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Convertible Debt As A Financing Tool – Friend or Foe?

Advantages & Disadvantages From The Perspective of the Founder Of Using Convertible Debt to Raise Capital

When you start a business and want to attract your first round of financing, Convertible Debt is one product that can be offered to Investors. While some consider Convertible Debt a great alternative to selling equity, others are vocal critics of the product. Scott Legal Services, P.C. regularly represents start-up Founders and many Founders have asked us to explain exactly what the "Convertible" means and whether they should issue Convertible Debt or Preferred Stock to Investors. This article summarizes some of the common questions and answers our clients have asked us related to Convertible debt, including some of the advantages and disadvantages of the product. The advantages and disadvantages that are listed are from the perspective of the Founder and a future article will deal with Investors. You should note that the questions and answers are simple answers to complex questions and should only be used as a basis for a discussion with a qualified start-up business attorney.

1. **What Is Convertible Debt?**

Convertible debt is a financial product that is debt (like a loan) that converts to equity (usually preferred stock) based on some trigger event (usually a Venture Capital or other funding/financing round). The debt usually accrues interest but the interest is not paid until the trigger event occurs. Once the trigger event occurs, the debt holders can convert the money they loaned, and the accrued interest, to preferred stock and they can usually get the same stock that the Venture Capital fund gets. In addition, Convertible Debt holders are usually able to purchase the preferred stock at a discount. There are other provisions covering various what-if scenarios, but those are the basics. Convertible debt is often referred to as a fancy bridge loan since it 'bridges' the company to its next financing.

2. **Is Convertible Debt a "Security" and Do I Have To Follow Securities Exchange Commission (SEC) Regulations If I Use It To Raise Capital?**

Yes & Yes. Unlike a regular loan, Convertible Debt is a security and if you sell it to Investors, you must comply with complex SEC and State regulations. You can find out more about this by clicking **here**.

3. **What are Some Advantages of Convertible Debt Over Equity from The Perspective of the Founder?**

There are three key advantages associated with Convertible Debt. They are as follows:

a. Simpler, Cheaper & Faster

A Convertible Debt term sheet and the associated documentation is often much shorter and easier to compile than preferred stock documentation. In addition, there often are not many terms to negotiate and this can cut down on back and forth time between founders and Investors. As the documentation is easier, the legal fees associated with them are cheaper. How much cheaper is debatable but a "light" preferred share offering would often cost twice as much as a comparable Convertible Debt offering.

Given the relative complexity, Convertible Debt is also faster. Once your investors are ready to talk terms, you can negotiate a term sheet in one week and close the deal one week after that as the documents are short and simple and as such there isn't much to discuss. This is compared to an equity financing which can take two weeks to negotiate and 4-6 weeks to close.

b. You Can Push Off Valuation of the New Company Until Later

Convertible debt allows a new business to get necessary investment funds without setting a valuation on the company before institutional investors enter the picture. If preferred shares are issued to Investors, the founders and Investors musts agree on a valuation of the company so that a price can be set for the shares. Another potential problem is that business owners can overvalue how much the business is worth and convertible debt can eliminate the risk of a the situation where a Venture Capital fund later buys shares at a share price that is lower than what is expected or paid by the original investors. Moreover, at the early stages of a company, most company's technology, business models & cash flows are largely untested and unproven (in some cases they do not exist) making any valuation difficult to do.

c. Ability for Founder to Maintain Control

If Convertible Debt is issued to Investors, Founders usually continue to control a company after the Debt has been issued. This can be the case with Preferred Shares also but only if the Preferred Shares do not have any voting rights. It is important for a Founder to maintain control so that he/she can promptly act if a Venture Capital Fund or other significant investor decides to invest, and Investors often dictate that the Preferred Shares that they buy have beneficial provisions (eg. voting and board election) which could force the Founder to give up some control.

4. What Are Some Disadvantages of Convertible Debt?

Here are three key disadvantages of convertible debt.

a. Investor May Not Understand The Product So You May Have Trouble Selling It

While the product is not that complex and people know what debt is, some unsophisticated Investors may not fully understand the conversion feature of the product. In contrast, everyone knows what a stock is and this may be an easier sell to Investors (in particular friends and family).

b. Interest Payments Have to Be Made & You Have Debt Outstanding

Convertible notes accrue interest from the date they are issued and even though the amount is not paid until a trigger event occurs, this costs the company money. Moreover, make no mistake that until converted this product is debt and if a financing event does not occur the amount (plus interest) has to be paid back. Depending on the wording of the contract, a delay in Venture Capital or other financing could allow the debt holders to force bankruptcy.

c. Investor Does Not Get Any Control So May Not Find the Product Attractive

While several pro-Investor features can be added to Preferred Stock, convertible debt is debt until a trigger event occurs. As such, an Investor cannot elect board members or have any say in the direction of the company. This may not be that attractive for some Investors who may look somewhere else to invest their money.

5. What Are Some Other Financial Products That Can Be Issued to Investors?

When a founder wants to raise capital for his/her company, there are a number of financial products that can be offered other than Convertible Debt. First, the company can get a simple loan. This is often impractical as most lenders (usually a bank) will not extend funds to new companies and new companies often cannot afford to pay the money back. Second, Preferred Stock can be issued. Preferred Stocks are usually non-voting shares where a dividend is paid and Investors receive preferential treatment if the company is liquidated. In addition, Preferred Stock can be tailored so that they have any feature associated with them that the founder would like. (eg. voting, right to appoint board members, etc.). Another product is Convertible Preferred Shares. This product is similar to convertible debt except the loan features (eg. interest) are stripped away.

6. Should A Founder Issue Convertible Debt or Equity?

It depends. It is not possible to give an answer of which instrument (preferred stock v. convertible debt) is "best" and you should sit down with your lawyer to fully understand the different options to assess which one works best for you given your goals. In fact, many in industry have very different view on which product is the best product for start-up companies. Speak to a lawyer at Scott Legal Services, P.C. so that your options can be explained to you.

If you are considering issuing securities, contact Scott Legal Services, P.C. for a consultation. You can call us at 212-223-2964 or email us at iscott@legalservicesincorporated.com.