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Comparing Crowdfunding Instruments: Common Stock, Preferred Stock, Convertible Notes and SAFEs

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Introduction

This practice note describes the various types of securities which are used in equity crowdfunding. It will describe the pros and cons of each security and, where appropriate, explain the reasoning behind the creation of the security. This practice note assumes the company raising capital is a corporation; however, each of these instruments may be adapted for use by a limited liability company (though it can a bit more challenging with convertible instruments).

The type of equity crowdfunding a company wishes to pursue will help determine the ideal instrument. Companies can "crowdfund" in several ways. A company can crowdfund to accredited investors via Rule 506(c) under Regulation D (Title II of the JOBS Act), crowdfund by carrying out a "mini-initial public offering" pursuant to Regulation A+ (Title IV of the JOBS Act), or crowdfund to accredited and non-accredited investors alike through Regulation Crowdfunding (Title III of the JOBS Act). A company can also take advantage of Rule 147 of the Securities Act of 1933 (Securities Act) to conduct an offering solely to investors, both accredited or non-accredited, that reside in the state in which the issuer's business is located. Rule 147 is termed an "intrastate crowdfunding." For additional information on Crowdfunding generally, see A Summary of Crowdfunding under the JOBS Act.

Crowdfunding Concerns for Both Companies and Investors

As counsel for a company considering crowdfunding, there are several concerns to keep in mind.

Number of Shareholders

The company should seek to avoid having a large number of shareholders on its cap table as a result of the crowdfunding. The company may later wish to raise money from venture capital funds or other sophisticated investors, and these investors do not like to see crowded capitalization tables, as the more investors there are, the greater the chance one or more investors will cause problems for the company and become a distraction to management. Unless the company is pursuing a Regulation A+ offering, it is unlikely to raise a large amount of money through crowdfunding. Thus, the company will wish to keep a relatively clean cap table that it can show to later investors, who could potentially invest a larger amount of money into the company than the crowdfunding investors.

Avoiding Registration

Second, the company will not want to be forced to register a class of securities with the Securities and Exchange Commission (SEC). Section 12(g) of the Securities Exchange Act of 1934 (Exchange Act) establishes the thresholds at which an issuer is required to register securities with the SEC. These thresholds were raised by the JOBS Act and the Fixing America's Surface Transportation (FAST) Act. Currently, an issuer that is not a bank, bank holding company, investment company, non-profit, or savings and loan holding company is required to register a class of equity securities under the Exchange Act if:

- It has more than $10 million of total assets
- The securities are "held of record" by either 2,000 persons, or 500 persons who are not accredited investors

The term "held of record" excludes securities held by persons who received the securities under an employee compensation plan in transactions exempted from the registration requirements of Section 5 of the Securities Act. In addition, investors in a Regulation Crowdfunding offering will not count toward the Section 12(g) registration threshold if the company is current in its annual reporting obligations, retains the services of a registered transfer agent, and has less than $25 million in total assets as of the end of its most recently completed fiscal year.

Minimizing Administration

The company will want to keep its administrative burdens to a minimum. Thus, a company undertaking a crowdfunding may want to restrict voting, information, and other rights typically provided to shareholders.

Avoiding Valuations

Fourth, the company may wish to avoid having to determine a valuation. Many companies looking to crowdfund are early stage companies, and determining how much the company is worth with any accuracy may be impractical. Professional valuation firms often charge several thousand dollars for a preliminary valuation, although a few will allow for payment to be made in installments, and early stage companies usually need to conserve their cash. (A valuation may be worthwhile, however, if a company anticipates that it will issue stock options, as a valuation also provides a safe harbor against tax liability under Section 409A of the Uniform Commercial Code.)

Investor Appeal

Perhaps most importantly, the company will want to make its offering attractive to investors. Counsel for companies that are looking to crowdfund will sometimes focus too much on making the terms of the securities being offered as advantageous to the company as possible. With crowdfunding, there is typically no one on the other side of the table to push back on the terms being offered, and counsel may lose sight of the fact that the offering will only be successful if investors purchase the security. There are many companies looking to raise money through crowdfunding, and it is very easy for investors to move on to the next company if they do not like what is being offered.

Crowdfunding Instruments

Common Stock

Common stock is the easiest security for investors to understand, and typically any math that is involved is simple and can be done on the fly. Many crowdfunding offerings, regardless of type, are conducted using common stock. Common stock, as well as any other type of equity, does not have to be paid back. Common stock also tends to be easier to transfer than some of the other types of securities described in this practice note.

However, common stock is not perfect for every crowdfunding offering. Common stock requires a valuation, since the company (and the investor) must determine how much each share is worth. As noted previously, this may be a challenge for early-stage companies. Also, common stock will typically carry voting rights, and though a company charter can eliminate voting, most investors interested in purchasing common stock will expect to be able to vote their shares. Lastly, there is no way to avoid listing common stockholders on a company's capitalization table.

In general, offering common stock is best for later-stage companies which may not have difficulty reaching a valuation (this applies whether a crowdfunding is intrastate or involves investors from multiple states). Investors in Rule 506(c) offerings will often push for preferred stock (see below), but investors in Regulation A+ offerings, which are most like an initial public offering (IPO) and normally carried out by more seasoned companies, will generally be satisfied with receiving common stock.

In general, offering common stock is best for later-stage companies which may not have difficulty approximating a valuation. Investors in Rule 506(c) offerings will often push for preferred stock (see below), but investors in Regulation A+ offerings, which are most like an IPO and normally carried out by more seasoned companies, will generally be satisfied with receiving common stock.

Preferred Stock

Preferred stock simply refers to stock that carries a liquidation preference to common stock. Many experienced angel and other investors will expect to receive preferred stock and may be resistant to purchasing any other type of security. Company founders may also wish to award investors preferred stock, as keeping the common stock to themselves will ensure the founders retain a bit of flexibility in pricing the common stock (assuming no valuation event has taken place). Preferred stock generally requires an estimation of the company's value.

Companies have a lot of leeway when designating the rights attached to preferred stock. In addition to a liquidation preference, preferred stock can—but does not have to—include a right to receive dividends, voting rights, and additional rights such as approvals on mergers and equity issuances. Preferred stock will occasionally contain a maturity date far into the future, but in general, preferred stock is considered straight equity and does not have to be paid back. Preferred stockholders appear on the capitalization table.

With regard to crowdfunding, preferred stock is best issued in Rule 506(c) offerings. Rule 506(c) investors, which must be accredited and are often experienced investors, will likely expect to receive preferred stock and attempting to offer any other type of security may result in diminished sales. Depending on the type of investors targeted in an intrastate crowdfunding (i.e., friends and family that may not be concerned with the type of security received, or sophisticated angel investors that very much care), preferred stock could be the security of choice for it as well. Preferred stock has been offered in Regulation Crowdfunding offerings, though to date there has not been an appreciable difference recorded in the results of common stock offerings versus preferred stock offerings. Preferred stock may be offered in Regulation A+ offerings, but is likely unnecessary, as common stock is issued in IPOs and a Regulation A+ offering is closer to an IPO than to a private placement. Thus, there should not be a groundswell of investor demand for preferred stock in a Regulation A+ offering.

Convertible Notes

Convertible notes are often used to invest in early-stage companies. Convertible notes begin life as debt instruments, and then convert into equity upon a "qualified equity financing," usually defined as the company's next equity financing (often of preferred stock) that raises a certain threshold amount of capital. Convertible notes do not require a valuation until the time of the qualified financing, as a valuation is unnecessary for a debt instrument. The rationale behind the convertible note is that at the time of the qualified financing, the company will be further along in its life cycle and the investors that invest in the later round may be better-positioned to determine the company's valuation. Often, a discount rate is provided (generally 20%), which has the effect of awarding the noteholder a certain additional percentage of equity in the qualified financing round than the investor would have received had the investor waited and only invested in that round. A valuation cap is also often provided, which places a limit on the amount the holder can be diluted in the qualified financing round. A convertible note can convert into either common stock or preferred stock.

Convertible notes have two primary benefits for investors: (i) no valuation is necessary, and (ii) the investor is likely better off holding a debt instrument in an early-stage company than holding equity, as debt takes priority over equity in the event the company is unsuccessful. The latter is particularly true if the company is a brick-and-mortar business with real assets that could potentially be seized and resold by creditors.

Experienced investors tend to be familiar with convertible notes. However, explaining the conversion process to inexperienced investors, particularly that the number of shares the investor will receive is unknown until the qualified financing, will often be a challenge. Also, as a debt instrument, convertible notes will have both a maturity date and an interest rate. Typically, the interest rate will be rather low (3%–6%) and interest will be allowed to accrue (and become convertible into equity along with the principal, following the qualified financing). The maturity date, on the other hand, is often no more than 24 months from the date of issuance and can become an issue for the company in the quite-possible event that no qualified financing has taken place by the time the note comes due. Early-stage companies are often unable to redeem convertible notes if the notes reach maturity, and either an extension to the note will have to be obtained from noteholders, or some other arrangement will have to be made (such as conversion to stock at a favorable rate). Counsel for issuers of convertible notes should always include a clause in the note requiring the noteholder—or a majority-in-interest of the noteholders to the series of notes—to take some action on or after the maturity date before the company is in default, such as presenting a written demand for redemption to the company or instructing a collateral agent to make such a demand.

At least one Regulation Crowdfunding platform only offers convertible notes, so investors perusing its offerings will be (or will quickly become) familiar with convertible notes. However, given the general inexperience of many Regulation Crowdfunding investors in startup investing, an offering of convertible notes sandwiched between offerings of common stock will likely be at a disadvantage. Convertible notes are ideal for Rule 506(c) offerings, as many accredited investors who invest in private companies are familiar with convertible notes and how they operate. Similarly, convertible notes may be appropriate for an intrastate crowdfunding, depending on the sophistication of the investors. Convertible notes should not be used in Regulation A+ offerings, which are unlikely to be shortly followed by a qualified financing.

SAFEs

Many early-stage companies are hesitant to issue convertible notes, as they are concerned about the threat of insolvency that arises should the notes reach their maturity dates with no qualified financing having occurred and the company unable to redeem the notes. Since the expectation of the convertible note investor is for the note to convert so the investor owns equity in a successful company, rather than to earn an interest rate and have the note be redeemed in two years with no equity being granted, it was decided that perhaps the debt portion of the convertible note could be done away with entirely.

Thus, the convertible equity instrument was born, with the Simple Agreement for Future Equity (SAFE) and its variations being far and away the most popular of this type of instrument. The SAFE offers no interest rate and has no maturity date. It is a somewhat nebulous instrument until the qualified financing occurs, at which point it converts just like a convertible note, often with a discount rate and/or a valuation cap. Like a convertible note, a SAFE can convert into either common stock or preferred stock. Since the debt portion of a convertible note is often where the bulk of the legal work and the negotiations between the company and the investor will occur, SAFEs are designed to be quicker to finalize and execute (hence the "simple" in SAFE). Typically, only the discount rate and the valuation cap have to be negotiated, and the instrument may not have either.

Many SAFEs used in crowdfunding do not provide voting rights after the instrument converts unless the investor reaches a "major investor" investment threshold. This is particularly the case for SAFEs used in Regulation Crowdfunding offerings, since the company is trying to reduce the administrative burden of the crowdfunding offering as much as possible, and there is a general belief that an investor in a crowdfunding offering—who may be investing as little as $20—is relying on company management to generate a return, and perhaps should not be granted a say in the direction of the company. Since a SAFE is not designed to have a maturity date, there is the possibility that the instrument may never convert, even if the company's business model results in the company earning large profits from customers (perhaps eliminating the need to raise a qualified financing round).

SAFEs are ideal for Rule 506(c) and Regulation Crowdfunding offerings. Investors in Rule 506(c) offerings may have to be talked into investing in a SAFE, but may come around, especially if a healthy discount rate is provided and preferred stock is being offered upon conversion. Investors in Regulation Crowdfunding offerings are typically investing small amounts and will be drawn to the relatively simple five- or six-page SAFE as opposed to a more lengthy convertible note with debt provisions, and likely have no expectation of voting or dividend rights. These investors should be educated as to the risk of total loss if the company is not successful, which is generally what the failure to raise a qualified financing will mean, so a company issuing SAFEs, along with its legal counsel, should carefully review the investor disclosures and education materials presented on the crowdfunding portal's website. Although SAFEs have not seen much use in intrastate crowdfunding offerings, that may change given the recent amendments to Rule 147 and the successful use of SAFEs in Regulation Crowdfunding offerings. Convertible instruments are not ideal for Regulation A+ offerings.

Crowd SAFEs

A Rule 506(c) offering will likely not result in a large number of shareholders, since the company will likely be seeking a substantial investment from each (accredited) investor. However, a successful Regulation Crowdfunding offering is likely to result in a large number of shareholders. Thus, a company could find itself with a Section 12(g) registration requirement problem if it ever exceeds $25 million in total assets.

The Crowd SAFE addresses this problem by eliminating the mandatory conversion of the instrument upon a qualified financing. Instead, the company has the option of whether to convert the instrument, until there is a liquidity event (e.g., acquisition, IPO, dissolution, etc.), at which time the instrument must either convert or otherwise be redeemed. Holders of SAFEs are not shareholders until the SAFE is converted, and since SAFEs are largely illiquid, the argument can be made that an investor does not need to be an actual shareholder until the occurrence of a liquidity event. Until then, the instrument might as well stay unconverted, and thus help the company avoid having to register under the Securities Act. The Crowd SAFE converts at a rate determined at the first qualified financing, even if there are subsequent financings that would also be considered a qualified financing. Crowd SAFEs are otherwise identical to SAFEs, and thus share the potential to never convert, even if the company turns out to be successful. The addition of a maturity date can eliminate this possibility.

The Crowd SAFE was specifically designed for Regulation Crowdfunding. Companies using others means to crowdfund would likely have more success with a SAFE, since a Rule 506(c) or intrastate crowdfunding is unlikely to attract enough shareholders to be in danger of the Section 12(g) registration requirement.

Revenue Share Agreements

There are few limits to the types of securities that can be offered in a crowdfunding offering (other than asset-backed securities may not be used in Regulation A+ offerings). One interesting instrument that has been utilized is a revenue sharing agreement (RSA), in which investors collectively advance a certain sum of money to a company—secured by assets or future revenue—which will then pay back that money by sharing a percentage of its revenue at regular intervals until the loan, plus a return, has been repaid. This type of structure has been most successful for brick-and-mortar businesses such as restaurants that already have a steady income, as opposed to boom-or-bust startups. The downside is that a RSA offers investors no equity interest in the company, which could be worth more in the long run than the return paid by the RSA. RSAs have been successfully used in intrastate crowdfunding offerings, where investors tend to be the company's patrons or clients, or otherwise have some other local connection, and could be appropriate for Rule 506(c) offerings targeted to the same potential investor group. They are not likely to be successfully used in Regulation Crowdfunding or Regulation A+ offerings, given that RSAs have no potential to grant investors equity in a company.

Conclusion

Since crowdfunding is still somewhat nascent, at least at the federal level, many companies will be relying upon counsel for advice as to not only which securities it can legally use (which will likely be several), but which specific security it should use. Counsel will need to consider the stage of the company in its life cycle, the amount the company is looking to raise and the applicable timeline, the type of investors the company is looking to attract, and many other factors.

Related Content

For additional information on Crowdfunding, see the following practice notes:

- Regulation A Plus
- A Summary of Crowdfunding under the JOBS Act
- Crowdfunding Intermediaries under the JOBS Act
- A Comparison of the JOBS Act Crowdfunding Regulations (and When to Use Them)