mcmillan

CONVERTIBLE DEBENTURES AND SAFES: ADVANTAGES AND DISADVANTAGES FOR STARTUP FINANCING

Posted on March 11, 2025

Categories: Insights, Publications

Convertible debentures and simple agreements for future equity ("**SAFEs**") are important financing tools for startups, allowing founders to raise capital without immediately issuing equity and simultaneously deferring valuation discussions to future investment rounds. While these instruments share similarities, each has distinct features that pose advantages and disadvantages to founders.

Convertible Debentures

Convertible debentures are debt instruments issued by a startup that allow investors to convert their debt into equity at a future date. Typically, conversion occurs on the maturity date or on the occurrence of a triggering event, such as a subsequent equity financing. Convertible debentures also contain standard events of default provisions, which, if triggered, would render all obligations, including all principal and interest, immediately due and payable.

Advantages:

- **Familiarity** – As convertible debentures are one of the more common financing instruments used by startups, investors have become familiar with their use and general terms.
- **Attractive to Investors** – As debt instruments, convertible debentures accrue interest and are subject to a maturity date, but they also give investors an opportunity to convert their investment into equity. The combination of interest payments and potential conversion to equity makes convertible debentures attractive to investors.
- **Deferred Dilution** – Convertible debentures do not result in an immediate dilution of the founders' equity in the startup, ensuring that founders maintain control over their business. Investors also benefit as the price of their equity is typically lower than that of future investors.

Disadvantages:

- **Maturity Date** – Founders may be under pressure if the startup fails to reach a triggering event prior to maturity. If a startup decides to seek an extension of the maturity date, investors may have significant

mcmillan

leverage in making certain decisions or taking actions to improve their position.

- **Restructuring Risk** – If the startup fails to raise a triggering event by the maturity date, or the investors refuse to extend the maturity date of their debentures, the investors may compel or force the startup into a formal restructuring arrangement. Investors may seek recourse through such an arrangement to liquidate the assets of the startup to repay all outstanding convertible debentures, including accrued interest.
- **Dilution Uncertainty** – The exact amount by which the founders' equity in the startup will be diluted remains uncertain until the maturity date or the occurrence of a triggering event. As such, it may be challenging for founders to plan for future financing rounds. In addition, as convertible debentures accrue interest, which is then added to the total amount of debt, these instruments may result in a greater degree of dilution of equity than the founders may have anticipated.

Simple Agreements for Future Equity

SAFEs are a non-debt instrument that allow investors to convert their investments into equity upon the occurrence of a triggering event, such as a subsequent equity financing or sale of the company. SAFEs are an effective financial tool for early-stage startups, particularly when the company's value is not yet established.

Advantages:

- **Expedient and Standardized** – SAFEs generally follow the Y-Combinator Canada SAFE template or the National Angel Capital Organization (NACO) Canadian SAFE template, which makes them a time- and cost-effective method of raising capital. Startups and investors rarely have to negotiate the terms of the SAFE, but they are not necessarily precluded from doing so. SAFEs can also be entered into on an individual basis, which reduces the time otherwise needed to coordinate a concurrent closing of a financing involving multiple investors.
- **No Interest, No Maturity, No Pressure** – With no interest and no maturity date, SAFEs allow startups to preserve some capital and avoid taking on a liability. SAFEs also impose less pressure on startups, as there is no deadline for repayment or the accumulation of interest.
- **Deferred Dilution** – Similar to convertible debentures, SAFEs do not result in an immediate dilution of the founders' equity. Until the occurrence of a triggering event, the founders maintain control of the business. From an investor's perspective, this arrangement offers the opportunity to obtain equity at a more favourable price per share compared to future investors in subsequent funding rounds, which can be appealing to investors.

Disadvantages:

- **Less Protection, Less Incentive** – SAFEs do not provide investors the same level of protection as convertible debentures by virtue of the latter being a debt instrument. Unlike debentureholders, SAFE investors do not benefit from interest accruing and maturity dates on their investments, and they must wait for a triggering event before they can convert their investment into equity. In addition to the lack of investor protection, the use of SAFEs remains relatively limited compared to convertible debentures in Canada with more sophisticated investors. Accordingly, startups may encounter challenges in attracting certain categories of investors and raising capital through SAFEs.
- **Lack of Negotiation** – There are typically less negotiated terms in SAFEs compared to a convertible debenture, which may deter sophisticated investors (typically those seeking to invest larger amounts of capital), particularly if those investors want to negotiate bespoke investment characteristics and rights not typically contained in SAFEs.
- **Multi-Faceted Uncertainty** – The exact amount by which the founders' equity in the startup will be diluted remains uncertain until a triggering event occurs. Further, given that SAFEs are neither classified as debt nor equity, startups must exercise particular diligence in documenting their SAFE financing activities on their financial statements and capitalization records.
- **Going Public** – While not an immediate concern for most startups, startups looking to eventually list their securities on a Canadian public stock exchange should be mindful that the exchanges may be less familiar with SAFEs. Accordingly, provided that a triggering event does not occur before the planned filing, startups may have to engage in more extensive pre-filing discussions regarding their capital structure to comply with the regulations and requirements of the exchanges.

Key Takeaways

Convertible debentures and SAFEs are valuable financing tools for startups, allowing startups to raise capital without having to issue equity immediately. Convertible debentures are especially appealing to investors because of their hybrid nature as both debt and equity instruments, but they carry risks for startups due to their debt obligations. SAFEs, by contrast, provide a simpler, non-debt solution to raise capital, making them particularly attractive for startups. However, the lack of investor protection and familiarity may prove challenging in securing investors by way of SAFEs.

While this bulletin has focused on startups, the same considerations apply to early-stage companies evaluating these financing tools. The choice of financing tool depends on the company's specific needs and circumstances. Startups and early-stage companies alike must weigh each tool's advantages and disadvantages in light of their growth strategies and long-term goals. For tailored advice, please contact a member of McMillan's Financial Services or Technology groups.

by Pat Forgione, Robert Piasentin, Isabelle Guevara, and Michael Christ (Articling Student)

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

© McMillan LLP 2025