Earlier, Jason discussed the discount as a way for investors to get some additional economics. Now we're going to talk about warrants, which another way for investors to get basically the same thing but using a more complicated mechanism.

Clint: What's a warrant?

Brad: A warrant is a type of financial instrument that allows an investor to sometime in the future pay some money and get a share of stock for the amount of money that they paid. You're setting the price today but you're giving the investor time in the future to what's called "exercise the warrant," which effectively means buy the share.

This may sound similar to something we talked about earlier, which is options. Warrants and options are very similar. They have some mildly different characteristics. Options generally go to employees. Warrants generally go to investors. Not always. It doesn't always have to be that way. From a purely legal perspective, again, some structural things around it.

In the context of a convertible debt financing, a warrant is used to give the investor some equity characteristics of the debt, which essentially gives them a discount off the next round of financing. A typical way to think about it is you could give the investor a discount of 20% off your next round of financing. If the financing gets done at a $5 million evaluation on a pre-money basis. Let's use pre-money so it's easier. A 20% discount off of that would be that the investors money converts at a $4 million pre-money evaluation.

You could give the investor warrants that represent 20% of the amount of money that they put in the round. As a result of that, they're getting the equivalent of a 20% discount with a lot of little different tricky things in there.

For example, the warrants could be penny warrants, which make them more valuable. The warrants are exercisable at a penny and the investors are basically getting the stock for almost free. The warrants could be exercisable at the price of the next round. In which case, the warrants only have value in the upside and the cost of the warrants is whatever all the other investors are paying for that round.

The warrant itself is often negotiated in terms of that exercise price and the amount in a convertible debt round. Generally, it's relatively easy to figure out the equivalent between a discount and what the warrant value might be.

It's worth noting that sometimes investors will ask for discounts and warrants. Not unlike participating preferred, it's essentially a case of the investor asking for double what they would normally get. Most of the time you see either a warrant or a discount, not both.

Clint: Why would an investor want a warrant instead of a discount? What's in it for them?

Brad: It's a long argued situation. Some investors like the idea of having a warrant because it allows them to have the ability to invest more money in the company and end up with more capital at work. Other investors, for some reason like the construct of the warrant better because if for some reason in the future you have a financing done at a lower price than the warrant has different characteristics around that as well. Generally speaking, there's not that much difference between the two as long as the math lines up.

Clint: If there's not that much difference between the two, should I as an entrepreneur have an opinion about which one is better?

Brad: Between these two I think your goal as an entrepreneur should be to keep your cap table as simple as possible. In the context of that, having a discount is better because really your investor simply gets more shares for their investment than the new investors get because they're getting a discount. If you're getting a warrant, what you do is you end up with this extra thing on the cap table.

As an investor, I get my shares and then I also get these warrants that you have to keep track of that have an exercise price that you have to keep track of that have some term that you have to keep track of. It's just more overhead. If your goal is to keep the financing simple then a discount is better.

Clint: Are there other terms in the convertible note that are worth noting?

Brad: Every now and then you'll run into a couple of other terms in a convertible note. This mostly happens in the context of investors trying to get the convertible note to look more like equity.

Sometimes you'll see a pro rata right, which essentially gives your convertible note investor the ability to invest in the round as well as the note and maintain some pro rata right or a super pro rata right a certain percentage of the financing. The other term that you'll see is some kind of a liquidation preference. Kind of by definition, a convertible note has a liquidation preference because it's still debt and it's going to convert into equity and that equity will almost certainly have a liquidation preference. Sometimes you'll see investors put participating preferences into the convertible note so that when it converts into equity they get a participating preferred instead of just a regular preferred.

You don't see this very often. You often see it I would say with overzealous lawyers or early stage investors who are loading up on all the terms they can get. Generally, as an entrepreneur, especially with the convertible note round the goal should be keep it simple. Try to push these things out of the note because they just complicate things.

The pro rata right is not particularly a struggle. You would normally want that investor to put more money in the round anyway. Like pro rata rights that we discussed earlier with equity, giving somebody a right to a certain percentage of the financing is not nearly as good than just giving them pro rata right where that percentage of the financing is more than what their pro rata right would be. On the liquidation preference side, I've always found liquidation preference dynamics in a convertible note round to be really overreaching and I generally encourage you to push back on.

Student: In general, are notes and warrants transferable at all?

Brad: It depends. I would say that most notes require the consent to be transferred. They don't have explicit language in them that say they can be transferred. For most convertible debt, it's not invisibly transferable. You have to actually have the company consent to it.

In the case of warrants, a lot of standard warrant language has transfer rights built into the warrant language. It's sort of the default forms but other times they don't. It's interesting to pay attention to if you're worried about where the shares end up. It's worth noting that generally the amount that you're talking about is probably going to be a relatively small portion of the company.

Other than the fact that it might get transferred to somebody that you don’t want to have involved in the company, it’s probably not going to be a material ownership in the company.