



**The Journal of Robotics,
Artificial Intelligence & Law**

Editor's Note: Data
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Matter Eligibility
Steven L. Wood

Novel Settlement Reached in Generative AI Deceptive Trade Practices
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Jennifer Rangel and Danielle A. Giaccio

The Impact of Artificial Intelligence on M&A Deals—Part I
Peter A. Emmi

**Start-Up Corner: The Role of Different Convertible Instruments in Start-Up
Financing**
Jim Ryan

- 83 Editor's Note: Data**
Victoria Prussen Spears
- 87 The European Union's Data Act**
Martin Braun, Anne Vallery, and Itsiq Benizri
- 107 Artificial Intelligence and Product Liability**
Joseph Mazzarella and Kimberly Castellino Metzger
- 113 The USPTO's AI Guidance on AI-Assisted Inventions and Patent Subject Matter Eligibility**
Steven L. Wood
- 121 Novel Settlement Reached in Generative AI Deceptive Trade Practices Healthcare Investigation**
Jennifer Rangel and Danielle A. Giaccio
- 125 The Impact of Artificial Intelligence on M&A Deals—Part I**
Peter A. Emmi
- 147 Start-Up Corner: The Role of Different Convertible Instruments in Startup Financing**
Jim Ryan

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Editorial Office

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Articles and Submissions

Direct editorial inquiries and send material for publication to:

Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc.,
26910 Grand Central Parkway, #18R, Floral Park, NY 11005, smeyerowitz@
meyerowitzcommunications.com, 631.291.5541.

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Leanne Battle, Publisher, Full Court Press at leanne.battle@vlex.com or at
202.999.4777

For questions or Sales and Customer Service:

Customer Service
Available 8 a.m.–8 p.m. Eastern Time
866.773.2782 (phone)
support@fastcase.com (email)

Sales
202.999.4777 (phone)
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Start-Up Corner

The Role of Different Convertible Instruments in Start-Up Financing

Jim Ryan*

In this column, the author explains how convertible instruments can help start-ups raise capital.

Start-ups of all sizes and at various stages of their life cycles need to raise capital. While selling shares may sound the simplest, doing so directly is not always the most efficient or appropriate choice. Raising capital by issuing priced equity requires agreeing to a fixed valuation of the company and, typically, a large variety of terms to govern the stockholders' relationship with each other and with the company. Sometimes the parties cannot agree (or cannot agree efficiently) on some mix of the valuation and the other terms of the transaction such as board seats, liquidation preferences, and down round antidilution protection, among others.

Enter Convertible Instruments

One solution, particularly for pre-seed companies, is a convertible instrument. These are investment contracts that provide the holder a right to convert their investment into equity of the company if and when certain pre-determined events happen, such as a priced equity round (i.e., a Series Seed financing). Convertible instruments can vary, but the two most common are convertible notes and simple agreements for future equity (Safes).

Convertible instruments allow the ultimate valuation of the company's equity, and much of the expense associated with negotiating shareholder agreements and issuing equity, to be deferred, with investor-protective guardrails, to a later date and time when

more data is available and, generally, when more money is being raised by the company.

In other words, convertible instruments allow companies to raise money earlier and more efficiently than if priced equity were the only option, while giving investors a potentially advantageous price at the expense of not getting governance or economic control at the time of their initial investment.

Common Features: Caps, Discounts, or “Better Of”

Both instruments are non-dilutive unless and until converted into equity. Standard conversion features are:

- Valuation cap;
- Percentage-based discount; and
- The “better of” the cap or discount.

Valuation caps set a maximum valuation at which the convertible instrument can convert in an equity financing. There are different formulations of cap (post-money and pre-money), but in either variation, the end result is that, in subsequent financings with valuations well above the cap, the convertible instrument will convert at a significant discount, and in subsequent financings with lower valuations, there may be no discount. The potential for the lack of a discount in some scenarios is the driving force behind percentage-based discounts.

Percentage-based conversion discounts apply the agreed discount to the price per share in the subsequent equity financing, giving the investor extra shares for each dollar invested. Another way of thinking about it is that these discounts lock in a dollar value premium relative to the investment. For example, a 20 percent discount gives an investor a \$0.25 boost for every dollar invested (for each invested \$1.00 / 0.80 = \$1.25 effective value). The discount therefore provides a guaranteed premium, but in some circumstances, the investors may not see this as a fair return for the early risk.

A “better of” approach covers both outcomes by giving the investor a conversion price that is the lower of the price based on their cap and their discount; this guarantees the investor that they

will be at least \$0.25 per dollar better off than a cash investor in the future conversion round (in this example).

Trends in the prevalence of these terms vary based on market conditions but, at the time of writing, according to data gathered by Carta looking at pre-seed companies (defined as those which have not raised a priced equity round),¹ 52 percent of Safes had only a valuation cap, 37 percent had a valuation cap and a discount (Better of), 9 percent were discount-only, and the remainder had none of these terms.

Convertible Notes

Convertible notes tend to be more favorable to investors than Safes because convertible notes are forms of actual indebtedness (until converted into equity), whereas Safes are not (most participants in the market take the position that Safes are equity for tax purposes). In a traditional convertible note financing, investors lend money to the company in exchange for the promise of a repayment or conversion in connection with either an equity financing, a sale of the company, an event of default, or maturity. Convertible notes, unlike traditional debt, typically do not require incremental repayment (although they can allow for such).

Since convertible notes are considered debt, they accrue interest and have priority over equity in the event of the company experiencing a liquidation event. In most pre-seed circumstances, convertible notes for early stage companies are unsecured and so will not have first priority if there is other secured debt.

Unlike Safes, there is no central starting point for the form of the documents. This means that convertible note financings can be significantly slower to get to closing than Safe financings.

Safes

On the other hand, Safes have many of the same features of convertible notes except they:

1. Do not have a maturity date or concept of events of default;
2. Do not accrue interest; and
3. Are generally not treated as indebtedness.

Because they are not debt, they do not have priority over equity in a liquidation scenario and instead are treated like preferred stock with priority over common stock. As there is no maturity date, Safes only convert to equity upon a preferred stock financing, initial public offering, or sale of the company.

Until their Safes convert into equity, Safe holders have few if any rights (unless Safes are issued with side letters granting the investors special rights).

Despite the company-favorable elements of Safes, they remain popular because of their ease of use and because, in the early stage context in which they are most often used, the downside protection of convertible notes is not typically of much practical benefit.

Trends in Convertible Instruments

Increased Popularity of Safes

In recent years, Safes have become increasingly popular among early stage start-ups. This trend is largely driven by the simplicity and speed with which Safes can be executed compared to convertible notes. The standardization of Safe documents by organizations like Y Combinator has also contributed to their widespread adoption. According to that same Carta data,² nearly 90 percent of pre-seed rounds were completed using Safes—they are the clear market leader over convertible notes, particularly in the most developed start-up markets.

Customization of Safes

Notwithstanding the benefits of simplicity, there has been a growing trend toward customization of Safes to include specific terms that address their unique needs and circumstances. These modified instruments may include elements like forced conversion dates or specific conversion triggers that provide additional flexibility. Some common customizations include:

- *Pro Rata Rights*: Investors may negotiate for the right to participate in future funding rounds to maintain their ownership percentage;

- *MFN (Most Favored Nation) Clauses*: These clauses ensure that if the company issues Safes with more favorable terms to new investors, the earlier investors will receive those same favorable terms;
- *Conversion Triggers*: Custom triggers for conversion into equity can be set, such as upon reaching certain milestones or revenue targets, hitting a specified date, or setting a minimum threshold for the size of the financing in which the Safe converts; and
- *Side Letters*: Investors may request side letters that grant them additional rights or protections, such as information rights or board observation rights.

This trend toward customization allows for greater alignment between the interests of the start-up and its investors, but does give up some of the benefits of having a standardized set of terms to facilitate moving quickly. There is also the added risk that founders may agree to do a financing on what they assume to be standard terms (because the term Safe is used), only for significantly modified documents to show up when the documents come across. As some market participants have used Safes as a way to involve lawyers later in the process (or entirely after the pre-seed financing has been completed), these deviations from the norm are often caught too late.

Conclusion

Both Safes and convertible notes are highly customizable documents, so founders should be careful to read them and seek the advice of counsel and other professional advisors. Understanding the nuances of these instruments and staying abreast of current trends can help founders and investors make informed decisions that align with their financial and strategic goals. Nevertheless, founders and investors should expect to see the elements in the most basic forms of Safes and convertible notes described in Table 1.

Table 1		
	Convertible Note	Safe
Maturity Date	Yes	No
Interest	Yes	No
Investor Priority in the Event of Liquidation Event	Yes, but generally not above secured lenders	Yes, but only above common stock
Discount	Negotiated	Negotiated
Valuation Cap	Negotiated, Post-Money or Pre-Money	Negotiated, Post-Money or Pre-Money
Repayment in Cash	Maturity (Investor’s Election) or Dissolution	Dissolution Only/Exit

Notes

* Jim Ryan, the “Start-Up” columnist for *The Journal of Robotics, Artificial Intelligence & Law*, is a partner in the Palo Alto office of Morrison & Foerster LLP. He may be contacted at jryan@mofo.com.

- 1. <https://carta.com/data/state-of-pre-seed-q3-2024/#safes>.
- 2. <https://carta.com/data/state-of-pre-seed-q3-2024/#safes>.