Is it Wiser to Buy Convertible Notes or Preferred Stock?
2016 ACA Summit

Outcomes Waterfall

Venture is Sold	*Venture Fails/Liquidated*
All debt is repaid	Secured debt gets paid first
Preferred stock	Junior/unsecured debt
Common stock	Preferred, then common

If You Buy Convertible Notes (convert into next preferred equity round)

Positives	*Negatives*
Each lender holds a loaded pistol (final maturity)	"Stranger Danger" ("loan to own")
Can threaten bankruptcy = the ultimate clout	Inter-creditor Agreement?
Get paid before equity in both scenarios	Often unsecured (so behind others)
Simpler documentation	No BOD seat or exit vote
Avoid haggling over valuation until next equity round	But, others will set the price
Convert into the next equity round at a discount (20%)	Gold Holders may object

If You Buy C Corp Preferred Stock (or Membership Units for LLCs)

Positives	*Negatives*
Unlimited upside potential returns	Dilution can destroy returns
BOD seat likely for each early round	Will Directors drive an exit?
Must approve sale of future debt/equity & company	Complex documentation
Get paid before founders/common shareholders	"Gold Holders" set the rules

Takeaways:

1) Always presume that holders of both convertible notes and equity will receive no cash before the exit.
2) At maturity all note holders will hold a hammer, so consider how "strangers" will react at maturity.
3) All the documentation protections of both notes and equity can be renegotiated by the lead investor of the next round. The main difference is that note holders can kill the company at maturity but stockholders must wait for it to run out of cash (lousy performance is not an "Event of Default").
4) Although note holders get paid first in a liquidation, such proceeds are usually nil so this feature rarely minimizes losses.

Huston's Viewpoint:

- Notes are inherently neither "good" nor "bad." It depends upon whether you are the founder, purchaser, or a BOD member……….and the specific financing situation/needs/challenges.
- I personally prefer to settle on the valuation, and then buy preferred equity represented by co-investors who will not only be strong Directors during the inevitable downdrafts, but will also drive a lucrative exit for the benefit of all shareholders. (I am comfortable with false negatives.)
- I like an inside round of convertible notes to build a quick cash cushion when entering due diligence for an exit.

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