This information should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your own lawyer concerning your own situation and any specific legal questions you may have.
## Corporate Structures

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<td>Yes – especially if cash generating</td>
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<td>Cost</td>
<td>Cheap</td>
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Debt vs. Equity in a Seed Round

• Convertible notes have been increasingly used as a seed round financing instrument

Charles River Ventures has used this instrument for its QuickStart seed funding program to fund numerous early stage startups quickly

• The advantages of convertible notes are particularly leveraged in a seed round:
  – Valuation is difficult, esp. if the startup is pre-revenue and still in the concept phase. A loan may carry the company to a higher priced first equity round if it has more traction
  – The company founder(s)’ equity is diluted less
  – Simplicity – term sheets and transaction documents are simpler, and the deal closes much faster than an equity round
Debt vs. Equity in a Seed Round

• Others have noticed that convertible notes may not have such a distinct advantage versus a Series A round:
  – Form documents (e.g., www.seriesseed.com) are bridging the gap in transaction costs
  – convertible notes with a capped conversion price are *de facto* valuations (even if not rigorously negotiated)
  – equity round better aligns interests of the company and investor (because the debt converts to equity at a fixed discount).
    • Especially important where the seed investor is providing non-monetary support to the company (contacts, coaching, etc.)
  – each situation requires consideration of both options
Why Use Bridge Loans

• Bridge loans are usually used in 3 contexts, or roughly stages of venture-backed companies’ life cycles:
  – In the seed round, as an alternative to a Series A equity financing (more on this below)
  – In between equity rounds, to carry the company to the next equity financing or to a milestone
  – To carry a company to exit without the expense and dilution of another equity round
Avoiding the “Bridge to Nowhere”

- Debt can be a red flag to prospective investors
- The company should be able to explain a clear goal (or milestone) for the loan and raise only the amount of debt needed to reach it
Common Convertible Note Terms

• **Unsecured** subordinated debt (typically)

• **Convertible** (with interest) into the class of company shares issued in the next investment round (at a discount)

• **Repayable** if the company fails to secure a next round of financing (downside protection)

• **“Equity Kicker”** (upside compensation)
  – compensates the investor for risk, usually through warrants or options over a percentage of the company’s equity

• **Tranched Payouts** which can be tied to milestones, especially common in investments into Life Sciences companies
A Risky Proposition for Lenders

- Bridge Loans are commonly made by existing investors who commonly have an equity stake in the company and have an incentive to see it succeed.

For new investors, venture-backed companies may not have any major assets to secure, revenue or track record of performance. Investors will typically expect alternative forms of consideration for such risks.

- Convertible notes typically contain the standard terms of a debt security plus equity “sweeteners” or “kickers” to compensate the lender for this additional risk.
Compensating the Lender for Risk

Investor

• Higher Conversion Discounts in the Company’s Next Equity Financing
  • Warrant Coverage in the Company’s Next Equity Financing
  • Price Protection Provisions (Price Caps)
• Security Interests in Assets (rare)

Entrepreneur

$$$$$
Splitting the Risk: Sliding Conversion Discounts

• Generally, the longer a debt is outstanding, the higher the risk of default for the lender

• Parties can “calibrate” the varying risk by increasing the conversion discount over time:
  – i.e., the longer the loan is outstanding, the higher the conversion discount in the next equity round
    • 15% discount in year 1
    • 20% discount in year 2
  – compensates the investor for any valuation increase while the loan is outstanding
Splitting the Risk: Milestone Drawdowns

• In a tranched loan, the company takes principal in installments when certain milestones are met

• Familiar mechanism in the Life Sciences industry:
  – Achievement of technical milestone (e.g., humanization of antibody)
  – filing of IND or application with FDA or regulatory agency
  – IRB approval or enrollment of first patient
Price Protection Provisions

- Provides lender/investors with protection if the value of the next equity financing is large
  - larger valuation means fewer shares per dollar of principal (plus interest) that is converted

- Example: Note converts in the next equity round at the lower of: (i) the current discount rate (e.g., 85% of deal value); or (ii) the price per share if the valuation of the company was $[5]M
  - Alternative: Conversion discount (e.g., 15% discount) will hold up to a certain valuation (e.g. $5M), but any higher valuation will trigger a deeper discount
Price Protection Provisions
Bad for Companies?

- Are price caps unfair to founders?
  - subsidizing the investor’s downside risk?

- Conversion discount plus price cap = more liquidation preference than the amount being invested:
  - For example company issues a large bridge loan, e.g. $1M, with a conversion discount of 50%
  - In the Series A round, the company will end up issuing $2M (with interest) of Preferred Stock to investors that paid $1M (the 50% discount)
  - But even at a 1X liquidation preference, another $2M of overhanging liability to pay upon a liquidation event has been created from the discount
Price Protection Provisions

- The use / nonuse of price caps have been an indication of the negotiating leverage between entrepreneurs and investors:
  - “Silicon Valley technology start-ups these days are more frequently being financed by uncapped convertible notes, in a sign of the shifting balance of power between investors and entrepreneurs.” From *Startups Gain Financing Leverage* printed in *The Wall Street Journal*, September 15, 2011
Other Negotiating Points

- Depending on the situation, a bridge loan may provide for:
  - no pre-payment without the consent of the note holders (otherwise they would just get interest)
  - specified payments upon a change of control event (similar to liquidation preference)
  - capping the amount of additional debt the company may take
  - basic protective provisions (prohibiting the company from taking certain actions without the consent of the note holders)
Advantages of Bridge Loans

• **For Both Parties:**
  – Delays valuation.
  – Allows for “arms length” pricing later

• **For the Company:**
  – Less dilution versus an equity round (at a lower valuation)
  – Buys time to reach critical milestones (resulting in higher valuation)
  – Simple transaction
    • Less documentation
    • Lower transaction costs
    • Little or no diligence

• **For Investors:**
  – Priority position over equity in case of bankruptcy AND equity exposure
Disadvantages of Bridge Loans

• **Misaligned Incentives:**
  - Lenders may prefer lower valuations
    • Each dollar of debt will buy more equity
  - Lenders may not subordinate their debt
    • Creates problems for lines of credit, purchase-money financing, etc.
  - If unable to force conversion, the company will have to repay the note at maturity
    • Risk of “giving away” the company for little in proceeds
Disadvantages of Bridge Loans

- **The Stigma of Debt:**
  - Using new money to pay off debt.
    - Investors do not like seeing equity dollars used to pay off earlier investors
  - “The Bridge to Nowhere”
    - The loan may send signals that the company has deeper problems and cannot find equity investors
  - Have a plan
    - Provide investors with reasons / milestones for borrowing, rather than borrowing large amounts to fuel long term growth
Summary

• Bridge loans are a useful mechanism with unique features that make them invaluable in certain situations
  – Seed funding, bridging gaps, and bridging exits

• They should not be used as a default funding mechanism, and both investors and companies should carefully consider their terms and possible outcomes
Questions?
Legal Considerations

• Approvals and consents:
  – from the Board or Stockholders to waive protective provisions or to amend the certificate to increase the authorized shares for warrant coverage
  – from third parties or other lenders holding senior debt (if any)
Senior Debt and Enforcement

• In traditional loans, senior and junior lenders typically negotiate the enforcement constraints that the senior lender has over a junior lender upon default
  – e.g. junior debt lenders usually have a limited standstill after default before junior lenders can take action

• In bridge loans, senior lenders typically refuse the junior bridge lender any enforcement action, resulting in a permanent standstill, regardless of how long a default has existed
  – this stems from the senior lender’s expectation that bridge loans are equity rather than true debt and should have privileges as such
Issues in Secured Bridge Loans

• Most bridge loans are funded by several VCs, which presents unique issues:
  – e.g. in a typical loan, one lender acts as agent
  – but VCs usually don’t have the experience or resources to undertake such a task
  – this usually leads to coordination under a security agreement to act together by vote
  – this requires careful structuring of voting mechanisms and thresholds, esp. for calling default or exercising remedies
  – this negotiation will be case-by-case, e.g., what if there is a lender with a controlling equity position in the company?
Scott advises clients in the private equity, life sciences and technology industries on a variety of corporate and transactional matters including mergers and acquisitions, corporate financing transactions and general corporate and securities law issues. Scott has been counsel to numerous software, hardware, medical device and other technology companies from incorporation through venture funding and final exit, as well as numerous investors and sponsors that finance these companies. He is a frequent lecturer on matters relating to securities laws, public offerings, private equity and venture capital.

Scott has worked on a variety of transactions including going private transactions, public company acquisitions and the representation of financial sponsors in buyout and minority investment transactions. Scott has handled public and private offerings of both debt and equity securities, representing issuers and underwriters, as well as working with investors in numerous PIPE and “registered direct” offerings.
Ryan is the managing partner of the San Francisco office and is a member of the corporate law department, where he practices within the following groups: securities & public companies, life sciences, and technology, media & telecommunications (TMT).

Ryan represents leading public and private companies, investors and underwriters in the biotechnology, technology and medical device industries in connection with securities offerings and business combination transactions. In addition, Ryan regularly serves as principal outside counsel for publicly traded companies and private venture-backed companies, advising management teams and boards of directors on corporate law matters, SEC reporting, corporate governance and mergers & acquisitions.