Seed Convertible Note Discounts

Reconciling “Stock” and “Liquidation Preference” Premiums

By:Jonathan D. Gworek
March 19, 2012

Seed Convertible Note Discounts:
Reconciling “Stock” and “Liquidation Preference” Premiums[1]

Background

Convertible notes have become the security of choice for early stage startups looking to raise seed capital. Convertible notes are perceived to be a simpler alternative to preferred stock. The main advantage is that promissory notes allow the issuing company and the investor to proceed with a financing without the requirement that a pre-money valuation be established. This results from the simple fact that no stock is issued until the next round of equity financing. The documentation required also tends to be lighter than for a preferred stock financing. As a result, the use of this security in seed investments has proliferated. This article will focus on one specific aspect of convertible notes—the discount on conversion— drawing a distinction between two types of premiums that can result from such a discount.

Most seed financing convertible notes are fairly straightforward instruments. The company issues promissory notes to the investors in exchange for seed capital. The promissory notes are convertible into preferred stock at the time of the first institutional round of financing. This conversion is typically at some discount to the price paid per share in that institutional round to reflect a risk premium. For example, if an investor invests $100,000 in seed capital in exchange for a promissory note from the issuing company for $100,000 which converts at a 20% discount (a fairly typical range), when the issuing company issues preferred stock in its next round of financing at $1.00, the note will convert at a price of $0.80 per share. As a result, the promissory note will convert into a number of shares equal to $100,000/$0.80, or 125,000 shares of preferred stock.[2] These additional 25,000 shares, referred to as the “stock ownership premium” for purposes of this article, dilutes other stockholders and at exit diverts proceeds away from the other stockholders who would otherwise participate in proceeds payable in respect of this stock premium.

There is a second and lesser appreciated premium associated with convertible notes. When notes convert into the next round of equity at a discount, not only does the noteholder get more equity per dollar invested as described above, but the noteholder also gets the liquidation preference that is associated with 125,000 shares of preferred stock. Liquidation preference is the right to be paid a certain amount per share, typically the purchase price, in certain exit scenarios. In the above example, the preferred stock issued would be entitled to $1.00 of liquidation preference per share for a total of $125,000 of liquidation preference in the aggregate. So not only has the above investor received a greater ownership position for the size of the investment— an extra 25,000 preferred shares—the investor has also received stock with a liquidation preference right equal to $125,000—an extra $25,000 of liquidation preference. This means that under certain exit scenarios, the investor is entitled to receive $125,000 for stock purchased for only $100,000.[3] This $25,000, referred to as the “liquidation preference premium” for purposes of this article, is also diverted from other stockholders who would otherwise participate in those proceeds.

Convertible notes have been around for a long time, and for most of that time investors and issuing companies have, either knowingly or not, accepted the impact of the liquidation preference premium as an acceptable by-product of the convertible note structure. This form of premium, like the stock ownership premium, can be rationalized as just another aspect of the risk premium. It has also generally been regarded as a manageable premium in the context of a successful outcome for stockholders and investors. A convertible note round of $1,000,000, which would be a large round by most standards, when converted at a 20% discount would only result in a $250,000 liquidation preference premium in the aggregate upon exit. For starry eyed founders and investors with hopes for lofty exit values, this is not a large sum.

However, for larger sized convertible note rounds, rounds with larger conversion discounts, or some combination of these two factors, this liquidation preference premium can become significant and can result in what some would consider an unfair windfall to the investors. For example, a $2,000,000 convertible note round with a 50% discount on conversion would result in an aggregate $2,000,000 liquidation preference premium. At this level the liquidation preference premium may start to look too rich.[4] The size of convertible note rounds and the applicable discount do in fact range over a broad spectrum. Often times the discount is determined by reference to a capped price that the convertible notes will convert at if such price is lower than the price determined based on the agreed upon discount percentage. This "ceiling" conversion price is a negotiated feature that is intended to ensure that if the issuing company leverages the convertible note seed capital into an out-sized pre-money valuation for its next round, the convertible noteholders are converted at a price more reflective of the value at the time their money came in. For example, if the $2,000,000 convertible note above had an agreed upon ceiling conversion price based on a $5,000,000 valuation, and the issuing company spent that $2,000,000 wisely enabling it to leverage into a preferred stock round at a $15,000,000 pre-money valuation, that $2,000,000 would convert in at one-third the price paid by investors who led that round.[5] This would result in a liquidation preference premium of $4,000,000!

Approaches to Eliminating the Liquidation Preference Premium

In response to this issue, several approaches have evolved in an attempt to allow the stock ownership premium to apply while eliminating the liquidation preference premium, essentially decoupling the two at the time of conversion. There are three different approaches that the author has seen applied to accomplish this objective while staying within the framework and simplicity of a convertible note structure.

One approach is to convert the promissory notes into a separate class of preferred stock from that issued to the new investors, which stock is issued at the agreed upon discounted price per share, but that has a lower liquidation preference that matches the actual price per share paid for the preferred stock. For example, if Series A Preferred Stock is issued to investors leading the next equity round at a $1.00 price per share, a $100,000 convertible note with a 20% discount feature would convert into 125,000 shares of a shadow Series A-1 Preferred Stock at $0.80 per share. This shadow Series A-1 stock would also have an $0.80 liquidation preference per share rather than the $1.00 liquidation preference per share that would be associated with the Series A Preferred Stock. As a result, the stock ownership premium is preserved, but there would be no liquidation preference premium. This approach works when all the notes are converting at the same discount per share. It does not work when, as is sometimes the case, the convertible notes convert in at different discounts per share. The main drawback to issuing a second class of preferred stock is that this class may have certain statutory blocking rights depending on the applicable corporate law.[6]

A second approach is to convert the promissory notes into the same class of preferred stock as that issued to the investors leading the next equity round, but establishing the liquidation preference rights per share by reference to documents external to the charter. The liquidation preference per share would be determined by reference to the convertible notes themselves, or some document summarizing the convertible notes.[7] This would allow different stockholders within the same Series A Preferred Stock class to have different liquidation preference rights per share, again preserving the stock ownership premium but eliminating the liquidation preference premium.[8] This approach may create, *de facto*, different classes of stock within the Series A Preferred Stock series where the differentiator for each class is the liquidation preference per share. If this were the case, the statutory blocking rights described above would apply. Unlike the previous approach, this approach can neatly accommodate situations in which the convertible notes are converting in at different discounts.

A third approach is to convert the promissory notes into the same class of preferred stock as that issued to the investors leading the next equity round, and at the same price per share as the investors, but dealing with the stock ownership premium by issuing in lieu of additional preferred stock an equal number of shares of common stock. For example, if Series A Preferred Stock is issued to investors leading the next equity round at a $1.00 price per share, a $100,000 convertible note with a 20% discount feature would convert into (i) 100,000 shares of Preferred Stock at $1.00 per share, plus (ii) 25,000 shares of common stock. This approach preserves the stock ownership premium in the form of common stock, and eliminates the liquidation preference premium. One concern with this approach is that the issuance of common stock for what amounts to a $25,000 conversion premium could have implications for the pricing of the common stock for stock option pricing and related IRC 409A purposes.

A fourth possibility, which is suggested by the third approach, is to eliminate the discount concept entirely in the context of convertible note financings and instead have the risk premium be in the form of warrant coverage. For example, and extending the illustration in the third approach, instead of issuing a convertible note with a 20% discount where the stock ownership premium is in the form of common stock, the convertible note could be issued along with warrants to purchase an additional 25,000 shares of stock. This "warrant coverage" approach is an established practice that likely pre-dates the practice of convertible note discounts, although it accomplishes the same objective. The issued warrant could be for common stock at a nominal exercise price, or for preferred stock at an exercise price per share equal to the price paid per share by new investors in the equity round. Either approach would eliminate the liquidation preference premium while again preserving the stock ownership premium. This warrant coverage approach is not new at all, and would be considered a regression to prior practice and documentation. This approach would also call for a warrant to be negotiated as part of the transaction thereby undermining to some extent the simplicity that the discount feature was intended to accomplish in the first instance.

Conclusion

In structuring and negotiating convertible note rounds with a discount feature, it is important to understand the distinct concepts of stock ownership premium and liquidation preference premium because unless they are understood their impact can't be fully appreciated and they can't be separated. The investors and the issuing company may well agree that the liquidation preference premium is acceptable in certain circumstances. When on the other hand the business deal calls for eliminating the liquidation preference premium, the approaches described above offer a range of alternatives, one of which will hopefully fit the circumstances and allow the parties to achieve the desired outcome.

For more information, please contact **Jonathan D. Gworek**.

Footnotes.

1. I would like to thank Roy Rodenstein, serial entrepreneur, early stage investor and passionate member of the Boston startup community, for the intellectual exchange that formed the basis for some of the ideas in this article.

2. For purposes of this article the accrued interest on the convertible note, and stock issued in connection with such interest, is disregarded.

3. This is true in only “certain exit scenarios” because the liquidation preference rights and their application for purposes of the distribution of proceeds depends on a number of factors, including whether the preferred stock is participating or not, and the magnitude of the exit itself in the event it is not participating. The liquidation preference premium will always be relevant when the issued stock is participating preferred. For non-participating preferred stock, at a certain exit value the stock received is treated like common stock and the liquidation preference is not applicable.

4. While beyond the scope of this article, the liquidation preference premium might look especially rich when the convertible note is converting into participating preferred stock as the investor would be getting the benefit of not just the liquidation preference premium, but also a percentage of the proceeds after the liquidation preference is paid out that reflects a 100% stock ownership premium.

5. Morse, Barnes-Brown & Pendleton, P.C. tracks first institutional rounds in New England, New York and New Jersey, and data for 2011 shows a sharp increase in pre-money valuations. In speaking with venture capitalists and others involved in the emerging company field, easier access to seed round capital and the ability of resourceful entrepreneurs to leverage that capital efficiently is one of the explanations for this trend.

6. This would be true under Section 242 of the Delaware General Corporation Laws.

7. The Delaware General Corporation Laws permit this external reference under Section 102(d).

8. This is a common practice in recapitalization venture capital financings when there are multiple series of preferred stock pre-existing, and a new lead investor requires that the stock be converted into a single series as a condition to funding.