Legal Issues for Startups: Understanding Convertible Notes

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What is a Convertible Note

- First and foremost, it is debt, so it sits above any equity (stock) in the capital stack.
- However, it also has an equity feature in that it converts upon specified events into stock of the company.
- The most common conversion is upon a “qualified financing” (generally an equity financing of a certain size), but notes can also provide for conversion on other events.
Key Features

- **Conversion rate:**
  - Fixed discount or increasing discount over time
  - Can have caps and collars (maximum and/or minimum conversion price)
  - If using caps, try to set a fixed price based on today’s cap table

- **Automatic conversion on qualified financing**
  - e.g. upon an equity financing of $1m

- **Optional conversion (sometimes included)**
  - By investor to common at cap price or other negotiated price
  - By company to common at floor price or other negotiated price upon maturity

- **Interest**
  - Converts along with principal
  - Interest rate is generally modest (for example, 5%), unless that is being used with a smaller discount
Example

- $100k convertible note, 5% interest, 25% discount upon qualified financing
- Company raises qualifying Series A at $1.00 per share one year after issuing the note
- Note converts into shares of Series A:
  - Principal + interest = $105k
  - Note converts at 25% discount, so at a price of $0.75 per share
  - $105k / $0.75 = 140,000 shares of Series A
Key Features (cont’d)

- Payment on acquisition:
  - Can be based on the discount, can convert at pre-determined price or can be a formula (e.g. 2x return)

- Maturity date
  - Later the better
  - Give yourself enough runway to get to the next milestone and have at least a 6 month cushion beyond that

- Collateral (secured or not)

- Amendment of notes
  - Use a single note purchase agreement that lets a majority of the principal amount of all notes amend the terms
When to use Convertible Notes

- In most cases, will be simpler, faster and cheaper than doing a preferred stock financing, but not always

- Generally speaking
  - $500k or less, use convertible notes
  - $1m or more, use preferred stock (even if “seed preferred”)
  - But there are exceptions to both of these

- Consider your future financing needs:
  - If you may never need to raise more money, do a stock deal or build in an automatic (or optional) conversion of the notes at maturity

- Consider if you are able to value the stock:
  - Often convertible notes are a way to treat friends and family money fairly by deferring a valuation until “sophisticated investors” can negotiate with the company
Company Pros and Cons

- Faster and cheaper to execute
- More control over your company (notes do not vote, and generally you don’t give board seats or significant protective provisions to note holders)
- Delays dilution until you can increase the valuation
- Risk of getting to maturity date without resources to repay or a “plan B”
- Quickly “insolvent” on paper as the money is spent (although this helps with valuation position with respect to employee options and equity)
Investor Pros and Cons

- Faster and cheaper to execute
- Discount can be small compared to the relative risk of the investment (misalignment of interests)
  - Valuation is too high in “homeruns” (can be mitigated by the use of caps)
- Having “debt” in an insolvent entity is not much protection
- Less control over the investment (delaying typical investor protections until conversion, but can negotiate for some, like pre-emptive rights or info rights)
- Will not qualify for special capital gains treatment available to investments made in qualified startups (generally C corps) in 2011 (unless converted in 2011)
Seed Preferred Alternative

- Increasingly, a number of “Series A Lite” or “Seed Preferred” deals are being done as an alternative to convertible notes

- Provides for equity without all of the usual bells and whistles of a full Series A deal

- Usually has at least a liquidation preference and pre-emptive rights, but may not have many more investor protections than that
Other Resources

- www.emergingenterprisecenter.com:
  - Glossary (commonly used terms)
  - Ask the Startup Lawyers (common questions and answers; submit your questions!)
  - Foley Hoag Venture Perspectives (our quarterly publication tracking terms of New England VC deals)

- VentureFizz article:
  - Should I raise my seed round using a convertible note or preferred stock? http://mar.gy/8Rn7
Questions?

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