"Who Bears It," Part 2:

Economic Arguments for Allocating Convertible Note/SAFE Dilution

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As previewed in our previous article (see article: "Who Bears It," Part 1: The Option Pool Shuffle), growth equity and venture investors should consider whether they will bear any share of the dilution resulting from convertible notes and/or SAFEs that are converted in connection with a financing. Similar to the negotiation of option pool expansion dilution, the company and new investors often have differing views on whether the dilution from the conversion of notes and/or SAFEs should be borne by the pre-money valuation (i.e., only by the existing owners) or the post-money valuation (i.e., by the existing owners as well as the new investors) of the company.

Although the back and forth in these negotiations may seem to be a simple matter of the preference that each side has in minimizing their own dilution, there are in fact sound economic principles that point to "right" or "wrong" answers in a negotiator's position. The most important of these principles is whether the cash proceeds from the earlier note/SAFE issuance are still an asset of the company and, if so, whether there has been a corresponding increase to the company's valuation to account for that cash (i.e., a balance sheet adjustment).

If the proceeds of the note/SAFE issuance remain on the company's balance sheet and available to support the company's future activities, it would be fair to argue that this cash should simply be treated the same as an additional investment in the financing, given the inherent fungibility of cash (essentially, treating the note/SAFE issuance as a prepaid investment in the financing). However, to the extent the note/SAFE contains a conversion discount (e.g., a fixed discount to the new round and/or a valuation cap), then there is a strong argument that the portion of the note/SAFE conversion that represents the discount should be borne solely by the pre-money owners because the company does not have cash which corresponds to the discount on its balance sheet.

On the other hand, if the proceeds of the note/SAFE issuance have already been spent, it can be properly assumed that in spending these funds, the company has already favorably impacted its prospects, and the company's valuation has taken this into account – as a result, the new investors are already getting a smaller share of the company for their investment (as they are investing at a greater valuation). In this scenario, if the dilutive effect of the conversion were pushed to the post-money owners, it would effectively double-count the note/SAFE proceeds for the benefit of the company (once by increasing the valuation, and again because the note/SAFE would be treated as new money in and dilute the new investors as well). Net, the new investors would be paying more for the company and would also be getting a smaller percentage of the company than they would have otherwise received – an outcome that is both negative and an incorrect on the economic merits.

As highlighted above, there are well-reasoned arguments to test the question of whether the dilution borne by the conversion of notes/SAFEs is the correct outcome, and understanding these arguments can provide you with an advantage in your own negotiations and investments when seeking to optimize their investments in growth equity and venture capital companies.

If you have any questions, please contact your primary attorney at Seward & Kissel LLP or Gary Anderson at anderson@sewkis.com or Eric Buchanan at buchanan@sewkis.com.

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