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Structuring Convertible Debt: Key Triggers, Valuation Terms

Due Diligence, Determining Priority vs. Other Creditors and Equity Holders

WEDNESDAY, AUGUST 26, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Kristine M. Di Bacco, Partner, **Torys**, Toronto

Josh Teichman, Attorney, **Torys**, Toronto

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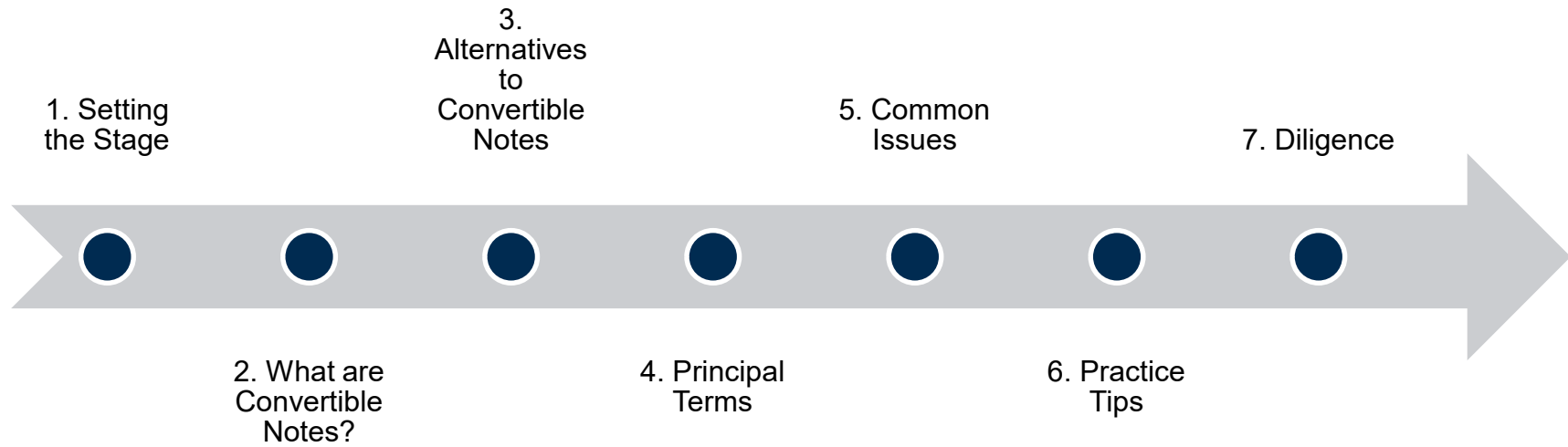
Negotiating and Structuring Convertible Note Financings: Discount Rates, Valuation Caps & Conversion Triggers

Kristine M. Di Bacco and Josh Teichman
August 26, 2020

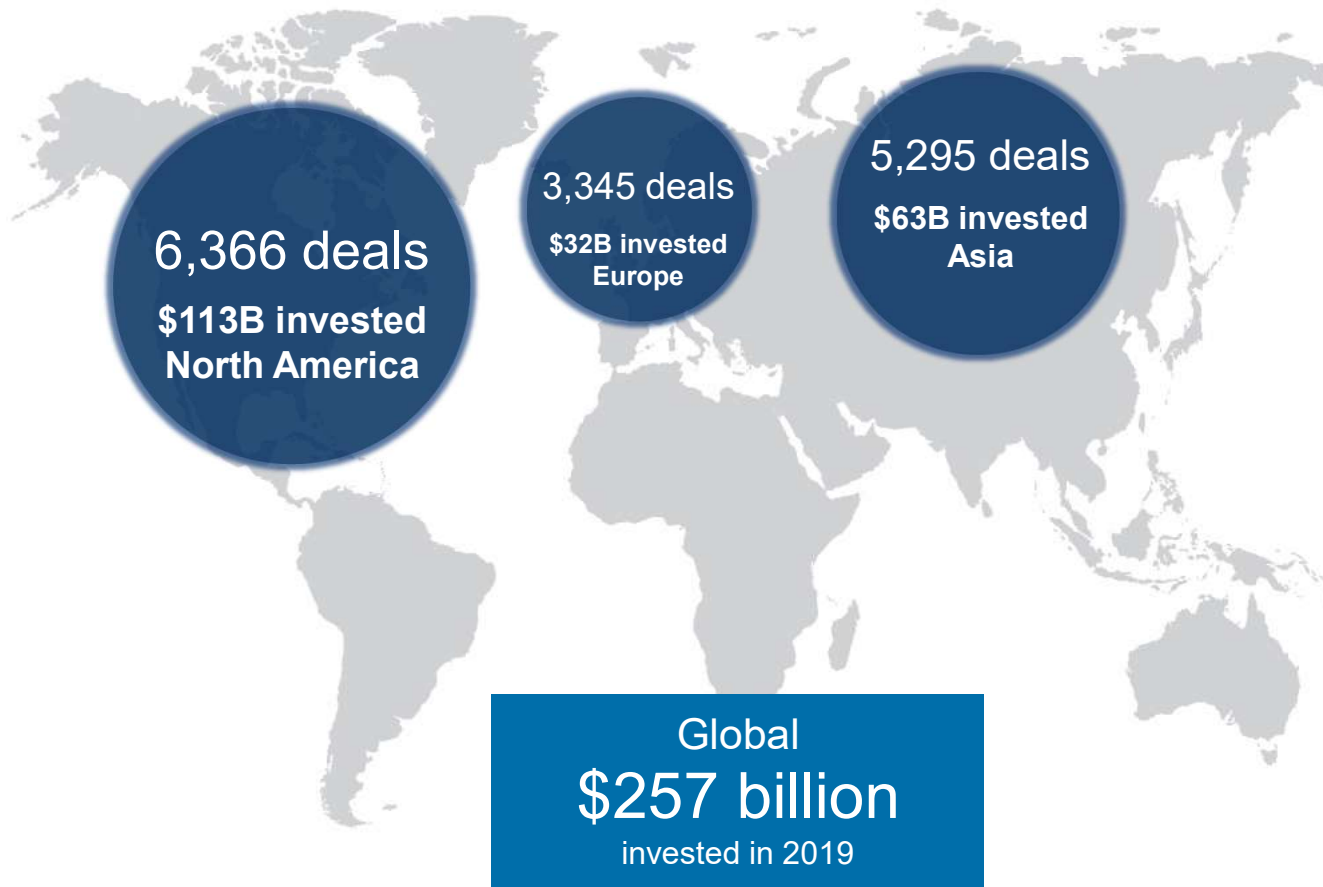
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Agenda

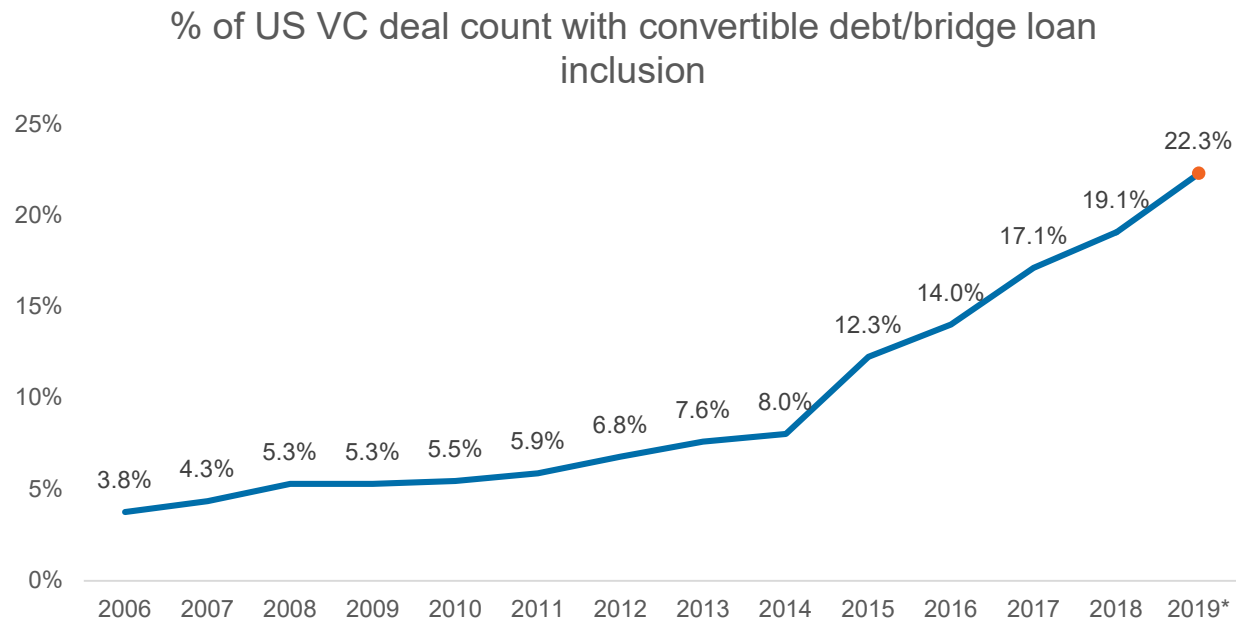
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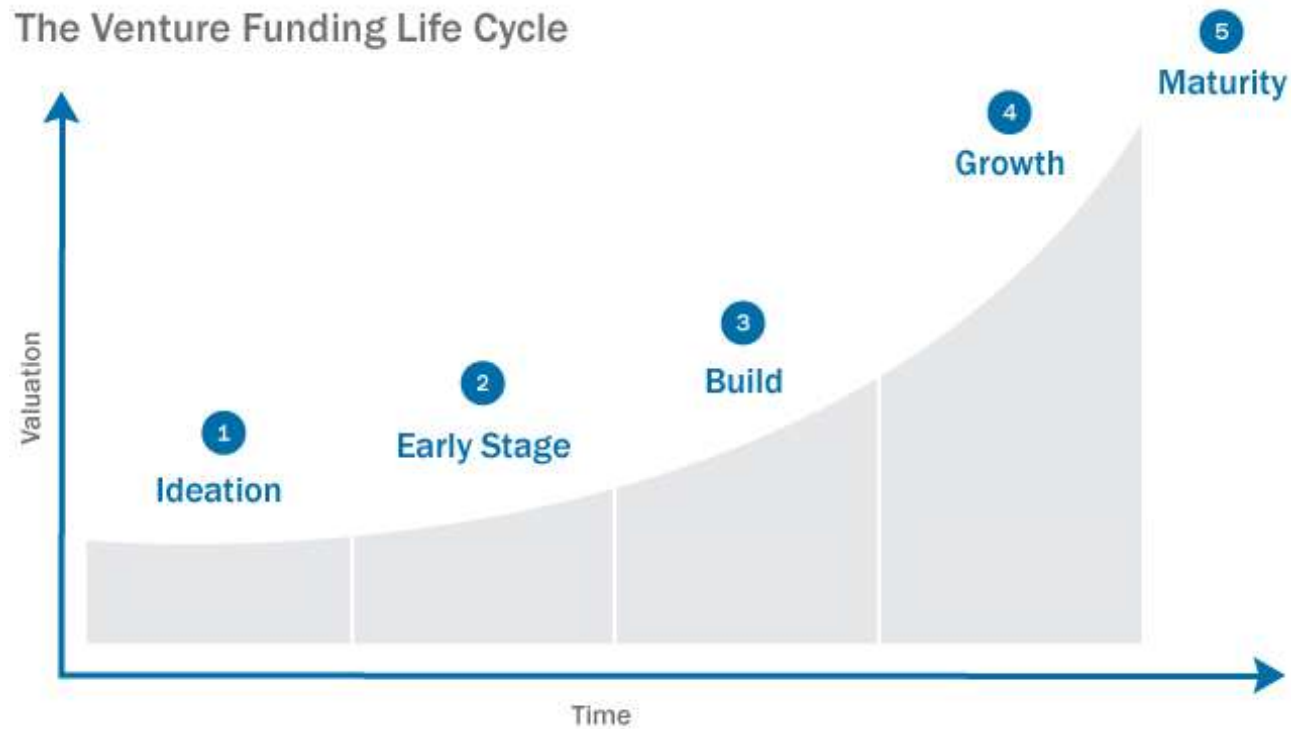
2019 global regional comparison



Increasing Popularity of Convertible Notes



- Prevalence among early stage financings is much higher.



- CN is flexible and can be used at any stage. Early stage or bridge between priced rounds.
- Investor type depends on the stage, but includes friends/family, angels, seed funds and VCs

What is a convertible note?

- Debt instrument
 - Obligates company to pay loan back to lender with interest
- BUT, convertible into equity
- Essentially an IOU, but instead of paying in cash, the Company pays in equity



SAFE

- “Simple Agreement for Future Equity”
- Developed by Y-Combinator

KISS

- “Keep It Simple Security”
- Developed by 500Startups

Equity

- Generally Preferred stock

Forms of Financing Comparison

	SAFE / KISS	Convertible Note	Preferred Stock
Cost	Low	Med	High
Speed	High	Med	Low
Document Complexity	Low	Med	High
Valuation Required?	No	No	Yes
Dilution Certainty	Low	Low	High
Investor Rights	Low	Low	High

Basics

- Principal amount
- Term / maturity date
- Interest Rate

Mechanics

- Conversion
- Change of control
- Events of default
- Amendment

Economics

- Discount
- Valuation Cap
- Type of conversion shares

- **Principal amount**

- The amount of money paid by the investors to the company in exchange for the CN

- **Term / maturity date**

- The length of time the CN remains outstanding before repayment or automatic conversion

- **Interest Rate**

- The percentage interest that accrues on the principal amount for so long as the CN remains outstanding

Principal Terms – Basics



■ Conversion Events

➤ Qualified financing

- ❖ CN automatically converts in the event of a financing of a certain size and type

➤ Non-qualified financing

- ❖ Note converts at option of holder in the event of a financing that is not a qualified financing

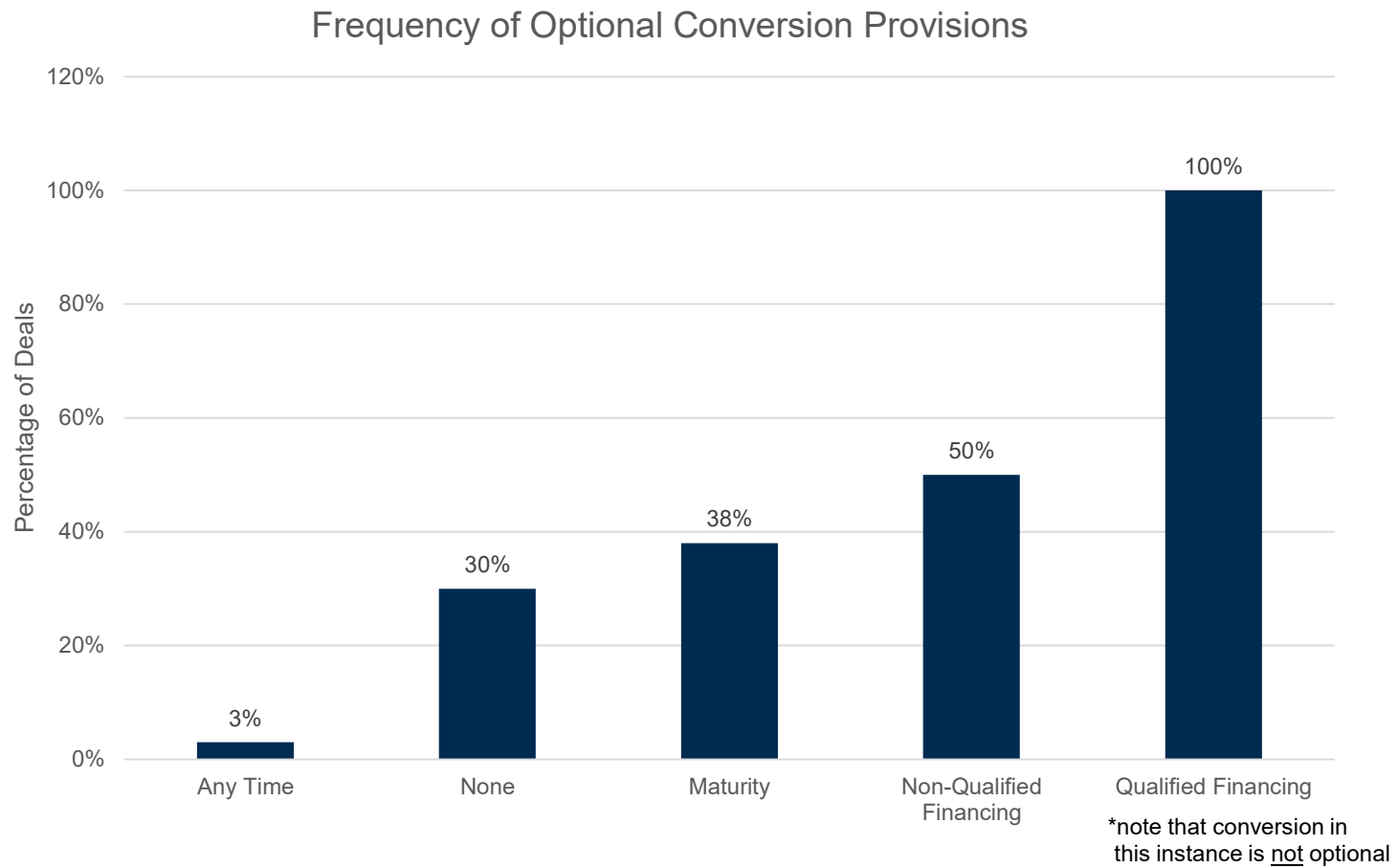
➤ Maturity

- ❖ At maturity, holder can chose to convert at valuation cap or be repaid in cash

➤ Option of the holder

- ❖ Holder may have option to convert at any time at the valuation cap

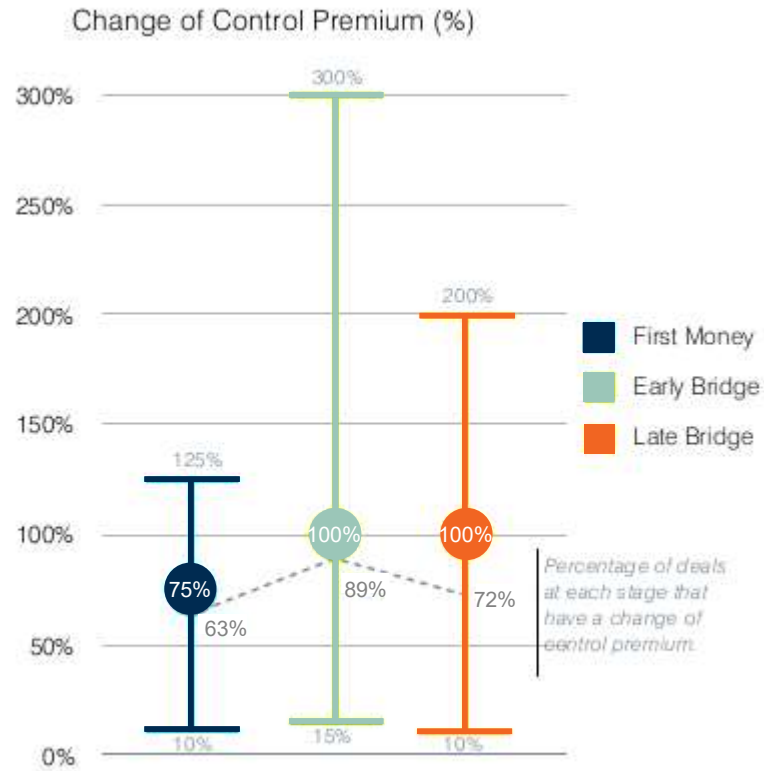
Principal Terms – Mechanics



■ Change of Control

- Upon occurrence of a change of control transaction, investor receives their principal and interest *plus* a premium equal to a certain percentage of the original principal amount
- Investor may also have the right to convert to capital stock at the valuation cap
 - ❖ In a seed financing, the note holder will likely receive common stock, as the company won't yet have preferred stock to issue

Principal Terms – Mechanics



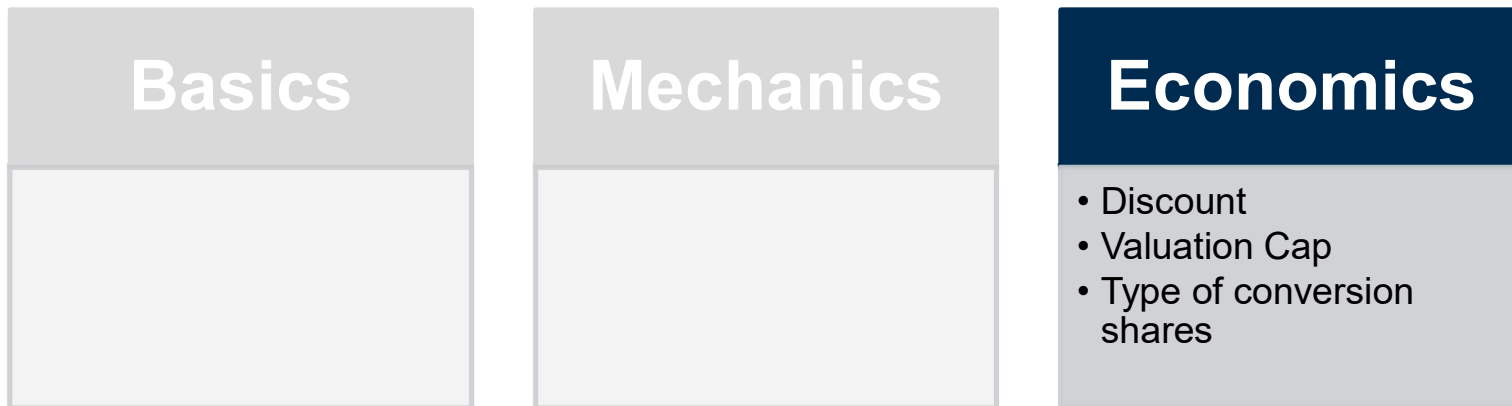
50% of deals provide option to covert to equity upon a change of control

■ Events of Default

- An event of default is deemed to be the maturity date
- Events of default typically include:
 - ❖ Inability of borrower to make payments when due
 - ❖ Bankruptcy
 - ❖ Material breach
 - ❖ Liquidation, dissolution or wind-up of borrower

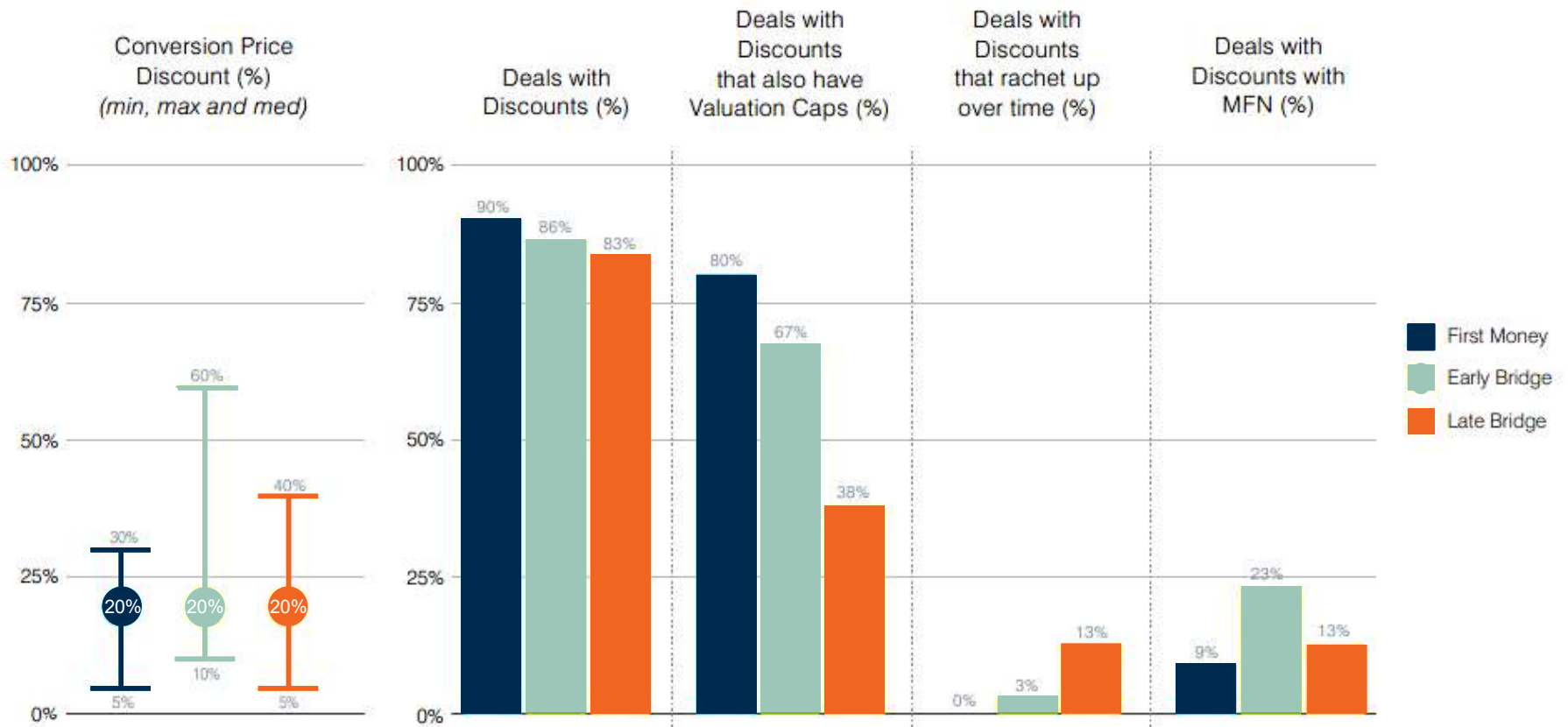
■ Amendment

- Often, CN can be amended with consent of majority of note holders (by \$) in the same round/series
- Provides flexibility to extend maturity date or change conversion terms in advance of a financing

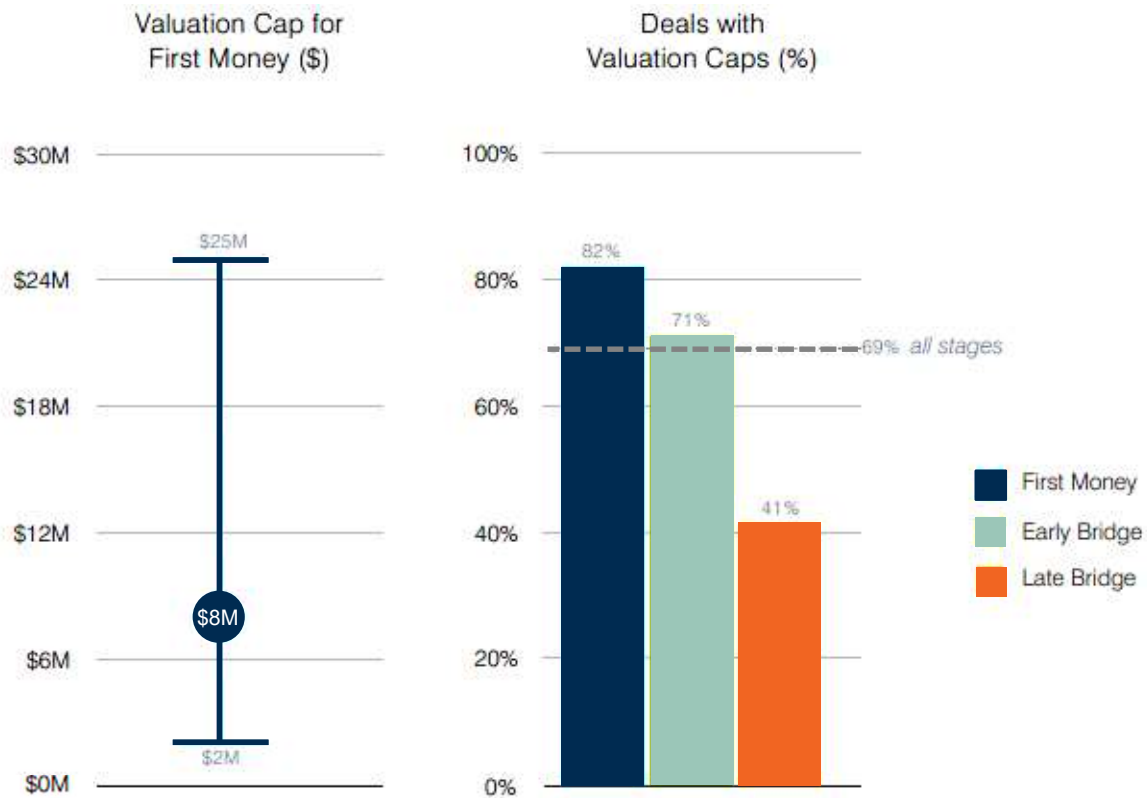


Principal Terms – Economics

- **Discount** – CN converts at a price/share that is discounted relative to price/share paid in qualified financing



- **Valuation Cap** – CN may specify a maximum valuation at which CN will convert, to protect against very dilutive qualified financing (= investor protection)



- **Type of conversion share**

- Problem:

- ❖ CN typically converts into same class of shares issued in qualified financing
 - ❖ These are typically preferred shares with 1X liquidation preference
 - ❖ BUT, CN holders paid less than 1X the per share price, due to their discount and/or cap, resulting in liquidation preferences greater than 1X their original investment

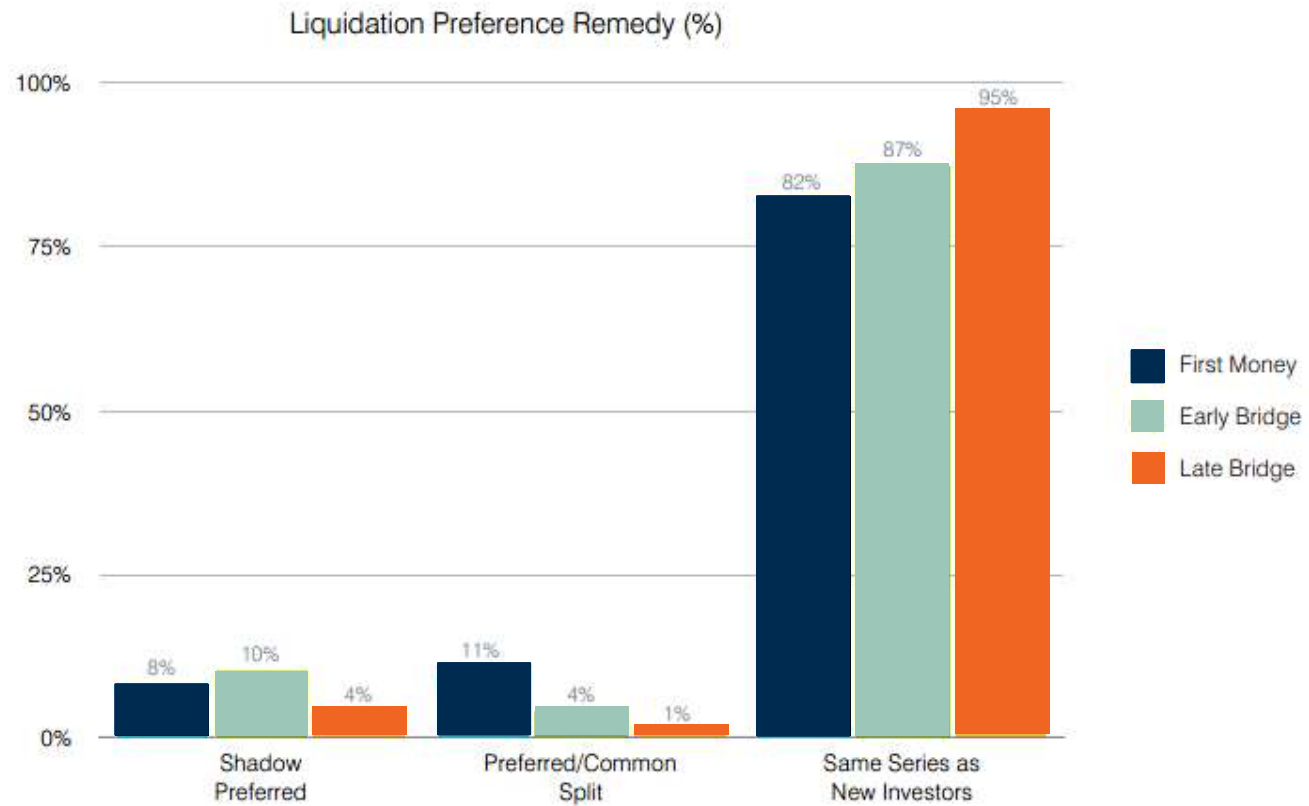
- Example:

- ❖ \$150,000 CN with \$2.5M valuation cap
 - ❖ Series A with \$5M pre-money valuation at \$0.50/share, 1X liquidation preference
 - ❖ CN converts at \$0.25/share (because of \$2.5M valuation cap) into 600,000 shares
 - ❖ CN's liquidation preference is \$300,000 (600,000 shares @ \$0.50/share), but only invested \$150,000 (i.e. a 2X liquidation preference!)

- Solution:

- ❖ CN converts into 'shadow preferred' stock with adjusted liquidation preference (but creates more complex capital structure); or
 - ❖ CN converts into combo of preferred and common, with enough preferred to get 1X liquidation preference and the rest in common.

Principal Terms – Economics



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- When a CN converts at the closing of a Qualified Financing, a number of issues need to be addressed:
 - CN holder needs to sign transaction documents
 - Will the CN holder be considered a ‘Major Investor’?
 - Are CNs included in pre- or post-money?
 - For convenience, CN holder may need to waive some interest so cap table can be settled in advance of closing

- Use of side letters (e.g. pro rata rights, information rights, 'Major Investor' status)
 - Multiple CN holders with different economics can complicate the cap table
 - Founders often don't understand the effect of CNs on dilution, especially with a series of CNs
 - Investors usually don't know the exact percentage of the company they will own when notes convert
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- Make sure correct legal structure is in place
 - Delaware C corporation is almost always the best entity choice for a high-growth technology company (most institutional investors require this structure)

 - Make sure company (not founders, employees, prior employer, etc.) owns all intellectual property (IP) that's been developed
 - Includes pre-incorporation IP
 - Make sure anyone who works for company assigns all IP to company
 - Consider issues with past employment (especially if founders or employees worked at a similar business before starting or joining new company)

- Make sure all company IP is protected

- Trademark – protects the symbolic value of a word, name, symbol or device that company uses to identify or distinguish its goods or services; especially important for consumer-facing companies

*Note: getting a corporate name by incorporating doesn't necessarily mean you can use this from a trademark/branding perspective

- Patent – gives company the right to prevent others from making, using or selling the patented subject matter; best protection for a new product
- Copyright – covers original works of authorship, like art, advertising copy, books, articles, music, software
- Trade secret – no filings necessary, but need to keep things secret (e.g. formula for Coca-Cola)

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- All equity should be issued and properly documented
 - Founders should have clear documentation showing issuance of founder stock (i.e. stock purchase agreement, payment for shares, board consent)
 - All “promised” equity should be cleaned up and documented through stock purchase agreements (i.e. investors worry about the Fifth Beatle problem)
 - *Make sure appropriate vesting has been put in place*
 - Compliance with employment laws
 - Employee vs. contractor misclassification
 - Compliance with securities laws
 - Every equity issuance in a private company needs a valid securities law exemption (i.e. accredited investors (Reg D offering), 701 compliant equity plan for service providers)
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