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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
 - $\$105\text{k} / \$0.75 = 140,000$ 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 preemptive rights, but may not have many more investor protections than that

Other Resources

- www.emergingenterprise.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>



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Questions?

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