions word for word. So, are these investments suitable for your clients?

SAFEs ("simple agreement for future equity") and KISSs ("keep it simple security") are investment securities which, like convertible notes, automatically convert into equity when the issuer later completes a preferred stock financing. At that time, the SAFE or KISS converts into the same class of shares as are purchased in the financing, but at a discounted price (20 percent is typical), or subject to an agreed valuation cap, or both. But unlike a convertible note, the investment bears no interest, nor does the company have any obligation to repay the investment at maturity. In fact, the SAFE provides for no maturity date at all. Either the investment will automatically convert to preferred shares in the later financing, whenever (if ever) it occurs — or it will be returned (with a premium, in a KISS) upon a sale or liquidation of the company to the extent proceeds permit.

Despite their common purposes, SAFEs differ from KISSs in several respects when compared feature-by-feature. For instance, in a KISS, automatic conversion occurs only if the triggering financing generates at least $1 million in proceeds. If no such financing occurs within 18 months, the holder may nevertheless convert the KISS into preferred shares featuring the terms and rights found in yet another set of open-source, standardized templates known as Series Seed Preferred Stock.

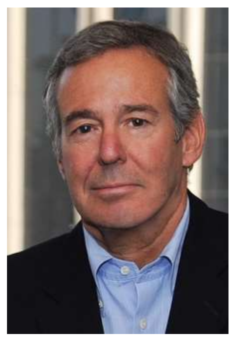
Cloud computing, open source software and similar developments enable today's entrepreneurs to launch startups on far less capital than ever before. Success no longer depends on venture capitalists hastily funding a complicated, $3-5 million Series A investment the day after incorporation. In this marketplace of lower budgets and diverse investors, the SAFE and KISS templates have achieved recognition as simple and straightforward, mutually fair to both company and investor, devoid of surprises, and ideal for quickly obtaining capital with minimal legal expense. Yet despite their benefits, SAFEs and KISSs frequently encounter investor resistance, and still represent only a fraction of seed financings. Pondering your client's questions, you begin to see why that is:

What if the company just crashes, burns, closes its doors and salvages what it can in a fire sale, never obtaining another financing? Your client's rights are junior to creditors, including any investors who (unless your client obtained "most favored nations" rights) acquired convertible notes after your client's investment. If this is a critical concern, your client is not the right buyer of a SAFE or KISS. Investors suitable for SAFEs and KISSs know their investments are highly speculative, are unafraid of losing them, and are focused solely on the "long shot" upside. In their view, the protection afforded by a convertible note is less important than demonstrating to the founders that they are in for the long haul, and the prospect of shutting down the company to recover their investment is largely hypothetical.

How negotiable are SAFEs and *KISSs?* They are as negotiable as the company will allow. But as the founders will tell you, negotiation (other than over discounts and caps) defeats the purpose of their efficiency and cost-effectiveness. The KISS is somewhat more comprehensive than the SAFE, and the SAFE itself is available in alternative formats depending on the usage of discounts, valuation caps and/or "most favored nations" clauses. But investors seeking board observer rights, broader information rights or other features not included in the templates will likely invite pushback and a warning that the company may move on to someone else.

What if the company is an LLC? Be very careful. SAFEs and KISSs, in their standardized forms, are exclusively for corporations. They can be (and increasingly are) tailored for use by LLCs as well, but careful customization is required — especially in addressing situations (such as optional conversion of a KISS) defined solely by corporate statutes or structures.

What else should I consider? The value of a SAFE or KISS depends on future valuations, future events and their timing, none of which is certain. But sometimes, negative indicators may be apparent from the start. If the company's most likely source of future capital are well-heeled but unsophisticated investors, or a potential strategic partner whose valuation is based on factors unrelated to intrinsic value — will your client's discount and/or valuation cap provide enough comfort to accept that investor's valuation as the basis for his or her own conversion price? Further, while SAFEs and KISSs both contain basic warranties of authority, enforceability and the like, neither contains warranties regarding the company's assets, liabilities, legal compliance or other business affairs — other than limited, qualified warranties as to intellectual property ownership and (in KISSs) absence of litigation. To the extent the company is willing to open its records and/or answer questions, it behooves the investor to ask ■



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