# Simple Agreement for Future Equity ("SAFE") and their Application in Kuwait

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## Introduction

SAFEs are an innovative investment instrument that allow startups to secure funding from investors without immediately issuing equity. They serve as a contractual promise to provide SAFE investors with equity at a future date (under specific conditions) without the complexity of a traditional equity round. SAFE was introduced by Y Combinator in late 2013 as a financing instrument tailored for early-stage startups and seed-stage investors. It’s significance in the venture capital and startup ecosystem is that it provides capital without immediate equity dilution or the financial burden of monthly payments.

## The Need for SAFEs in Startup Financing

Traditionally, investors will invest through convertible notes or equity. Convertible notes are usually issued during the pre-seed or seed financing stage, as a debt instrument convertible notes convert into equity once the company has a valuation (e.g. during Series A fundraising). Convertible notes offer flexibility for startups with potential downside protection for investors. Equity provides investors with the most control but comes with the risk of dilution for founders. However, SAFEs are not debt instruments, they have no maturity dates or interest rates, but they do typically come with a valuation cap and/or conversion discount. They offer a balance between the two, with a focus on simplicity and potential benefits for both founders and investors. SAFE’s most significant trait is simplicity, it is traditionally more concise and less complex than traditional equity or debt financing documents. This streamlined approach allows startups to remain focused on their core business operations rather than being diverted by prolonged negotiations.

## Legal Framework and Structure of SAFES

SAFE is a financing contract that may be used by a start-up company to raise capital in its seed financing rounds. The SAFE investor receives the future shares when a priced round of investment or liquidation event occurs. SAFEs are not a loan; it is more like a warrant. Therefore, SAFE agreements are not subject to the regulations that debt instruments may be in many jurisdictions, so they cannot lead to insolvency proceedings directly. When the conversion event occurs, the SAFE remains outstanding indefinitely and the investors receives a right to convert the SAFE into equity at a lower price than the investors in the subsequent financing (based either on the discount or valuation cap in the SAFE).

## SAFE'S Vocabulary:

- **Valuation Cap**: is a ceiling on the pre-money valuation which is used as a starting point in execution of the SAFE contract and "conversion" into shares in a next financial round.
- **Discount Rate** is a percentage of which the price of the shares for the early investor in subsequent financing round shall be reduced.

**Note**: if both are included the share price for the early investor shall be determined by using whichever method gives the investor a lower price per share.

- **Conversion Trigger**: the event that initiates the conversion of the SAFE note into equity.

- **Maturity Date & Repayment Terms**: SAFES notes do not involve an interest rate or maturity date. Safe notes lack an explicit repayment obligation. maturity dates define the lifespan of a security or loan, informing investors and creditors when they receive their principle back.

- **Most Favored Nation (MFN) Clause**: assures early investors that they receive terms equal to or better than future investors, protecting their interests in dilution in subsequent funding rounds.

- **Preemptive Rights Clause**: give existing shareholders the right to purchase new shares before they are offered to third parties.

**Types of SAFES**

- **SAFE With Valuation Cap**: this type sets out the maximum value in equity you can get in the agreement. If the company's valuation when a triggering event (like a funding round) occurs is more

- **SAFE With Discount**: this type is used as a mechanism to address the higher risk of investment that SAFE investors take when investing in an early-stage startup. It is a discount off the price per share paid by new investors in the equity financing. The discount may range anywhere between 5% to 30%, with 20% being the norm.

- **SAFE With Both Valuation Cap and Discount**:

converting the SAFE into SAFE preferred stock, either the Valuation Cap or the Discount Rate applies:

1- If the conversion price implied by the Valuation Cap is smaller than the discounted price per share of preferred Stock, the Valuation Cap applies and the Discount Rate is disregarded.

2- In Contrast, if the Conversion Price implied by the Valuation Cap is larger than the discounted price per share of Preferred Stock, the Discount Rate applies and the Valuation Cap is disregarded.

- **Pre-Money SAFES**: In Pre-Money SAFES, the valuation cap doesn't include the capital raised in the SAFE round itself, Investors' ownership is determined without accounting for the dilution caused by the SAFE itself, Calculations for equity conversion are more complex especially when multiple SAFEs are issued.

- **Post-Money SAFES**: In Post-money SAFES, the valuation cap includes the amount raised through the SAFES, provides greater clarity to investors, as the ownership percentage they will receive upon conversion is explicitly calculated. Makes it easier for founders and investors to predict and understand dilution. However, founders often bear the brunt of dilution from multiple SAFE rounds.

## Legal Risks and Considerations

SAFEs don't provide immediate ownership in the company. This means the investors won't have equity or voting rights until the SAFE converts, which might not happen if the company doesn't survive until its later funding round. If the startup fails before the conversion event, SAFE investors may end up with nothing. Unlike debt instruments, SAFEs typically don't protect investors like creditors if there's a company liquidation.

In some cases, triggering events in a SAFE might not occur, leaving investors without equity. For instance, if a startup becomes financially self-sufficient, no longer requires additional funding, and isn't acquired by another entity, then the conditions for converting the SAFE into equity might never be met. This scenario could mean the investor doesn't receive equity despite the initial investment.

## Advantages and Disadvantages of SAFES

Advantages:

- **Simplified Negotiation Process**: SAFES have standardized terms that can be quickly agreed upon, that allows startups to focus on building their business rather than getting caught up in negotiations.

- **Flexibility in Conversion**: SAFEs offer flexibility in converting into equity, providing options like a future-priced round or a liquidity event such as an acquisition. This adaptability empowers startups to customize agreements based on their specific needs and goals at various stages of their growth journey.

- **Value Preservation**: they allow startups to maintain their valuation until a future financing round or liquidity event occurs.
- **Investor Protection**: SAFEs offer protections that traditional equity financing may not provide. These protections could include discounts on future funding rounds or even priority access to proceeds in the event of an exit or bankruptcy involving start-up.

<u>Disadvantages</u>:

- **Ownership dilution**: they can result in a decrease in the percentage of ownership percentage. As a startup raises funds through rounds or liquidity events, converting SAFE agreements into equity will lead to the issuance of new shares. This can reduce the ownership stake for founders and early investors.

- **Valuation Uncertainty**: when opting for SAFE agreements, the absence of a fixed valuation, known as an uncapped SAFE, introduces flexibility in equity conversion. This model relies on funding or liquidity events to determine conversion rates.

- **Limited Control for Investors**: Investors may have more control rights compared to equity financing. Typically, they do not hold voting rights or board representation until their investments convert into equity.

**Structuring and Negotiating SAFES:**

**Understand the terms and conditions:** create a term sheet that outlines the conditions you're willing to accept and those you want to negotiate. This should include valuation caps, discount rates, pro rata rights, and conversion triggers.

**Align interests with investors:** Find investors who offer more than just capital. The right investors bring industry expertise, networking opportunities, and strategic value to your startup.

**Come in with a plan:** enter negotiations with a clear understanding of your startup's valuation and how it justifies the terms you're proposing. Be prepared to discuss your startup's milestone, financials, and market potential.

**Clauses you must add in a SAFE:**

The principal amount, the valuation cap., discount rate, conversion trigger, dissolution protection, events of default, governing law and jurisdiction. However, adding a **non-disclosure agreement** is highly recommended, to protect confidential information which investors receive during communication.

**Enforceability of SAFES in Kuwait:**

The enforceability of SAFEs in Kuwait would depend on several factors, mainly, the clarity of the clauses and the ability to convert such SAFEs into equity. Generally, Kuwaiti courts will attempt to uphold all types of contracts as they are unless they are contrary to public policy or specifically in contradiction to local laws and regulations.

## The Legal Strength of SAFES as Opposed to Governmental Articles of Association

As a general rule, the Articles of Association of any entity in Kuwait, as provided by the Ministry of Commerce and Industry ("MoCI") and the Ministry of Justice ("MoJ") have legal precedence over any other "unofficial" agreements, including SAFEs. In the event of a dispute, the party attempting to prove its equity ownership through SAFEs will face an uphill battle when the "official" documents state a different equity structure.

## Foreign Ownership through SAFES

Generally, Kuwait operates through a 51% minimum local and 49% maximum foreign ownership scheme. With SAFEs used for entities in Kuwait as well as the dilution issues discussed, such foreign ownership will need to be addressed when the SAFE's terms are reflected in any later conversion.

## Conversion of SAFES into Equity

When a triggering event occurs and the SAFE is converted into equity, each SAFE holder will have to be physically present at the MoCI and the MoJ to sign and officially reflect their equity ownership per the SAFE's terms in the Articles of Association of the entity. This contradicts the objective of SAFEs which is to enhance efficiency.

Further, the entity in which the equity is to be reflected in must allow for the introduction of new shareholders. SAFE holders in Kuwait must be cautious of the limitations to each type of entity (i.e. with limited liability, shareholding, etc.) and the regulations required to include additional shareholders and to increase the capital of the entity

As with any other financial contract, in the event of a dispute, Kuwaiti courts will examine the validity of the agreement and the enforceability of its terms, specifically the triggering events.

## Conclusion

SAFEs have revolutionized startup financing by offering a simplified, flexible, and founder-friendly alternative to traditional funding instruments like equity and convertible notes. The streamlined structure reduces the complexities of negotiations, enabling startups to secure funding quickly and focus on scaling their business. However, SAFEs are not without risks. Founders must carefully manage potential dilution, and investors must understand the lack of immediate ownership and protection in liquidation scenarios. Ultimately, SAFEs strike a balance between simplicity and strategic financing planning, making them a valuable tool in the startup ecosystem.

In enforcing SAFES in Kuwait, SAFE holders and issuers alike must be aware of the risks involved in their issuance as well as the enforceability of such SAFEs in the country. Kuwait's laws and regulations must be carefully studied to ensure that the SAFE provides sufficient protections prior to the occurrence of any triggering event or dispute.

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