Using Convertible Notes or Safes? Beware of The Liquidation Overhang!

Description

The Problem: The Dreaded Liquidation Overhang

Convertible promissory notes and SAFEs (Simple Agreement for Equity) (let's call both of these "convertible instruments") are used regularly to raise capital in the early stage company space. It's not uncommon for convertible instruments to have what's called a "valuation cap." Valuation caps set the maximum valuation at which the convertible instrument would convert in a subsequent financing, regardless of the valuation set in such subsequent financing, and are designed to reward the convertible instrument investors by allowing them to convert their convertible instrument into equity at a lower price than the "new money" investors.

Low valuation caps sometimes create an unforeseen result when a new round of financing occurs at a valuation that exceeds the valuation cap – the early investors holding these convertible instruments could get a liquidation preference that is much higher than intended (i.e., more money will go to investors, and less to the founders!). Companies that have a hard time raising money, and consequently have little leverage to negotiate deal terms, are often forced to agree to a lower valuation cap to get a deal done. This "problem" has become further exacerbated as the function of convertible instruments has evolved from short term "bridge loans," with terms of just a few months, to longer term loans that may remain outstanding for several years. The practical impact of a longer term is that the valuation can change more dramatically over a few years as compared to a few months.

As an illustration, let's assume the following:

- 500,000 shares of Common Stock outstanding on a fully-diluted basis
- $200,000 convertible note seed round with a $1,000,000 valuation cap
- The $1,000,000 valuation cap means the notes convert at $2.00 ($1,000,000 / 500,000 shares)
- $5,000,000 pre-money Series A round valuation, resulting in a per share price for new investors of $10.00
- The Series A Preferred Stock has a 1x participating liquidation preference (so, each share of Series A Preferred Stock will have a liquidation preference of $10.00)

So, the $200,000 in convertible notes will convert (ignoring interest for simplicity), into 100,000 shares ($200,000 / $2.00 per share).

Assuming the convertible notes convert into the same Series A Preferred Stock as the new money Series A investors, the convertible note holders would have a total liquidation preference of $1,000,000 (100,000 shares x $10.00 per share). If you crunch the numbers, it is not difficult to see that the $200,000 has earned them a $1,000,000 liquidation preference, which is equal to a 5x liquidation preference rather than the 1x liquidation preference the new investors will receive (economically, this is equal to an extra $800,000!). This liquidation overhang will reduce the amount paid to the founders in liquidation and should be top of mind if you are issuing convertible instruments with potentially "low" valuation caps and longer terms.

A Solution: Shadow Preferred

A common and effective solution to the liquidation overhang issue described above is to create a sub-series of the Preferred Stock being offered in the new financing round, sometimes called "shadow preferred." Oftentimes, you will see the primary class of Series A Preferred Stock called "A-1" and the shadow class called

“A-2.” The Series A-2 would have identical rights, privileges, preferences and restrictions as the shares of Series A-1, except with respect to: (i) the per share liquidation preference and the conversion price for purposes of price-based anti-dilution protection, which will equal the price they actually paid (i.e., the $2.00 per share in the example above); and (ii) the basis for any dividend rights, which will be based on the price they actually paid (i.e., the $2.00 per share in the example above). This ensures that the convertible instrument holder will have the same liquidation preference, conversion, and dividend rights, while still giving them the benefit of purchasing the Preferred Stock at a much lower price.

While having to create an additional “class” of Preferred Stock involves a little extra work in the deal documents, and likely costs a few extra thousand dollars in additional legal fees to address this issue at the onset, the savings down the road could quickly grow to hundreds of times that amount!

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