Shadow Preferred Stock:

A Crack In The "SAFE" Seed Finance Documents?

By:Jonathan D. Gworek
February 01, 2015

Background

Since the relatively recent release of the "SAFE" (Simple Agreement for Future Equity) documents by Y Combinator, we have received frequent inquiries about the pros and cons of using this new breed of document over a more traditional form of convertible note. While the SAFE has the potential to simplify fundraising for early stage companies, reducing both the time and costs involved in the process, like any financing instrument it is complex in its own right and needs to be deployed with care.

There is one particular feature of the SAFE that may merit special consideration on a case-by-case basis. More specifically, the SAFE is designed to convert at the time of the next preferred stock financing into a series of preferred stock commonly referred to as "shadow preferred stock". This shadow preferred stock is a separate and distinct series of preferred stock from that preferred stock (the "new investor preferred stock") which is issued to the new investors in the preferred stock financing that triggers the SAFE conversion. Shadow preferred stock is intended to be identical to the new investor preferred stock in most respects. While as discussed below there are good reasons for this approach, this shadow preferred stock will enjoy certain protections under §242(b)(2) of the General Corporation Law of the State of Delaware (the "DGCL"). The stockholder rights that are created by virtue of §242(b)(2) should be understood by any company issuing SAFEs and weighed against the benefits of creating this shadow preferred stock.

Safe Shadow Preferred and the Liquidation Preference Premium Dilemma

SAFEs typically convert into shadow preferred stock. This shadow preferred stock is intended to have the same rights as the series of preferred stock issued to new investors in the financing round that gives rise to the SAFE conversion, except that the liquidation preference, conversion price, and dividend rate of the shadow preferred stock are all calculated based on the price per share of the shadow preferred stock rather than the price per share of the new investor preferred stock. The shadow preferred stock is a rational approach and solution to one particular asymmetry that would otherwise result if the SAFE converted into the new investor preferred stock—the liquidation preference premium.[1]

A brief refresher on the economics of convertible notes helps illustrate the liquidation preference premium dilemma that SAFEs are designed in part to address. In a typical convertible note offering, the company issues promissory notes that are convertible into the preferred stock issued to investors at the time of the next round of equity financing. This conversion is typically at some discount to the price paid per share in that round to reflect a risk premium. For example, if an investor invests $100,000 in seed capital in exchange for a promissory note for $100,000, and this note converts at a 20% discount, then when the issuing company issues preferred stock in its next round of financing at $1.00, the note will convert at a price of $0.80 per share. As a result, the promissory note will convert into a number of shares equal to $100,000/$0.80, or 125,000 shares of preferred stock. This extra 25,000 shares represents a “stock ownership premium” inherent in the discount. In addition to this stock ownership premium, the noteholder also gets a liquidation preference that is associated with 125,000 shares of preferred stock. Liquidation preference is the right to be paid a certain amount per share, typically the purchase price, in certain exit scenarios. In the above example, the preferred stock issued would be entitled to $1.00 of liquidation preference per share for a total of $125,000 of liquidation preference in the aggregate. So not only has the above investor received a greater ownership position for the size of the investment— an extra 25,000 preferred shares—the investor has also received stock with a liquidation preference right equal to $125,000—an extra $25,000 of liquidation preference. This means that under certain exit scenarios, the investor is entitled to receive $125,000 for stock purchased for only $100,000. This extra $25,000 represents a “liquidation preference premium”. This result is considered by some to be an inequitable unintended consequence of the more standard convertible note structure, and the shadow preferred stock contemplated by the SAFE is intended to eliminate the liquidation preference premium.

DGCL §242(b)(2) Risk and Alternatives

While the shadow preferred stock reflected in the SAFE is a rational approach to solving the liquidation preference premium dilemma, the creation of a series of shadow preferred stock is not without some corporate governance cost and risk. DGCL §242(b)(2) provides a statutory blocking right to the stockholders of any class of stock with respect to any amendment to the certificate of incorporation that would “alter or change the powers, preferences or special rights of the shares of such class so as to affect them adversely.” Creating the shadow preferred stock in an effort to solve the liquidation preference premium will result in the creation of a separate class of stock, and the stockholders of this class—the former holders of the SAFEs—will have blocking rights pursuant to §242(b)(2). This right might be implicated, for example, in any recapitalization in which all series of preferred stock need to give up certain rights as a condition to a future financing or M&A transaction.

There are alternatives to the creation of shadow preferred stock that might be preferable in view of this §242(b)(2) risk. One option would be to simply let the SAFEs convert directly into the new investor preferred stock notwithstanding the liquidation preference premium. Often times the amount of the liquidation preference premium that would result if the SAFEs converted into this preferred stock would be relatively small. Imagine, for example, SAFEs with an aggregate face value of $500,000 converting into a shadow preferred stock at a 20% discount to the new investor preferred stock. The total “savings” to the company and the other stockholders by converting into shadow preferred stock at this discount would be $100,000 in liquidation preference premium. It might be worth absorbing this cost in order to avoid potential pitfalls of §242(b)(2). If the company is determined to eliminate the liquidation preference premium, either on principal or because it is too large a number to accept in the context of the transaction, another alternative would be to allow the SAFEs to convert into the new investor preferred stock, but to provide that the liquidation preference per share, and associated anti-dilution and dividend rights, with respect to the preferred stock issued upon conversion of the SAFEs shall be determined by reference to the price per share at which the SAFEs converted pursuant to their terms. This would be permitted pursuant to DGCL §102(d), which provides that “any provision of the certificate of incorporation may be made dependent upon facts ascertainable outside such instrument.” While this approach may still result in §242(b)(2) risk in certain circumstances, it might mitigate this risk to some extent.

Conclusion

Any company issuing SAFEs with shadow preferred stock should weigh the benefits of eliminating the liquidation preference premium with the costs of conferring statutory §242(b)(2) blocking rights under the DGCL. Depending on the total cost inherent in the liquidation preference premium, the company might decide it is better to let the liquidation preference premium stand rather than risk the pitfalls of §242(b)(2). Alternatively the company might be able to serve both purposes by issuing one series of preferred stock to new investors and SAFE holders alike, but setting up a different set of rules for the stock issued upon conversion of the SAFEs pursuant to the flexibility afforded by §102(d).

For further information on this topic, please contact **Jonathan D. Gworek**.

Footnote.

1 For a more comprehensive discussion of the liquidation preference premium, see "Seed Convertible Note Discounts: Reconciling 'Stock' and 'Liquidation Preference' Premiums", by Jon Gworek, March, 2012.