

## Convertible Notes: Advantages & Disadvantages

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**Overview:** Convertible notes can be viewed as being either a tremendous or a toxic financing vehicle depending upon their specific terms and conditions, plus whether one is selling, buying, or approving them (as a company Director).

The note's structure often reflects the BOD's consideration of these two factors:

1) Who will be leading the equity round into which the notes convert? Will it be an "inside round" (i.e. comprised of current noteholders and shareholders), or an "outside round" (i.e. must involve a significant number of new investors) in order to fill out the round? Obviously, it is much more likely that the conversion discount will be honored for an inside round.

2) What is the relative likelihood of the venture's possible outcomes? BODs know that experienced angels often employ an "Outcomes Map" when assessing their note purchase opportunities. For instance, young ventures selling convertible notes face these nine possible outcomes:

- Go out of business
- Bootstrap, never raising any more capital prior to the exit
- Sell more debt
- Sell more equity
- Sell both more debt and equity (in which order?)
- Are bought prior to ever raising more capital
- Are eventually bought (or IPO-ed) after raising subsequent rounds of capital
- Require a total capital restructuring which might involve debt forgiveness (or conversion into equity, which can generate taxable income)
- Become a zombie (surviving, but cannot or will not attract an acquirer)

The advantages and disadvantages below are grouped into three vantage points: Those of the entrepreneur, a BOD member, and the angel considering buying the notes. Their sensitivity to the "inside/outside" and "Outcomes Map" issues vary greatly, which affects their assessment of the appropriateness of convertible notes for this venture at this time. (Refer to my glossary regarding the terms used herein.)

### Entrepreneur's Viewpoint:

- *Advantages compared to raising a priced (preferred equity) round:*

1) I can delay placing a valuation on my venture, while I use the note proceeds to hopefully increase it when the next equity round is sold.

2) I can close this round sooner, easier and cheaper

- a) More angels (at least newer angels) are familiar with debt than equity documents
- b) The paperwork is less daunting
- c) Avoiding negotiating valuation speeds the process (unless I am stuck with a valuation cap)
- d) I can avoid the discussion of whether my venture should be an LLC or a C Corporation qualifying for QSBS treatment under the Internal Revenue Code

e) For smaller rounds, I can minimize total transaction costs as a percentage of the capital raised

3) Until the notes convert I am raising non-dilutive financing (unless I must provide warrant coverage)

4) Note buyers do not usually request a seat on my Board of Directors

5) Note buyers do not expect to have much say over how I run my company (i.e. not the usual protective provisions equity buyers expect)

6) I may not have to provide noteholders as much financial reporting or even an annual meeting

7) Just like for accrued stock dividends, if I can accrue the note interest until conversion, I will be conserving my precious cash.

8) If my venture fails, I understand that noteholders will be paid first from any liquidation proceeds. My shareholders (including myself) are less likely to receive anything if we fail once I sell notes. However, the odds of my venture's demise are very low in my opinion. And, I know that in liquidation shareholders rarely get anything anyway. Therefore, I am not really hurting my shareholders by selling notes.

9) If my venture is successfully exited at a profit, selling notes in the early rounds may have diminished my dilution (presuming a nice uptick in share price for the round into which these notes will convert)

10) If I can negotiate a high valuation cap that will signal the next round investors of my company's worth in the minds of my noteholders, and this might set the pricing floor.

11) If I can attract VCs to lead my next equity round they might dishonor the conversion discount, expunge the accrued interest, or require the note holders to convert to common (or all of the above). Each and every one of these "cram downs" will benefit me (as the largest holder of common shares) since the fewer preferred shares outstanding, the better for all common shareholders.

12) If I sell my company before I need to raise the next equity round the noteholders might only get back their principal and interest, thereby boosting shareholders' returns (if I can avoid a minimum return upon sale covenant).

13) If I can bootstrap my company and avoid selling equity in the future, maybe I can negotiate an extended repayment plan with my noteholders, thereby retaining my ownership position.

14) The convertibility of the notes gives me an excuse to refuse even mentioning collateral in these notes. Ideally, I will be able not only to avoid providing a perfected security interest on my assets but also providing a negative or double negative pledge.

15) I can gain approval for a large note round and use a rolling close over many months. This means I might only sell notes as needed, thereby diminishing the amount of accrued interest.

16) My tax advisor might allow me to deduct the accruing interest, thereby increasing my tax loss carryforwards that could have value in the future.

17) My legal counsel may not require me to sign the SEC Form 506 (“Bad Actors” Questionnaire) when I sell notes instead of equity. (NOTE: THIS IS NOT LEGAL ADVICE; CONSULT LEGAL COUNSEL)

- *Disadvantages compared to raising a priced (preferred equity) round:*

- 1) Since at maturity noteholders will be holding an expired note, I must hope that they won’t try to extract onerous terms by threatening bankruptcy. Therefore, I should only sell convertible notes to those I trust, which decreases the pool of potential buyers.
- 2) Each unpaid noteholder can declare an Event of Default at maturity, so I might need to draft an Inter-creditor Agreement, adding substantially to this note round’s legal cost and protracting the negotiations.
- 3) If note buyers require collateral, filing the UCC-1 will notify my customers and suppliers that I had to pledge our assets in order for my venture to borrow money. Granting a lien on my assets exponentially increases my risk of selling a note to a “Loan to Own” buyer.
- 4) Noteholders will probably want veto power over my selling additional debt (even if they are unsecured), and their approval may not be forthcoming (or without a price)
- 5) If the noteholders must approve the sale of equity (hopefully I can avoid this), then they could refuse to approve future rounds, preferring to be paid back over time, thereby precluding my access to growth capital.
- 6) Noteholders must be paid their principal and interest before shareholders receive any proceeds so, in essence, they have the same 1X liquidation preference that preferred equity holders expect.
- 7) Selling convertible notes causes obvious NRI (“Next Round Incongruence”) because the BOD will want to raise the next equity round at the highest possible price for the benefit of all shareholders. However, noteholders would benefit from the lowest possible price (so that they will convert into a larger ownership position). This causes goal incompatibility among those who have funded my venture to date and the new noteholders.
- 8) I think I would benefit from having a Board of Directors that includes noteholders, but they may decline to join my BOD due to the obvious NRI mentioned above.
- 9) If selling notes causes my delaying forming a BOD then I am forestalling learning how to manage a BOD.
- 10) If the notes allow holders to sell them without the BOD’s approval then I could end up with creditors I do not know (or worse, are predatory “Loan to Own” sharks).
- 11) If some note buyers naively think that they can be paid back at maturity if no equity round has occurred, this could cause much strife since we will probably be able to retire the notes at maturity with cash on hand. Furthermore, it would be highly unlikely to be able to arrange a loan from new creditors to pay off these noteholders.
- 12) If the notes contain any financial covenants I might have to renegotiate them from a position of weakness (by being out of compliance) plus incur extra legal fees for amendments and waivers.

- 13) Noteholders might want an enhanced return if I am able to sell my company before I need to raise the next equity round. They might require an exit preference that is greater than the usual 1X liquidation preference preferred buyers expect (i.e. perhaps 1.5 – 2X).
- 14) The conversion of the interest on the notes (often 6 - 10% per annum) into preferred equity further dilutes my ownership, stacking more preferred shares on top of my common shares.
- 15) When I raise the next equity round and the notes convert per their terms, then my post-money valuation will be bloated by the sum of their principal + accrued interest + conversion discount (and I have already spent the principal). This puts added pressure on me to grow my company into this higher valuation or face a down round if I have to sell more equity prior to the exit.
- 16) If the lead investor of the next round requires changes to the conversion terms of the notes then this might be tough for me to negotiate with the noteholders, causing delay plus discord between them and the new equity providers.
- 17) Any of my directors who are noteholders will have to recuse themselves when voting to approve the next equity round due to their obvious conflict of interest. Will I have enough votes to approve the deal and what will be the optics to other noteholders and shareholders?
- 18) If the investors of the next equity round do not honor the note's discount, there could be hard feelings among my Directors holding notes.
- 19) Even if I have no noteholders on my BOD, if their discount is dishonored they may now be disinclined to provide any future financial support to my company.
- 20) If the note buyers require a cap on the next round's valuation, whatever we agree to might be used by the round's lead investors as the ceiling, and not the floor.

#### **Note Buyers' Viewpoint:**

- *Advantages compared to buying preferred stock:*
  - 1) Due to the speed of closing, I can take a hotly pursued deal off the market before those requiring preference shares can negotiate their term sheet.
  - 2) By avoiding the valuation discussion (if I do not require a cap) I can more swiftly build trust and rapport with the entrepreneur (and friends, family, and prior equity buyers).
  - 3) Notes enable me to delay making the decision of whether converting to a C Corp is wise at this time. This is often a problem with equity buyers who might be divided between preferring the LLC or C Corp legal structure.
  - 4) As a creditor, I get my principal and interest before shareholders receive any distributions yet avoid having to explain to the entrepreneur the usual 1X preference preferred stock buyers expect.
  - 5) If the notes are merely a short-term bridge to the equity round that will be led by the note buyers, then we are not at risk of having our discount disregarded. After all, this is the original purpose for which convertible notes were designed (bridging to an equity round already under discussion).

- 6) Convertible notes work well for sudden, temporary cash flow shortfalls so long as the next round will be an inside round. For instance, they nicely enable covering payroll if the closing of an equity round already in documentation is delayed.
- 7) If a letter of intent arrives and we want to build a war chest to withstand protracted due diligence, convertible notes sold to current investors may avoid having to get shareholders votes at a crucial time.
- 8) If I can negotiate a valuation cap then I have probably set a valuation ceiling for the next round, enabling me to calculate my potential ownership prior to future dilution.
- 9) If the company is underperforming and a priced down round would be appropriate, convertible notes allow me to avoid triggering the complicated anti-dilution mechanism which usually impacts morale in the C Suite and among other employees who are option holders.
- 10) Lower legal fees result in more of my capital being available to grow the company.
- 11) It might be easier for management to fully subscribe a note round than an equity round (presuming more angels prefer notes to equity).
- 12) I can exert 100% control over all future capital raises (or at least debt sales) which means that even if my notes are not currently collateralized, I can preclude others being given any liens.
- 13) If my notes are collateralized, then I may be able to retain my first lien position when additional debt is raised. And, as the company gains more traction, my likelihood of total loss should diminish if any subsequently added assets have fire sale value.
- 14) Unless I am paid at maturity, I might be able to extract onerous terms in exchange for an extension. As a shareholder, I do not have any clout until my vote is needed per my protective provisions.
- 15) If I am concerned about possibly pernicious behavior by other noteholders, I might be able to mitigate this risk via an inter-creditor agreement.
- 16) If I am concerned about whether the leaders of the next equity round will honor my conversion discount I might request warrants instead (even though they will only enable me to buy common stock).
- 17) If I cannot be converted into the next equity round against my wishes, I have a free option to either participate, keep my note, or negotiate other terms (presuming the company cannot return my full principal plus interest without my approval).
- 18) If I can negotiate that I can never be paid back against my wishes I can be a hold-out, perhaps extracting some benefit at the exit or in future rounds.
- 19) If I can negotiate some financial performance covenants, every violation provides me with an opportunity for improving my terms and perhaps collateral position.

- *Disadvantages compared to buying preferred stock:*

- 1) If the next equity round will be led by a new investor not already on the cap table (i.e. an “outside round”) then I am taking the significant risk that investors I have yet to meet will treat me kindly by

- honoring the terms of these notes. Why should they do so? This is especially true if they are VCs whose primary fiduciary responsibility is to their LPs (not angels who have financed the venture to date).
- 2) The long-term capital gains clock only starts ticking when the notes convert into equity. When I buy equity I will get long-term capital gains treatment if the company is suddenly sold after 366 days.
  - 3) If the company is suddenly sold prior to the next round, even if I have a 1.5 – 2X liquidation fee, this is a capped return. Had I bought equity my upside would be uncapped.
  - 4) If the venture is a C Corp qualifying for QSBS treatment under the Internal Revenue Code, then starting the clock is even more important in order to qualify for the special tax treatment via IRC 1202. This section can shield me from all federal income taxes on gains from the sale of such stock if held for at least five years (capped at \$10 million of gains or 10 times your investment). Again, buying notes does not enable this treatment, and the time limit clock only starts ticking upon conversion to equity. (THIS IS NOT TAX ADVICE. Consult your professional tax advisors regarding IRC Sections 1202, 1045, and 1244 that apply to stock purchased from QSBS issuers.)
  - 5) Note sellers do not routinely offer noteholders a BOD or Observer seat, robust information rights, or protective provisions.
  - 6) Convertible notes often lack pro rata rights enabling me to increase my holdings in the future. To think that the company has used my capital to grow to the point of warranting a higher valuation, and then not allowing me to invest further (which preferred buyers are routinely granted) is off-putting.
  - 7) If multiple creditors are involved then my rights and remedies as a lender may be neutered substantially by an inter-creditor agreement.
  - 8) I may hold a hammer at maturity, but I will feel intense pressure from fellow noteholders to go along with any restructuring, so holding an expired note will not be that powerful.
  - 9) If the note is uncapped I take the risk that those pricing the next equity round will do so wisely. Otherwise, my discount (if honored) will provide me little protection.
  - 10) If the note is capped then I take the risk that those pricing the next equity round will view it as the highest possible evaluation they need to offer. If I am also a shareholder, this might lower my returns (due to more dilution that might occur than if the notes had been uncapped).
  - 11) After the first equity round has been sold (past the Friends & Family round), Capital Access Plans rarely include plans for a convertible note round prior to exit. Therefore, selling them is an admission that the company is off track. Buying them represents a large “dope slap” risk if the venture subsequently fails since the company was clearly underperforming at the time of purchase.
  - 12) Even if conversion discount is honored, several studies suggest that it provides an inadequate return for the risk I am taking at this juncture in the venture’s life cycle.
  - 13) In essence, by lending the venture my cash via a convertible note I am helping it attain a higher valuation in the next round. But if they are successful in negotiating a much higher valuation, this diminishes my ownership position post-conversion, thereby lowering my potential returns. Said differently, without a cap the company is using my money to get a valuation that will be higher than I could probably negotiate now.

14) There are many tax nuances of notes that I will need to discuss with my tax professionals. One is whether the accruing interest is taxable income to me prior to conversion. If so, I will be paying tax on “phantom income” which I always try to avoid. If I lose all my principal and accrued interest I will need tax advice regarding IRC 165 and IRC 166. (THIS IS NOT TAX ADVICE. CONSULT YOUR TAX PROFESSIONAL REGARDING HOW TO RECORD A LOSS OF PRINCIPAL AND INTEREST.)

### **Directors’ Viewpoint:**

- *Advantages compared to selling a priced (preferred equity) round:*

- 1) Selling notes can be faster, easier, and cheaper thereby enabling management to divert less time and attention to raising capital.
- 2) I am protecting all current shareholders equally if we can avoid a cap on the notes.
- 3) If the company’s results are so woefully behind plan that a down round would be likely, then by selling notes I am avoiding the negative impact on the team’s morale, giving them a chance to improve results and hopefully warrant a price uptick in the next round.
- 4) Likewise, a down round might put all employee options “underwater” further hurting morale and motivation.
- 5) Even if the company fails, shareholders’ returns are not likely to be lessened by the new noteholders’ having the first call on any liquidation proceeds. Therefore, placing debt holders ahead of them is not likely to significantly lessen their liquidation proceeds if we must cease operations.
- 6) If we foresee missing the next payroll or two, a quick inside convertible note round can probably raise cash faster than a priced round.
- 7) Likewise, if we are entering Due Diligence with a strategic or VC investor, building a cash cushion for possibly protracted negotiations can probably be done easier via convertible notes than equity. In fact, the new investors might prohibit our selling more equity during their Due Diligence.
- 8) If a Letter of Intent suddenly arrives, selling notes to insiders to build a war chest might be far preferable to gaining approval of all shareholders for selling more equity.
- 9) Company’s legal counsel may not require me to sign the SEC Form 506 (“Bad Actors” Questionnaire) when I sell notes instead of equity. (NOTE: THIS IS NOT LEGAL ADVICE; CONSULT LEGAL COUNSEL)

- *Disadvantages compared to selling a priced (preferred equity) round*

- 1) If this is the company’s first note round we now have two providers of capital and their rights, remedies, and interests are not aligned. Shareholder behavior can change once they also own notes.
- 2) I must now research and understand the Zone of Insolvency and whether it is applicable (which depends upon our state of incorporation). If it is, then this might be a surprise to shareholders as the BOD’s primary fiduciary duty shifts from them to creditors.

3) The risk of a future down round is increased due to the bloated post-money valuation caused by the note conversions.

4) Because note holders hold a hammer at maturity, the BOD must have a better grasp of the likely behavior of these individuals than with equity holders. One “shark” can ruin a company and the BOD may be criticized for bringing aboard such an investor (i.e. Reputation Risk).

5) As a Director, I am expected to participate in the company’s fundraising rounds. In fact, I may prefer to invest much larger amounts in my portfolio companies on whose BOD I sit. However, if I buy convertible notes my Next Round Incongruence (NRI) is both painful and obvious. I can either decline to buy the notes, stating this inherent conflict, or I can buy them and possibly be accused of not seeking the highest possible valuation in the next equity round (i.e. Reputation Risk).

6) If I am a note holder and the leaders of the next equity round change any of the notes’ terms and conditions, my fellow noteholders might complain about my “selling out” the noteholders (i.e. Reputation Risk)

7) My reputation might also suffer if any note buyers did not understand the low likelihood that they will ever receive any principal or interest prior to the company’s exit.

**SUMMARY:** Convertible Notes are neither “good” nor “bad.” Their appropriateness as a financing vehicle is affected by:

- Whether the equity round into which they convert will be an “inside” or “outside” round
- The viewpoint of the individuals involved (whether they are the entrepreneur, BOD member, or potential purchaser)
- A full understanding of the terms and conditions needed to fill out the round, in light of the Outcomes Map analysis.