Next up, we're going to talk about the deep dark dangerous depths of convertible debt.

Clint: When convertible debt goes bad what does it look like?

Brad: The first thing to remember about convertible debt is that it's debt. Debt has different characteristics than equity. If you're not careful around debt you can sometimes get into trouble. You can also find that debt can be used in ways that's more aggressive in terms of a negotiation because of the liabilities associated with it.

Let me give you two examples of convertible debt gone bad. One example was actually one that I encountered in a financing. It was a financing where were leading the first equity round. The company had already raised about a half a million dollars of convertible debt. Half of that convertible debt was from one person. The convertible debt terms were not well written.

All of the stuff that we've been talking about in the previous sections were not really conformed to and the convertible debt holder had a lot of leverage over what happened when an equity financing occurred. We were doing a relatively small equity financing of about $2 million.

We didn't want as investors that $2 million to go out the door, half a million of it to the convertible debt holders. This particular convertible debt holder, since he had half the convertible debt (he actually had a little bit more than half) he could compel the whole $500,000 of convertible debt to do whatever he wanted it to do.

He didn't like the terms of our financing. He thought that we weren't paying a high enough price. He thought as a result, the amount of equity that he was getting for his debt was too low. We thought that we were paying a fair price. We actually thought relative to the entrepreneurs the amount of equity he was getting was ridiculously high. We weren't very sympathetic to his point of view as new investors. He wasn't very sympathetic to our point of view. The people that got squeezed in the middle were the founders who were trying to get a financing done.

This convertible debt holder because of the way the convertible debt was written, essentially had a blocking right on any financing. He had to consent to a financing to have the financing happen. He used that right to hold up the financing. Ultimately, what the entrepreneurs did was they gave him some of their equity just to get the financing done.

It wouldn’t have mattered if we had given a higher evaluation because again his debt was converting. It was more that he just wanted more ownership post-deal than what he was getting relative to how everything worked out. He used the convertible debt and the fact that he controlled it to force that negotiation with the entrepreneurs.

We walked away from that financing. We actually said, “We’re out. We’re not doing it.” The company would have likely failed. The entrepreneurs wanted to do the financing so they figured out to get a deal with that debt holder that worked.

The story had a happy ending. The company ended up getting sold a couple of years later. Everybody including the entrepreneurs, us, and the convertible debt holder made plenty of money. It was a situation that was unbelievably and unnecessarily tense because of the behavior of the debt holder and the amount of control he had over the company.

Another example was a situation with convertible debt where the company failed. The company was in a situation where it was insolvent. It had the debt plus it had run out of money. It had spent all the debt and it had liabilities greater it. What had happened was that the founders hadn’t paid close attention to paying their payroll taxes along the way.

The convertible debt put them into a zone of insolvency earlier. When the company failed and they tried to wind down the company, the creditors came after the founders personally. There was no board. It was just the founders. They came after the founders personally. They ended up having to go out of pocket for what amounted to $25,000 or so to pay some taxes.

In the situation where there had been equity, it would have been unlikely that that would have worked, that they would have had to pay those taxes because the company would have failed and they wouldn’t have had to pay the payroll. The dynamic around it was because it was debt the creditors were able to do that and from a legal perspective they got hung up in it.

There are some situations where understanding the rules of failure and understanding the leverage dynamics around debt are important. They are quite different on those bad cases of equity. It doesn’t happen very often. When it does happen it can be really uncomfortable.