Convertible Debt “Matures”

Many early stage companies acquire capital by borrowing money that is convertible into equity of the borrower. This type of loan, known as convertible indebtedness, is “maturing”, evolving from straightforward typically unnegotiated bridge loans, into full-fledged term loans with many of the bells and whistles of commercial term loan financings typically provided by commercial banks and debt funds.

Convertible indebtedness has typically been structured as bridge loans, often for venture companies, intended to “bridge” cash shortfalls for companies until they raise their next round of equity. The loans were (and still are) intended to be converted into equity at the next round. Convertible debt has always been deeply subordinated to any senior secured financing. The convertible debt lenders assumed if no new equity was raised, the borrower’s prospects were bleak, and the lenders would write off the loan. The lenders did not (and still only briefly analyze) the downside scenario. They were really purely equity investors and the bridge loans were equity by another name.

Traditionally, convertible loans were short, often with one-year maturities or less, as the next equity raise was imminent. Now the trend is to have fewer and less frequent but larger equity raises, larger in part because the intervening rounds of convertible debt convert (usually automatically) into equity upon the issuance of the next round of equity. With less frequent equity rounds, convertible indebtedness is beginning to look more like traditional debt. Historically, convertible indebtedness was not secured, had few if any, affirmative and negative covenants (other than informational deliveries), and was generally not negotiated, largely because the maturity was short and because the lenders were really equity investors. Most of the discussions concerning convertible indebtedness traditionally revolved around the terms of conversion and various investor rights (such as board observation).

Because, at least in part, of the increasingly length of the tenor of convertible debt, it is now increasingly common to negotiate the loan terms of convertible debt, with lenders requiring commercial debt terms (as opposed to “insider” terms) including pledging the assets of the company as collateral, requiring current payment of interest (as opposed to compounding) and mandating restrictions on the incurrence of additional debt, the incurrence of liens, the sale of assets, the making of investments, the issuance of dividends, and the conduct of business with affiliates.   Maturities of convertible indebtedness can now be three years or more.

Agreeing to subordination terms with the senior lenders may also slow down the closing process (if not derail it) because of the added complexity. The terms of the subordination agreement allowed conversion of the convertible debt into equity, but essentially prevented any other repayment of interest or principal on the convertible debt until the senior debt was paid in full. Now that convertible debt may be secured, or have terms requiring regular payment of interest, agreements between the senior lenders and convertible debt lenders are not as straightforward and are often negotiated, especially if the convertible debt lenders are not the traditional equity backers of the company, but rather customers or suppliers, also known as “strategic investors”.

Additionally, each “round” of convertible debt financing must account for the existing outstanding convertible debt. It is not unusual to have multiple rounds of convertible debt with different terms. If outstanding convertible indebtedness prevents the incurrence of additional debt, for example, those outstanding lenders must approve the subsequent incurrence of debt. Similarly, corporate activities such as incurring senior debt or the acquiring a large piece of equipment via a capital lease may require the consent of the convertible debt lenders, giving those lenders a veto to such actions, much like senior secured lenders have always had.

These changes now require convertible lenders (and their counsel) to be more conversant in debt terminology and debt market trends. Lending convertible indebtedness is no longer an equity investment by another name. Convertible indebtedness is now, more and more, true commercial subordinated debt.