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For Attorneys Advising a New Tech Startup: Disadvantages of Convertible Notes

By Brenton Twitchell

Over the last few years there has been a lot of back and forth in the startup and VC community about the pros and cons of convertible notes. A simple search on the Internet will reveal a myriad of blogposts and articles arguing for and against convertible notes, proposing novel alternatives to convertible notes, etc. The following are just a couple of the possible disadvantages of using convertible notes as a financing mechanism.

Default Risk

If they don't convert, the notes eventually come due. This can result in the end of the startup if the note holders aren't willing to negotiate, and the startup doesn't have the means to pay off the notes. The possibility of negotiation is why it is prudent to put a provision in the note that allows a majority of note holders, by dollar amount, to amend or alter the terms of the note. You use dollar amount as the measure because you want to minimize the number of note holders you have to convince to work with you. If the majority of the note holders by dollar amount are willing to work with the startup, the maturity date could be extended, the notes could be converted into equity, or some other arrangement could be made to prevent the startup's default. Be aware that this is a major disclosure item.

Dilution in Unexpected Ways

If the convertible note offering has a valuation cap feature, and the startup raises money in a subsequent "qualifying offering" at a valuation that is below the cap value, then the convertible note investor owns even more of the startup than originally anticipated.

EXAMPLE: Assume the facts in the entitled "Conversion Features" in the article entitled "The Basic Terms of a Convertible Note Offering," except the pre-money valuation for the Series A is $2,500,000. The Series A investors are paying $2,500,000/5,000,000 = 0.50/share. Thus, the note investor receives $200,000/$0.50 = 400,000 shares. So, instead of 200,000 shares, the note investor has received 400,000. The dilutive effect of the lower priced equity round is even more extreme if there is a discount feature in the note.

Can Annoy VCs

A typical VC isn't going to love creating a bunch of other equity holders by buying into a startup's Series A. Additionally, a valuation cap can be unattractive to VCs because they mean the more money the VC pays per share, the better the convertible note investors are doing. For this reason, a VC can refuse to invest unless the note holders' conversion features are changed in their disfavor. It's not fun trying to convince note holders to make those sorts of changes to the terms of their investments.

Conclusion

Convertible notes are one financing option, among many, for startups. The advantages of being generally cheaper, faster, not requiring a fixed valuation, and being free of control provisions and board seat requirements have made it one of the more popular forms of financing. That being said, there can be some distinct disadvantages: the looming maturity date,

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dilution surprises and potentially driving off VCs. Understanding your client's business, its capital structure, its capital needs, and its expectations will be key to helping you help your client evaluate whether it wants to raise money by selling convertible notes.

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