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Convertible Debt and Priced Equity Rounds: Evaluating the Preferred Deal Structure for Early-Stage Financing

Pros and Cons of Different Financing Options from Perspectives of Entrepreneurs and Investors

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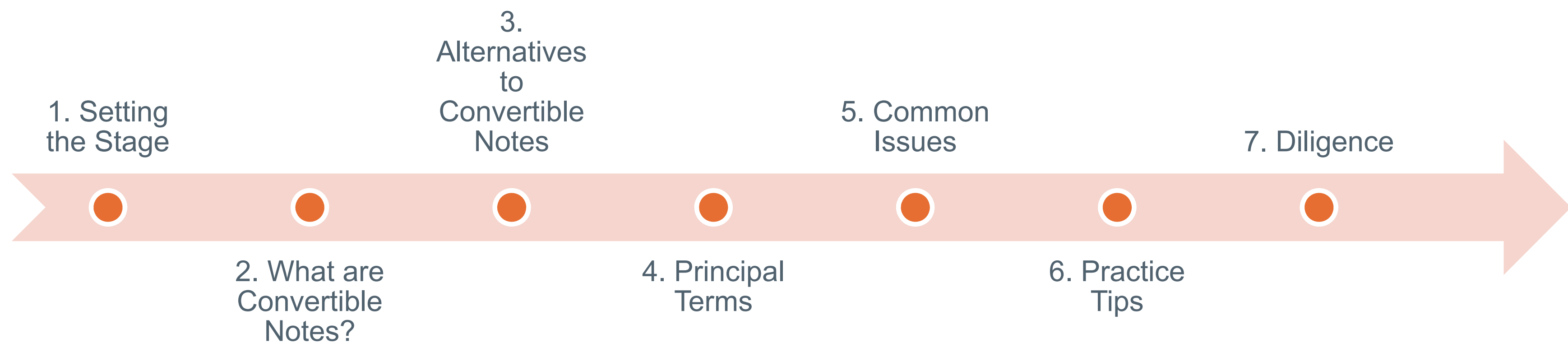
OVERVIEW

- What are Convertible Notes?
- “Bridge Loan”
- Who Uses a Convertible Note?
- Why Convertible Notes?
- Key Features of Convertible Notes
- Risks of Convertible Notes
- Investor Considerations
- Overview/Summary



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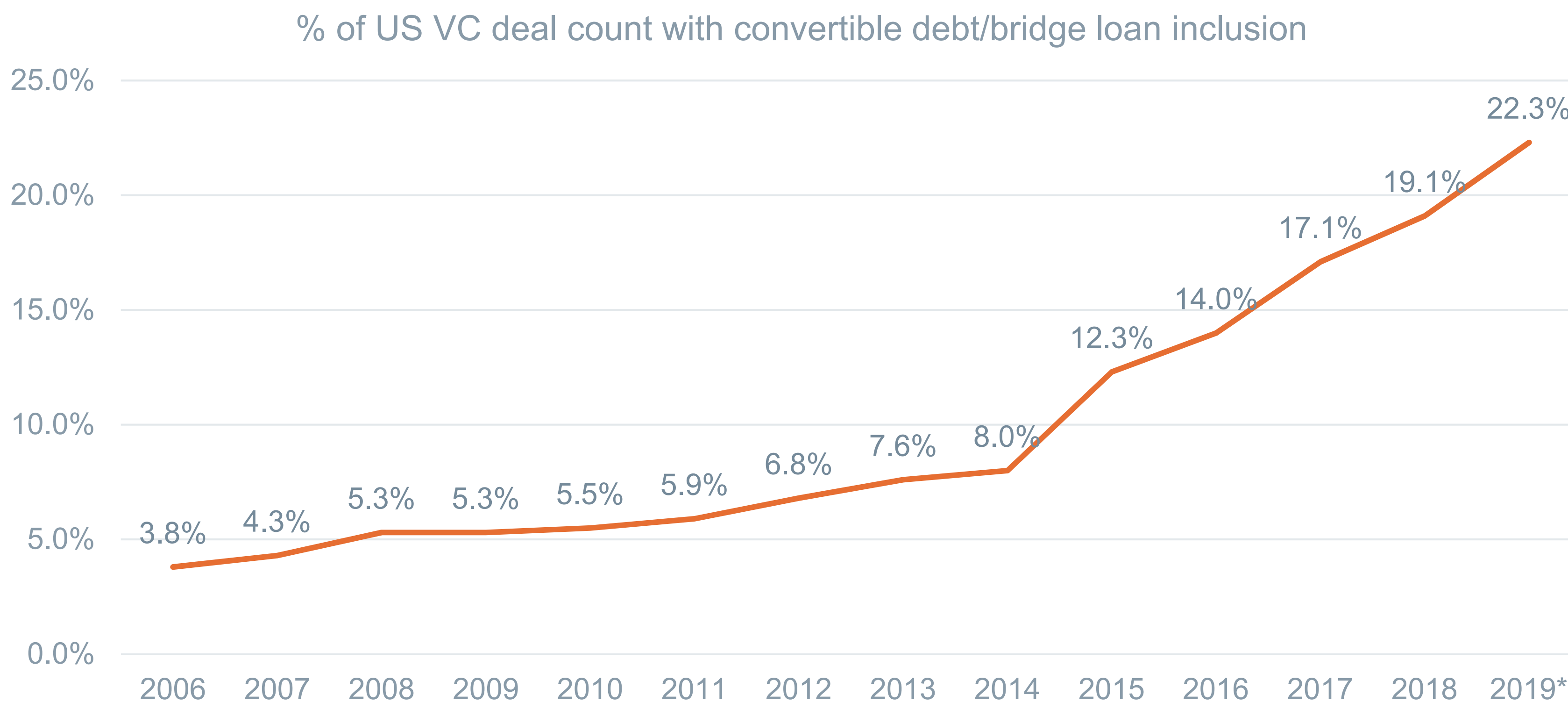
Increasing popularity of convertible notes



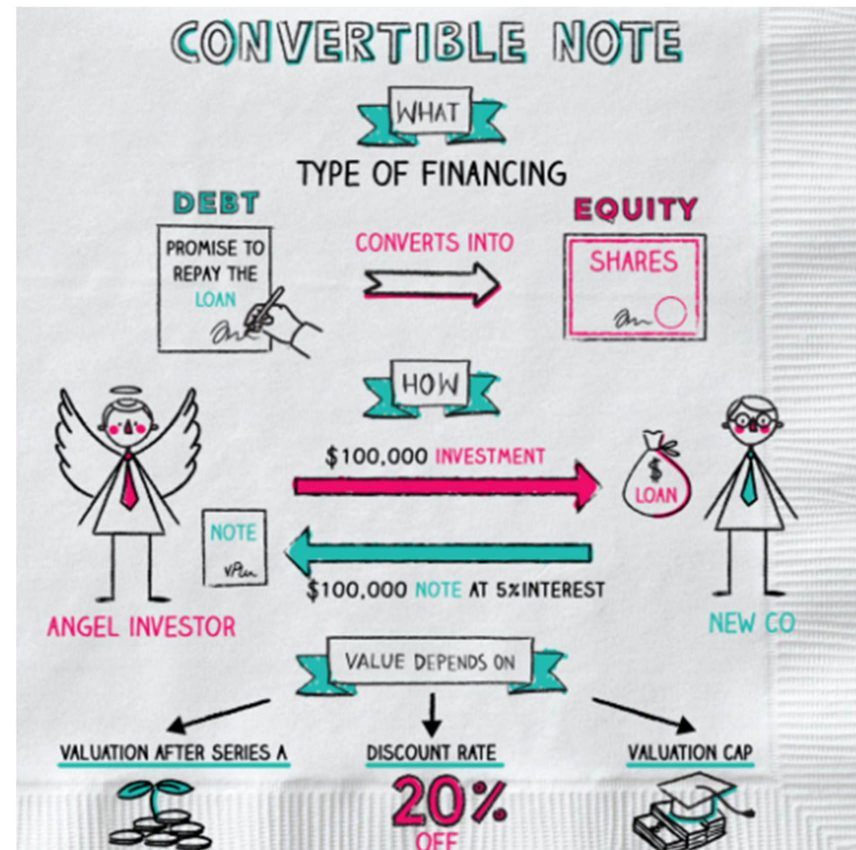
- Prevalence among early stage financings is much higher.

Data source: Pitchbook Venture Monitor

What is a convertible note?

Generally, a convertible note is a debt instrument that is convertible into equity of the issuer [or another entity]. **A convertible note is a way for seed investors to invest in a startup that isn't ready for valuation**. They start as short-term debt and are converted into equity in the issuing company. Investors loan money to the startup and are repaid with equity in the company rather than principal and interest. The convertible note is automatically changed into equity once a specific milestone has been reached, usually when the company is officially valued for later investments. Since a valuation is unnecessary, there are no dilution, taxes (depending on your country) or option pricing issues for the founders.

Essentially an IOU, but instead of paying in cash, the company pays in equity.



Graphic from Napkinfinance.com

What is a convertible note?

Traditionally . . .

Convertible notes were seen as debt securities that include: (1) a principal amount due at a maturity date, (2) interest that accrues on the principal balance, and (3) a claim superior to all equity holders of the company.

These days . . .

Start-ups and investors view convertible notes as a security that will convert into the same preferred equity security the start-up issues to its first institutional venture capital investor in the company's fixed price round (Series A).

What is a convertible note?

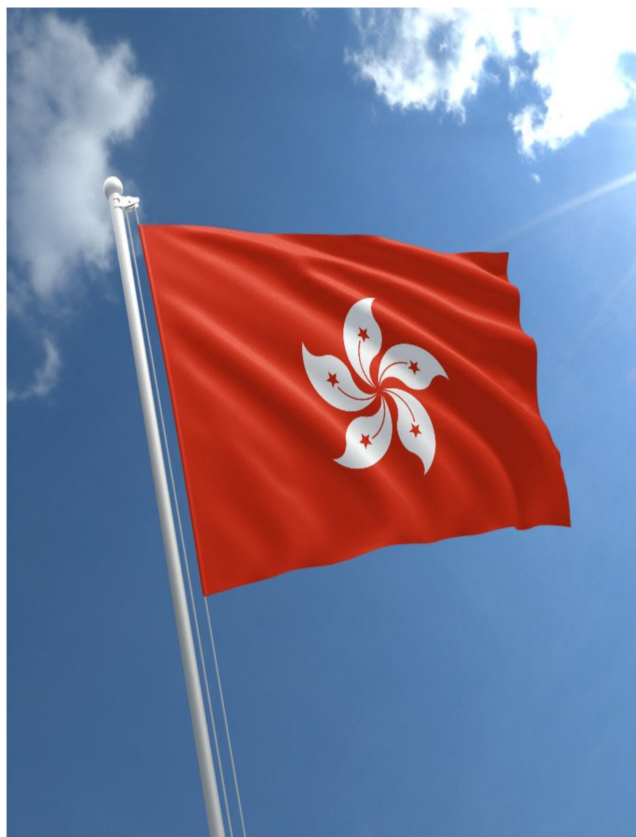
In the U.S., convertible notes are securities

- Section 5 of the Securities Act mandates that every time a security is sold, it must either be registered with the SEC or exempt from registration.

Common exemptions:

- Regulation D ("Safe Harbor")
- Section 4(a)(5) (Accredited Investors)
- Rule 147 (Intra-State Offering Exemption)

Is a Convertible Loan Note a security in Hong Kong?



- A Convertible Loan Note issued by a Hong Kong incorporated company will not be considered a security, if it specifically provides that it is not negotiable or transferable.
- Founders should always ensure that there is a restriction on assignment of the Convertible Loan Note. This must be expressly stated in the terms; it will not be implied. The restriction should require the consent of the company to any assignment of the Convertible Loan Note by the investor. This is important because founders could find themselves with persons holding shares in the company whom they have not approved. Also, if the Convertible Loan Note was freely assignable, then it would be considered a security under Hong Kong law. This would impose a higher standard of regulation.

BRIDGE LOAN

BRIDGE LOAN is short-term loan, which serves commercial or individual needs. These are offered at 2% higher interest rate than the usual loans.
A Bridge loan is also known as gap financing, swing loan, interim financing or caveat loan.

Features

- Short Term Loan
- Repayment Capacity of the borrower determines the loan amount
- Hefty rate of interest is charged until the whole amount is repaid.
- Rate of interest depends upon the loan amount and the capacity to repay

How does it work ??

Working depends upon purpose for which it has been taken:

- **COMMERCIAL PURPOSE** : It would take up caveat loan so as to systematically maintain its operations until business is in state of equilibrium or is earning profits.
- **RESIDENTIAL PURPOSE** : The borrower might use the loan to offset the mortgage on the old home and make down-payment of the new home. Else it can be only used to make the down-payment of the new house, which adds additional debt enabling to pay for two loans.

ADVANTAGES

- ✓ Short-term loan
- ✓ Ability to choose the repayment options
- ✓ Quick access to the loan not like those traditional ones, taking a long process
- ✓ Bridge loan overcome the issues relating to cash-flow

DISADVANTAGES

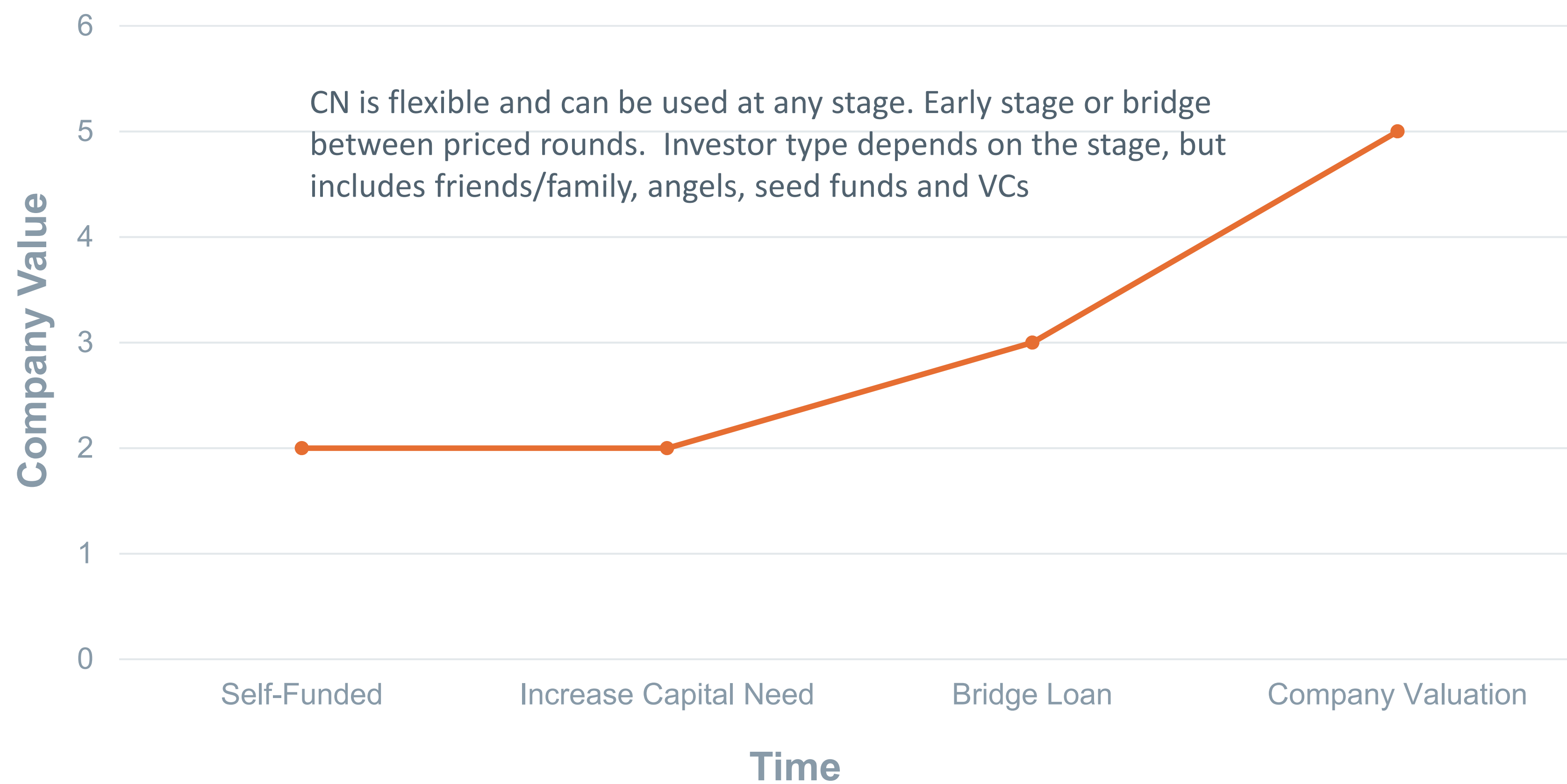
- ✓ The rate of interest charged is quite hefty
- ✓ Bridge loan might increase the debt burden
- ✓ Some Bridge loan might have pre-payment penalties
- ✓ the loan needs to be paid prior to traditional loan.

"BRIDGE LOAN"

With the general goal of having a higher valuation in a following round of financing, convertible notes serve as a "bridge" between the need for immediate capital to the point in time that the company is ready for a proper valuation.

Graphic from: efinancemanagement.com

"BRIDGE LOAN"



If I wait just a few more months, I can get a higher valuation...
Need Cash
$2.0 M
Self-fund
Series A
6 months
Bridge Loan
(first funding)

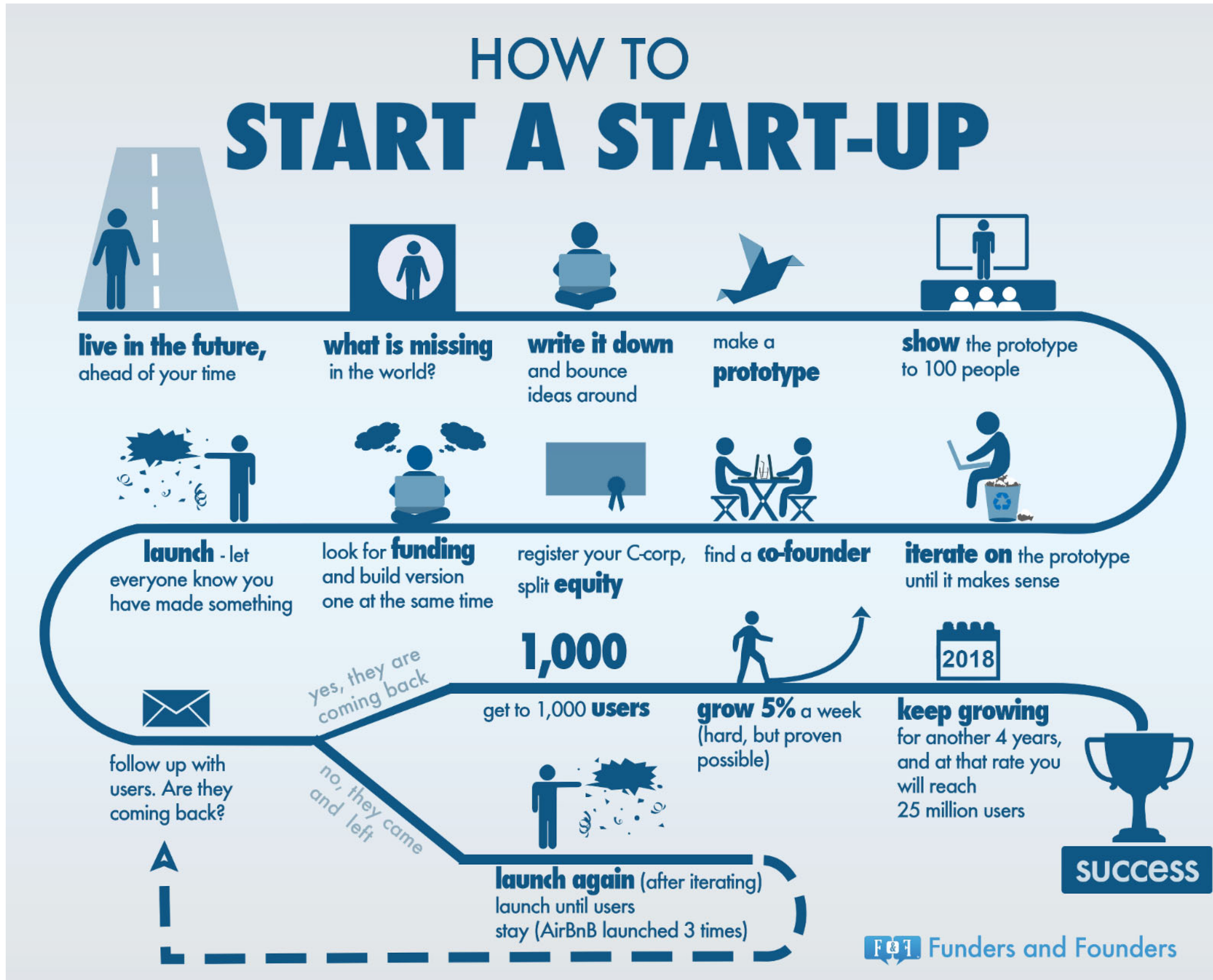
WHO USES A CONVERTIBLE NOTE?

Pre-Valuation Start-ups

- Used in seed-stage financing.

Developed Start-ups

- Used to bridge need in capital to later-stage or subsequent fixed price round financing.



HOW TO
START A START-UP
live in the future, ahead of your time
what is missing in the world?
write it down and bounce ideas around
make a prototype
show the prototype to 100 people
iterate on the prototype until it makes sense
find a co-founder
register your C-corp, split equity
look for funding and build version one at the same time
launch - let everyone know you have made something
follow up with users. Are they coming back?
yes, they are coming back
no, they came and left
1,000
get to 1,000 users
grow 5% a week (hard, but proven possible)
2018
keep growing for another 4 years, and at that rate you will reach 25 million users
success
launch again (after iterating) launch until users stay (AirBnB launched 3 times)
Funders and Founders

WHY CONVERTIBLE NOTES?

Defer company valuation

- Generally, valuation determines what percent of the company is being offered. This valuation, however, can be difficult to determine for many early-stage start-ups.
- Deferring valuation provides the start-up an opportunity to establish proof-of-concept, data points, and other key metrics.

Simple/Efficient/Fast

- May be issued in mere days reducing legal and accounting fees.
- Less features to negotiate than a fixed price round.

Maintain control of company

KEY FEATURES OF CONVERTIBLE NOTES

- Interest Rate
- Conversion Discount
- Qualified Financing Defined
- Valuation Cap
- Most Favored Nation

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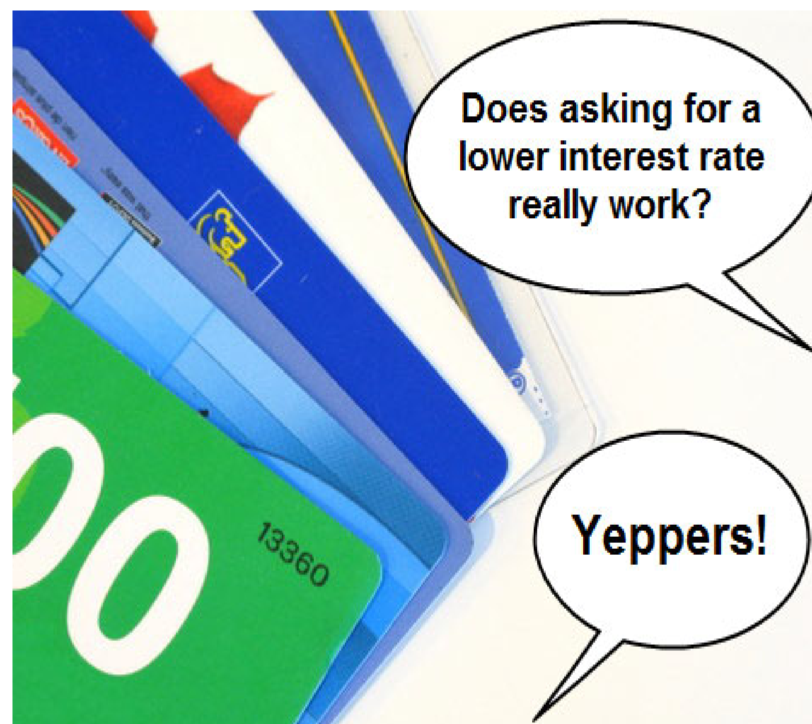
Key features of convertible notes

- Interest Rates
  - Subject to negotiation between the start-up and investor.
  - Interest is not paid on a periodic basis, but instead accrues. The total amount of interest due is added to the total and converted into shares upon a successful fixed price round.



Key features of convertible notes

Convertible Notes - SAFE	Majority of Pre-Series A Deal Terms
Interest rate	Less than **8%** (from **4-7%** in most cases).
Maturity	**12** months or more
Conversion rate subject to capped valuation	There is **a cap** in most of the Pre-Series A convertible notes.
Conversion to equity at discounted price	Yes, most of the time the discount rate is between **10% to 30%**, with a majority at **20%**.

- Conversion Discount
  - A mechanism to reward the convertible note holders for their investment risk.
  - Grants note holders right to purchase stock upon closing of fixed price round financing at a reduced price compared to the fixed price round investors. A “sweetener” for investors.
  - Discounts range from 10% on the low side to 35% on the high side.

Key features of convertible notes

- Example:
  - Conversion discount of 20%
  - Convertible note valued at $100,000 (not including interest)
  - Subsequent fixed price financing round sets price of share at $1.00
  - Note holder would convert the note at an effective price of $0.80 per share resulting in 125,000 shares ($100,000 divided by $0.80 per share)

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Key features of convertible notes

- Qualified Financing
  - A mechanism that automatically converts the convertible note debt into equity upon the start-up closing equity financing above an identified threshold. And that conversion is typically at a discount to the "Qualified Financing" equity round price.
  - Adds protection to the note holder from having note converted to equity prematurely during a small fixed pricing round.

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Definition of qualified financing

- "Upon the closing of a Qualified Financing, the principal and accrued interest of this Note will be converted automatically without the consent of the Holder into securities of the same class or series issued in the Qualified Financing. The number of securities to be issued in the conversion will be determined by dividing the sum of the then outstanding principal amount of this Note and all accrued but unpaid interest thereon by the Conversion Price. The "Conversion Price" is an amount equal to 85% of the price per share paid by the investors in the Qualified Financing."
- It is extremely straightforward – here the discount was 15% to the Qualified Financing price. Sometimes, though not in this example, you will see a valuation cap built in too so that the debt holder gets the better of the discounted price of the valuation cap price.
- Here is the definition of Qualified Financing from the same promissory note:
  - "Qualified Financing" means the issuance of equity interests (or debt securities convertible into equity interests) in the Company to investors before the Maturity Date (as the same may be extended) in one or a series of related transactions, the principal purpose of which is to raise capital, which transaction or series of related transactions result in the Company receiving gross proceeds of not less than $700,000 (inclusive of the principal amount of the Notes that will convert into equity in connection with the consummation of the Qualified Financing)."
- Typically, in the definition of Qualified Financing the amount of the outstanding convertible debt notes do NOT count towards achieving the Qualified Financing threshold as it is NEW cash that gives the company the breathing room and runway. In the definition above, the threshold is $700,000, which would give the company meaningful time to achieve its next set of milestones and set it up for additional capital raising if required. Now, **I hope some of you see the problem in the definition above**. It uses the word "inclusive" as opposed to "exclusive".

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Key features of convertible notes

- **Valuation Cap**
  - Entitles note holders to convert the outstanding balance on the note into shares of stock at the lower of (1) the valuation cap or (2) the price per share in a qualified financing (or, if there is a discount in the note, then the discounted price per share).
  - To make a note investment attractive to investors the notes will generally convert at a cap or discount. Without a cap or discount, the notes would typically convert into the issuing company's preferred stock in the qualified financing at the same price as the preferred stock issued in that financing, which would not be an attractive investment to investors because they would not receive any benefit for being an early investor.
  - It is not a valuation of the company based on the company's current projections or assets (but, there is ongoing debate about this in the VC community). It is intended to ensure that an investor does not miss out on significant appreciation of a company between the time of the sale of convertible notes and the qualified financing.
  - The investor should have some comfort that if an investment is made when the company has very little value, that the note will not convert at an astronomical valuation and thereby deprive the investor of participating in all the upside that was made possible by the early investment.

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Key features of convertible notes

- Example:
  - Note purchased for $100,000 and includes $5,000,000 valuation cap provision
  - Fixed price round at $10,000,000
  - Price per share set at $1.00
  - Note holder would convert at an effective price of $0.50 per share ($5,000,000 divided by $10,000,000)
  - Note holder would get 200,000 shares (This is a 2x return, not including any accrued interest)
  - The previous discount example only gave the note holder 125,000 shares after the 20% conversion discount.

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What does Valuation Cap do?

Establishes an upper limit on the conversion price per share in a qualified financing.

Protects investors against dilution if the company's valuation increases between financing events.

If the valuation cap is higher than the qualified financing, investors receive no benefit.

https://www.youtube.com/watch?v=0h3PNjxm0wY

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KEY FEATURE OF CONVERTIBLE NOTES

Most Favored Nation

Also known as a “me too” provision, a most favored nation clause may be included in a convertible note allowing the note holder to inherit any more favorable terms that are offered to any subsequent investors.

Risks of convertible notes

- Fixed price financing has gotten faster and cheaper.
- Some preferred investors prefer fixed price rounds.
- If no fixed price round occurs, company has debt.
- The interest of the founders and the investors can be "misaligned".
  - Founders' interest is to maximize company valuation, whereas the note holders' interest is to minimize company valuation. (Note holder will get more % of company with lower valuation.)

Risks of convertible notes

- Danger of a lower than expected fixed price round.
  - Generally, start-ups anticipate that a deferred company valuation will reveal a higher company value during a fixed price round.
  - However, many start-ups do not protect against the effects of a convertible note with a conversion discount if the company valuation goes down.
  - This can result in the note holder gaining significantly more equity than anticipated by the start-up.

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Investor considerations

- Is delaying valuation in the interest of the investor?
  - When an investor is seeking equity through a convertible note, the investor is seeking ownership. (Investment ÷ Company Value) = Percent Ownership.
  - Because the parties are allowing a fixed price round to set the company valuation (hopefully at a higher price than at the time of convertible note investment), the holder of the convertible note is neither rewarded for their initial risk, nor getting the equity they might have thought.

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Investor considerations

- Importance of a valuation cap:
  - A conversion discount still does not adequately reward the note holder for their early investment and risk.
  - A valuation cap (with a discount) provides added value to protect investors from an inflated company valuation. This is often called a Discounted Convertible Note with a Cap.

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Perils of convertible debt: Do I own the debt, or does the debt own me?

THE EXISTENTIAL THREAT

Imagine:

- You're a founder. You raise $300k and use a convertible note because it's weird to put a multiple million-dollar valuation on your new startup.
- Two years after raising the debt, your company isn't scaling quickly but is sustainably profitable… if not for the upcoming debt obligation.

What happens next?

Perils of convertible debt: Do I own the debt, or does the debt own me?

THE EXISTENTIAL THREAT

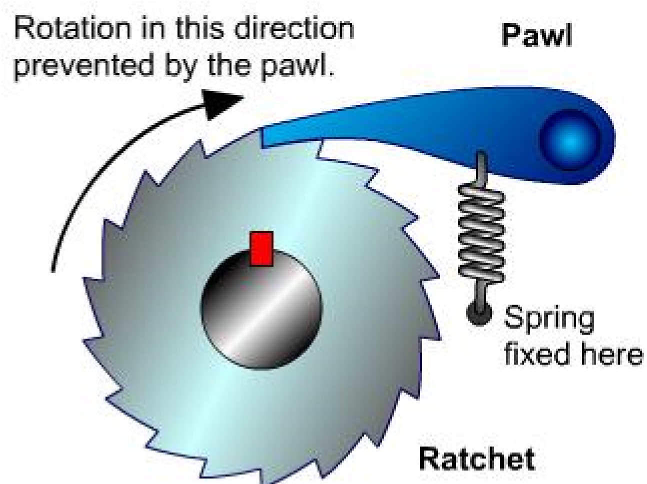
Investor calls in the debt:

- Facing an existential threat
- Company negotiates without leverage
- Investor might file lawsuit
- Going to be more difficult to raise next round
- Huge distraction from what founder wants to be doing

- Would you rather have done an equity round?
- What could you do differently to protect the company from this existential threat?

Weighing the pros and cons, it becomes clear that the **benefits of investments in convertible notes varies** with the perspective of the **issuing company** and the **investor**. The terms profitable for one will automatically become expensive for the other. Hence, it is advisable to seek assistance from a financial consultant before closing deals involving convertible notes.

Perils of convertible debt: Do I own the debt, or does the debt own me?



https://www.notesandsketches.co.uk/Ratchet.html

THE FULL RATCHET

- 99% of deals don't have a full ratchet
- Full ratchets are too harsh on founders.
- But convertible note holders get the full ratchet.
- It's even worse than that for the founders, because 82% of the time the investor gets a 10-30% discount on top of the ratchet.
- The ratchet effect is hidden by the terms of the note; so it's not so difficult to swallow

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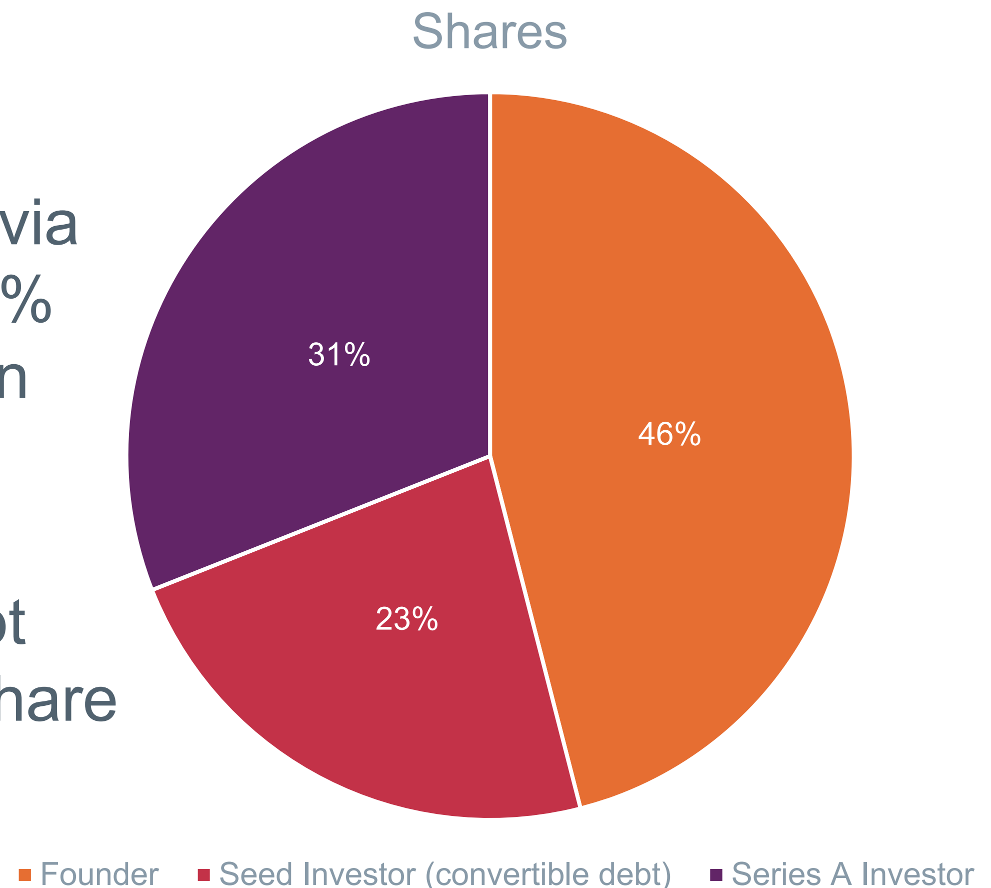
Perils of convertible debt: Do I own the debt, or does the debt own me?

THE FULL RATCHET

Example A:

- Company raises $300k via convertible debt with 20% discount and $2.7 million cap
- Series A is raised at .50/share valuation; debt holder converts at .40/share

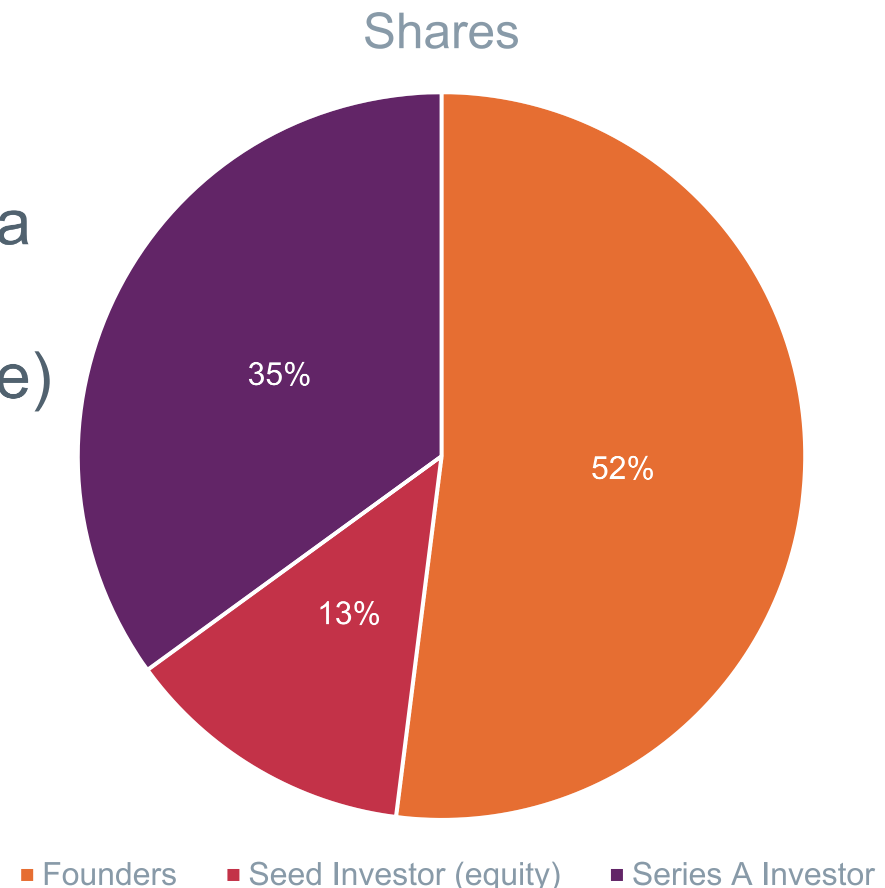


Perils of convertible debt: Do I own the debt, or does the debt own me?

THE FULL RATCHET

Example B:

- Company raises $300k via equity at $2.7 million pre-money valuation ($1/share)
- Series A is raised at .50/share valuation



Perils of convertible debt: Do I own the debt, or does the debt own me?

MULTIPLE LIQUIDATION PREFERENCE

- Most VCs doing early stage deals don't request multiple liquidation preferences (81% of liquidation preferences recently were non-participating).
- But convertible debt holders often get a multiple liquidation preference in effect.

See https://www.lightercapital.com/blog/the-hidden-trap-of-convertible-debt-multiple-liquidation-preference/

Perils of convertible debt: Do I own the debt, or does the debt own me?

MULTIPLE LIQUIDATION PREFERENCE

Example:

- Seed investor puts in $300k with $2.7 cap
- Series A investor puts in $1.5 million at $7.5 million pre-money valuation (price of $1/share)
- Seed investor gets $750,000 worth of shares, which presumably have 1x liquidation preference, entitling seed investor to an effective 2.5x liquidation preference

- Solutions?
  - Issue “shadow series” with adjusted preference (https://www.sec.gov/Archives/edgar/data/1734237/000110465919056558/tv530996_ex2-1.htm)
  - Issue discount shares in common stock
  - Don’t do convertible notes

Perils of convertible debt: Do I own the debt, or does the debt own me?

CAP ISSUES

If there is no cap, deal is bad for investors

- If investor puts money in when company is worth $1,000,000, and company is later valued at $10,000,000, it's not fair for the investor who took more risk to pay the same price as the investor buying in after the company's value increased ten-fold—the investor receives one-tenth the number of shares he or she would have received based on the value of the company when he or she invested.

If there is a cap, deal is bad for founders

- There's never a minimum price, so if there's a cap, the founders have all the pricing risk (recall the ratchet slide).

Perils of convertible debt: Do I own the debt, or does the debt own me?

COMPLEXITY

- I often hear people say convertible debt deals are simpler. I don't agree.
- Great subtlety in identifying ramifications of convertible debt
- You've also got to deal with additional terms like when and how the price will be calculated, what the conversion rights are, and the terms for interest and repayment.
- And one way or another, you've got to deal with it later (hopefully just converting it, not dealing with outstanding debt).

Alternatives to convertible notes

1. **Don't use convertibles**. As one of the main "points" of doing a convertible note was to not fix a valuation in the first place, and with a cap, some believe you basically have set a valuation, go with a "Series Seed" equity deal instead. Series Seed deals can be simple to document, do not generally come with lots of control-strings attached, and will result in the investor having a liquidation preference that matches the investment. While the documentation is more extensive (read, costly) than a SAFE or a note, the certainty and tidiness are bonuses.
2. **Issue the "discount shares" in common, not preferred**. While it requires a small amount of additional drafting complexity, the note can convert into a combination of (a) shares of the "next round" preferred stock with liquidation preference matching dollars invested, and (b) the balance of shares in common stock .
3. **Have the instrument convert into a "shadow series" of preferred stock**. To avoid issues associated with issuing common stock to the investors, some companies create a series of preferred that is identical to the series issued to the new investors and votes together with that series on all matters – with one exception: the aggregate liquidation preference of the "shadow series" equals the principal amount of the note.

The approaches in #2 and #3 have some complexities and potential pitfalls (such as, if the balance shares are in common stock, whether the founders lose control of the common stock vote), most of which can be worked through and addressed with your investors and counsel.

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Overview / Summary

PROS	CONS
Simple, efficient, fast	If you don’t have qualified financing by the maturity date of the note, you have debt
Traditionally low cost	Convertible notes may be disfavored by potential investors in subsequent fixed price round
Postpones company valuation	May have “misaligned” incentive between start-up and investors
Maintain control over company	Some provisions difficult to negotiate (conversion discount, valuation cap, most favored nation)

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SAFE: A hybrid security

- The SAFE has some features of warrants, preferred stock, and convertible debt
- But it can't accurately be categorized as any of these three more common types of securities
- A SAFE is an agreement that if a company raises money (or is sold or has an IPO), the investor will get an amount of preferred stock valued at the price of the new round of financing (or the sale price of company).

THIS INSTRUMENT AND ANY SECURITIES ISSUABLE PURSUANT HERETO HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "**SECURITIES ACT**"), OR UNDER THE SECURITIES LAWS OF CERTAIN STATES. THESE SECURITIES MAY NOT BE OFFERED, SOLD OR OTHERWISE TRANSFERRED, PLEDGED OR HYPOTHECATED EXCEPT AS PERMITTED UNDER THE ACT AND APPLICABLE STATE SECURITIES LAWS PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT OR AN EXEMPTION THEREFROM.

[COMPANY NAME]

SIMPLE AGREEMENT FOR FUTURE EQUITY (SAFE)

THIS CERTIFIES THAT in exchange for the payment on or about [Date of Agreement] by the University of Chicago, on behalf of its [Booth School of Business/Chicago Innovation Exchange] (the "**Investor**"), of $[________] (the "**Purchase Amount**") to [Company Name], a [State of Incorporation] corporation (the "**Company**"), as a [winner of the Investor's New Venture Challenge/company funded by the University of Chicago Innovation Fund], the Company hereby issues to the Investor the right to certain shares of the Company's capital stock, subject to the terms set forth below.

SAFE: Like, and not like, convertible debt

- Convertible debt-like features:
  - The valuation of the company is delayed
  - The investment will convert into securities on a future event
- Differences from convertible debt:
  - It's not debt.
  - There's no repayment date.
  - There's no interest.

SAFE: like, and not like, preferred stock

- A preferred stock-like feature:
  - The owner of the SAFE usually ends up with preferred stock
- Differences from preferred stock:
  - SAFE holder doesn't have any rights of preferred stock holder until a conversion event

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SAFE: Like, and not like, warrants

Stock Warrant

YOUR COMPANY NAME

SHARES ISSUED TO

A warrant-like feature:

- The owner of the security instrument will receive stock upon the happening of some future event

Differences from warrant:

- The valuation is deferred—it's not a right to buy at a certain price
- The contingent event (a subsequent financing) is beyond the control of the holder of the SAFE

SAFE: VARIETIES

- There are four flavors of SAFEs:
  - Valuation cap
  - Valuation discount
  - Discount & cap
  - No discount; no cap

SAFE: Upside to SAFEs

SAFEs fix the biggest problem with convertible debt

- There's no existential threat from a maturity date
- Also, there's no interest that's accruing

RRE VENTURES | RAISING SEED CAPITAL

SAFE

SAFE – Simple Agreement for Future Equity – is a newly-formed funding instrument meant to replace convertible notes; essentially, SAFE has the benefits of convertible debt without the debt portion (maturity date and accrued interest).

Key Terms/Elements

- ***Equity Financing Event***
  SAFE investors will be issued a form of preferred stock, and the SAFE instrument will expire
- ***Liquidity Event***
  SAFE investors will be have the option to receive cash payment or common stock, and the SAFE instrument will expire
- ***Dissolution Event***
  SAFE investors would have preference over capital stock owners in the distribution of assets

Why SAFE?

- **No Maturity Date**
  Less pressure on startup to raise further capital in tight timeframe
- **No Accrued Interest**
  SAFE is not a loan – founders will not owe accrued interest
- **Speed**
  Very simple terms and quick funding timeline
- **Cost**
  Limited transaction costs due to standardized forms

Source: http://ycombinator.com/safe/
Source: http://techcrunch.com/2013/12/06/yc-safe/

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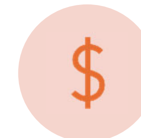
SAFE: Downside to SAFEs

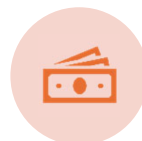
One seemingly large problem from the investor standpoint:



There's no guarantee that these contracts ever convert. The company could successfully grow at small and steady pace without raising money, selling its business, or going public.

From the founder's standpoint, the largest problem with notes remains:

Valuation cap (not fair to investor if no cap; not fair to company if there is a cap)



Founder doesn't know what he or she is giving up in exchange for the investor's capital

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BE CAREFUL OUT THERE . . . .

Investor Bulletin: Be Cautious of SAFEs in Crowdfunding

May 9, 2017

The SEC's Office of Investor Education and Advocacy is issuing this Investor Bulletin to educate investors about a type of security, often described as a SAFE (a "Simple Agreement for Future Equity"), that may be offered in crowdfunding offerings.

Be Safe—5 Things You Need to Know About SAFE Securities and Crowdfunding

Some issuers have been offering a new type of security as part of some crowdfunding offerings—which they have called a SAFE. The acronym stands for Simple Agreement for Future Equity. These securities come with risks, and are very different from traditional common stock. Indeed, as the Securities and Exchange Commission (SEC) notes in a new Investor Bulletin, notwithstanding its name, a SAFE offering may be neither "simple" nor "safe."

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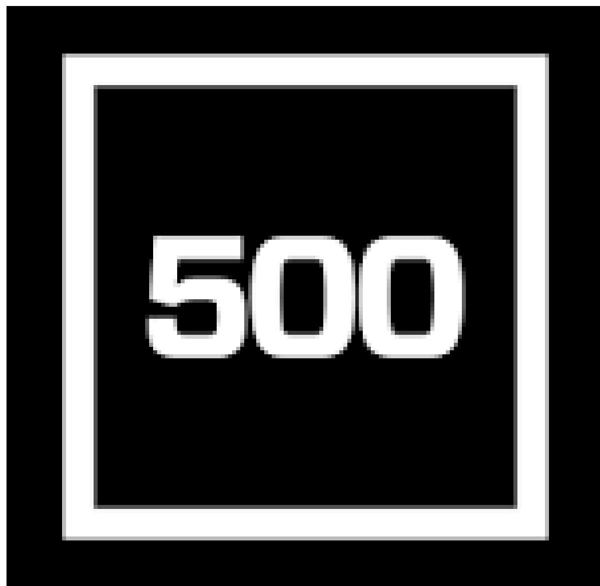
Alternatives to convertible notes

SAFE	KISS	Equity
• "Simple Agreement for Future Equity" • Developed by Y-Combinator	• "Keep It Simple Security" • Developed by 500Startups	• Generally Preferred stock



VS

https://medium.com/frontiernode/the-key-differences-between-y-combinator-and-500-startups-ce76fa28d91e

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Two varieties of KISSES

One is an equity structure.

The other is a debt structure.

Neither is F….h.

The two varieties are nearly identical, except:

- The convertible debt version accrues interest and is repayable at maturity
- The standard terms call for 4% interest and an 18-month term

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KISSes: Conversion

- Upon a conversion event, the KISS will turn into preferred stock (nothing is converted into a prince by virtue of the KISS).
- The conversion event is a subsequent financing round in which the company raises $1,000,000.
- Like with similar docs, the conversion price is based on the discount or the cap (whichever results in a lower share price).

Leopard frog. Credit: Paul Reeves *Getty Images*

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KISSES: Acquisition

- Upon an acquisition, the investor chooses between:
  - Having the KISS convert to common stock at a price based on the valuation cap, OR
  - A 2x return on purchase price of note before any distribution to shareholders
- For example:
  - Investor has $300k KISS; $2.7 million cap; fully diluted capitalization is 1.5 million shares
  - Company is purchased for $10 million in acquirer's stock
  - Investor can choose between $600k cash or 166,667 shares of common stock, which would be convertible into $1 million in acquirer's stock

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KISSES: Maturity

- Unlike the SAFE, KISSes establish an 18-month maturity date. If the KISS has not converted by the maturity date then:
  - The **equity version** of the KISS may be converted to Series Seed Preferred Stock at a price determined by the valuation cap. The most recent series seed documents at (http://www.seriesseed.com/) govern the terms of that series seed preferred stock; or
  - The **debt version** may similarly convert to Series Seed Preferred Stock, or the purchase price and accrued interest may be deemed due and payable at the investor's election.

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KISSES: Investor rights

- **Most favored nation**: If the company issues another convertible instrument before conversion of the KISS, and the investor determines that the subsequent instrument contains more favorable terms then those in the KISS, then the investor may choose to convert the KISS to the terms of the subsequent instrument.
- **Assignable**: Unlike the SAFE, the KISS is assignable without Company consent: "Subject to compliance with applicable securities laws, this KISS and all rights hereunder are transferable in whole or in part by the Investor to any person or entity upon written notice to the Company."
- **Major investor rights**: The KISS defines a major investor as one "with an aggregate Purchase Price equal to or exceeding $50,000." If the KISS investor is a major investor, then they are entitled to full information rights and participation rights.

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KISSES: SHADOW SERIES

KISSes solve the multiple liquidation preference and full ratchet issue by providing for conversion into a shadow series:

- “Shadow Series” means shares of a series of the Company’s Preferred Stock identical in all respects to the shares of Preferred Stock issued in the Next Equity Financing (e.g., if the Company sells Series A Preferred Stock in the Next Equity Financing, the Shadow Series would be Series A-1 Preferred Stock), except that **the liquidation preference** per share of the Shadow Series equals the Conversion Price (as determined under Section 1(b)(i)), with corresponding adjustments to any **price-based anti-dilution** and dividend rights provisions.
- (SAFEs have something similar)

KISSES: Upsides

- As compared to the SAFE, it's more investor friendly
- It solves the SAFE's issue of the investor not having any conversion right
- Like the SAFE, KISS solves the issue of convertible note holders getting a multiple liquidation preference and full ratchet anti-dilution protection

KISSES: Downsides

- There are additional points to negotiate (investors rights)
- It reintroduces the existential threat with the possibility that the deal would be structured as debt.

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Comparing CN, SAFE, and KISS

	Convertible Note	SAFE	KISS
Existential threat from maturity date	Yes	No	Maybe (Yes, if debt; No, if equity)
Multiple liquidation preference	Yes	No	No
Full ratchet effect	Yes	No	No
Silly acronym	No	Yes	Yes
Info rights for investors	No	No	Yes
Have a good solution for valuation cap issue	No	No	No
Conversion	On maturity or subsequent financing	On subsequent financing only	On maturity or subsequent financing

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A typical priced round

Priced rounds are **equity investments based on a negotiated valuation** of a company. After agreeing on your company's valuation, an investor gives you money in exchange for preferred stock in your company at a price per share determined by the valuation.

The convertible bridge note, next round pricing, has been used by minority investors, principally in an early, smallish round in which the parties are anxious to avoid a contentious negotiation on pre-money valuation at a stage when hard evidence on valuation, and therefore pricing, is down the road.

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How do priced rounds work?

- Priced rounds require **more upfront accounting and negotiating than convertibles**, but they also give you a clearer picture of how much your company is worth.
- The price for preferred stock is based on what the company is worth at the time of the investment. Given that the price is set at the time of investment, investors get equity immediately.
- **Investors may also get more control rights** in your company with a priced round, including voting rights, anti-dilution rights, and a potential seat on the board as a lead investor. Lead investors, or institutional leads, can serve as liaisons between you and other investors, acting on your behalf to drum up interest in the company and raise more capital. **As a founder, you may get more money** as a result of having an institutional lead, but you also have to cede more control to investors.
- Priced rounds can be a good option for founders who are confident in what their company is worth, expect impressive growth, and need to raise a lot of capital.
- Accounting / tax considerations: https://shaycpa.com/convertible-notes-vs-safes-accounting-tax-considerations/

Pros and Cons of priced rounds

Pros	Cons
Offers clear terms and certainty on dilution: It takes more time to negotiate the term sheet of a priced round, but detailed guidelines can help prevent misunderstandings and problems down the road. Plus, agreeing on a pre-money valuation gives you a better idea of how much company ownership you're giving up. **Appeals to investors:** Investors have more protection and rights with priced rounds, so they may be inclined to invest more money than they would with a convertible. **Generates interest:** A lead investor can help create buzz around your company and raise even more money.	**Requires more time:** Not only do you have to agree upon a pre-money valuation, but you also have to negotiate your investors' preferential rights. **Expensive:** It costs more money in legal fees to set up a term sheet (guidelines) and negotiate definitive documents for a priced round. **Less autonomy:** You may have to give a certain amount of control over to investors.

For an equity round which is conventionally ‘priced’, there are, of course, a number of issues that need to be faced and negotiated before the closing.

To start, with the percentage of the company the investors in the seed round ….typical description….wind up owning as of the closing. And the negotiation of that number can be expensive in terms of legal fees.

https://capbase.com/priced-and-unpriced-financing-rounds-what-are-the-differences/

The bridge investors, in short, pay less money per share to join the party but their risk is conceptually greater. They put cash into the deal before the valuation analysis has run its course.

There, indeed, may never be a seed round. If so, the bridge investors may be creditors, but they are not likely to stand alongside parties supplying goods and services in a bankruptcy.

https://apoliticni.hr/golden-gate-bridge-golden-miracle-world/

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https://nvca.org/

As far as the terms of the seed round, the bridge investors sometimes have veto rights on specific terms but not typically in a down round.

Bridge investors can get a preview of sorts on likely seed terms by, for example, sending their counsel to the NVCA site to check out the deal terms reference points put in the literature.

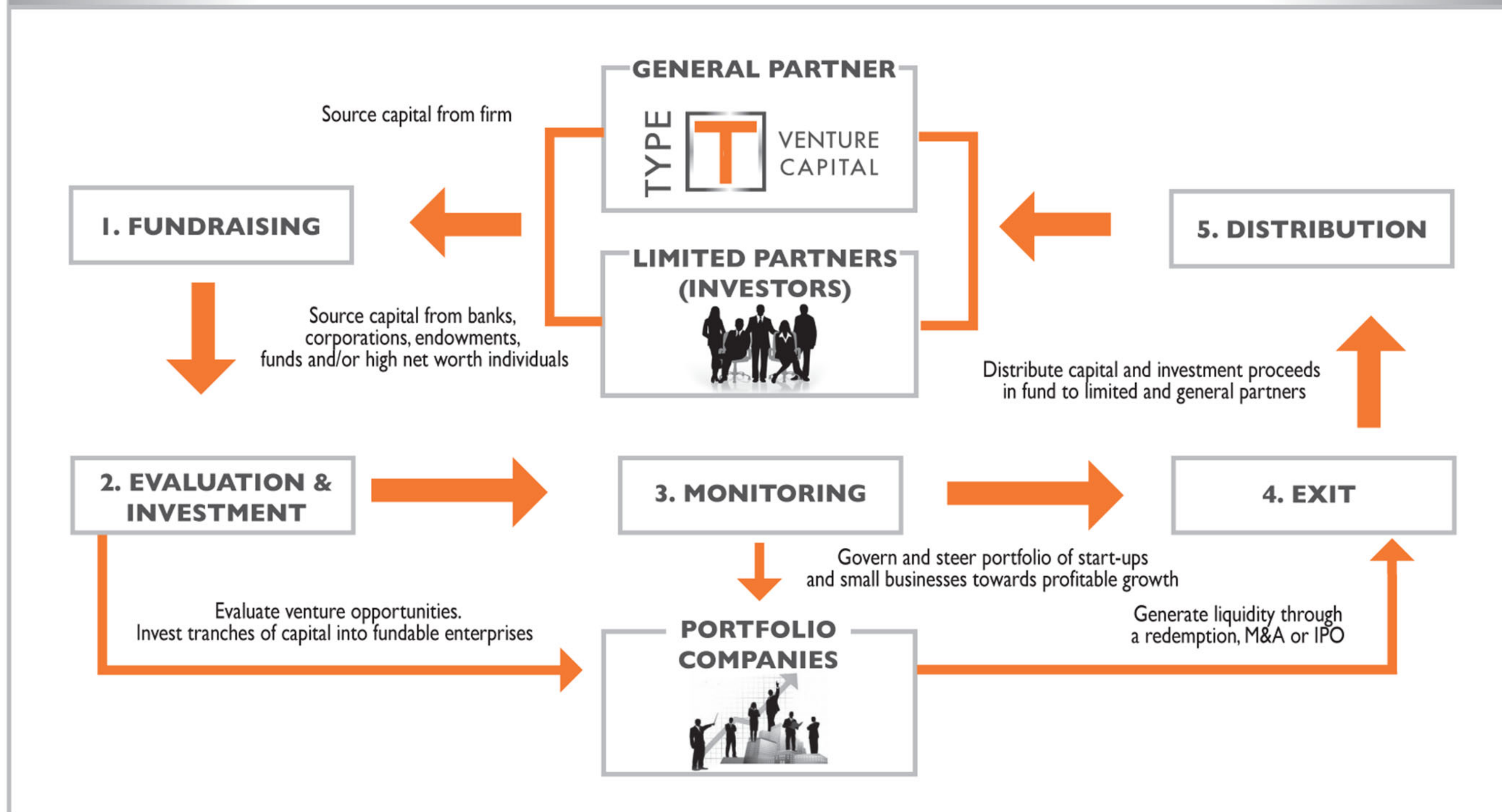
Where does all this lead?

The answer in short is:

When considering a bridge round, focus on

‘Your price, my terms’

Early stage investors need to have a laser focus on ‘Dilution, Dilution, Dilution’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GENERAL PARTNER
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Source capital from firm
1. FUNDRAISING
LIMITED PARTNERS (INVESTORS)
Source capital from banks, corporations, endowments, funds and/or high net worth individuals
5. DISTRIBUTION
Distribute capital and investment proceeds in fund to limited and general partners
2. EVALUATION & INVESTMENT
3. MONITORING
4. EXIT
Govern and steer portfolio of start-ups and small businesses towards profitable growth
Evaluate venture opportunities. Invest tranches of capital into fundable enterprises
PORTFOLIO COMPANIES
Generate liquidity through a redemption, M&A or IPO

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https://www.youtube.com/watch?v=hgw_yprN_-w