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Introduction

The economic recovery is upon us, and with investor confidence up, entrepreneurs are successfully raising start-up finance. But this time it's different. Investors are now seeking new, less risky, more profitable and flexible ways to invest in shares. The new preferred solution is called the Convertible Loan Note Instrument. Despite the antiquated name the Convertible Loan Note Instrument can be a simple document that allows the investor to loan money to the venture and later convert the loan into shares. For example, an investor loans the start-up £100,000. Later this £100,000 converts into company shares worth £100,000 with the effect that the company no longer owes money to the lender.

The convertible loan note instrument, or just 'loan note', is a common investment arrangement in the United States and is now gaining major traction in the United Kingdom.

Lets not even talk about valuation

When entrepreneurs are seeking money to fund their venture they strive to put a value on each share. This often leads to lengthy and frustrating arguments. But with the loan note these discussions can be bypassed. Initially the investment can take place by way of loan and valuation of the shares can be postponed to the time of conversion applying a pre-agreed discount factor in the capital growth of the company and until the company has grown and become easier to value. Therefore, it's possible to raise money from friends and family, without having fear of ripping them off with an overzealous valuation. Instead, the valuation can come at a later date when the company is raising money from venture capitalists or more professional investors who can properly allocate the time and resources required to value the company accurately.

This can make a first-round friends and family investing fair and fast.

Other advantages

Circumventing annoying valuation discussions is definitely the greatest advantage of raising money using convertible loans. However, there are several other advantages which I detail below.

Firstly, being a lender to the company places one in a better position vis-a-vis other shareholders if all goes wrong and the company is wound up. Assets of the company are distributed to shareholders last, and this gives lenders to the company a priority on assets available for distribution. Furthermore, depending on how the loan note instrument is drafted it may be possible to call the loan at a time where you see the company struggling and get your money back. This would not be possible with a traditional equity investment in the company.

Another advantage of investing using a convertible loan note is that, like a mortgage, you can take security over the company assets and entrepreneurs generally seem willing to give a charge over company assets in return for loan monies. Security can be taken over a number of different assets, for example:

- a patent or other intellectual property
- a personal guarantee by the entrepreneur, other shareholders or the directors;
- any movable or immovable assets of the company;
- the company's book debts; or
- its possible to take a floating charge over all of the assets of the company

Unlike traditional share investments where the investor must rely on company trading profits to provide dividends, a loan note instrument can carry an interest rate payment. In this way investors can receive monthly payments whether the company is making money or not. This allows the investor to recoup some of his investment and hedge risk against inflation.

One of the final important benefits of the convertible loan note is that it can be drafted with simplicity or with the same level of sophistication as a detailed shareholders agreement complete with minority protections and/or anti-dilution provisions.

Disadvantages of Convertible Loans

The flexibility advantage of the convertible loan comes with the disadvantage of the time consuming and often tricky drafting that is needed to define conversion mechanics. A second disadvantage for UK taxpayers is that the convertible debt instrument does not qualify for the Enterprise Investment Scheme where you can claim back 30% of your income taxes.

Conclusion

Investing via convertible debt has many advantages, particularly during the friends and family round. As the economy heats up there is no doubt that the convertible loan note instrument will become an integral part of the economic recovery for venture capital.

For more information on money raising by way of convertible debt please contact Derek Stinson of SC Andrew LLP.

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