RW Blears

Comparing Convertibles - Advance Subscription Agreements and Convertible Loan Note Instruments

In our latest 'Fundamentals' explanatory guide, Hannah Cordwell and Bethany Johnson take a look at advance subscription agreements and convertible loan note instruments – two popular fundraising instruments for early stage companies – and their comparative advantages and considerations.

Advance subscription agreements ("**ASAs**") and convertible loan notes ("**CLNs**") are upfront funding options that are commonly used by growth companies as a form of short term 'bridge financing' in contemplation of a future equity round. Both options provide a fundraising company with an immediate cash injection which will, or may, later convert into shares in the company.

ASAs and CLNs tend to become more popular when fundraising conditions are choppy, when companies may find it more difficult to agree valuations that are acceptable to both founders and existing shareholders. Temporary funding from an ASA or CLN allows a company to sustain its business until the next equity funding round without the immediate need to fix a valuation or enter into lengthy negotiations of long-form equity investment documents.

In this article we summarise the key terms of, and differences between, ASAs and CLNs, which companies (and investors) should consider when deciding on the most appropriate funding option.

Before we dive into the detail on ASAs and CLNs, it's worth noting that investors may also come across SAFE ('**s**imple **a**greement for **f**uture **e**quity') and KISS ('**k**eep **i**t **s**imple **s**ecurity') agreements. The SAFE was created in the US by the *Y Combinator* in 2013 and, although not the same, it is often referred to as the US version of an ASA and is considered a founder-friendly form of financing. KISS convertible notes were created by *500 Startups* as an alternative to the SAFE, and unlike the SAFE, include investor protections. Both the SAFE and KISS have been developed for use in the US market (incorporating US legal terms), and we would advise exercising caution when using in respect of an investment in a UK company.

What is an ASA?

An ASA is a bilateral short-form agreement between an investor and a fundraising company pursuant to which an investor makes an advanced payment to the company in exchange for the right to be issued shares at a later date.

It is usually agreed that those future shares will be issued at a discount (typically around 20%) to the agreed price per share payable by other investors at the next funding round, provided that an agreed funding target is met. Sometimes a valuation cap is agreed, which should represent an optimistic estimate of the valuation the company might reasonably expect to achieve for the next funding round – this is included to protect the investors from discounting into an unusually high valuation that they would never have agreed to.

If, by a specified longstop date (usually 6-12 months from the date of the ASA), there has been no funding round meeting the target size, the advance subscription funds will automatically convert into shares on that longstop date. The price to be paid for those shares is typically calculated by reference to a floor price (often the post-money valuation from the last round, if recent enough, or an estimate of the valuation at the date of the ASA).

Money invested via an ASA is technically a pre-payment, not a debt; the amount does not generate interest and cannot become repayable in cash, which has clear advantages for fundraising companies.

ASAs can be preferable for start-ups and investors alike because, unlike CLNs, they may be eligible for tax advantages under the Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS), provided that certain conditions will be met at the time of conversion into shares. As a result, HMRC take the view that the longstop date should be no more than six months from the date of the ASA, due to the likelihood of changes to the business in any longer period. Legal advice should always be sought if an investor is looking to obtain S/EIS relief to ensure that the ASA is structured in a S/EIS compliant way.

What is a CLN?

CLNs are debt instruments whereby the principal amount (and usually any accrued interest) will convert into shares in certain prescribed circumstances. Similar to ASAs, a CLN will usually convert into shares at the valuation achieved at the next qualified funding round or at a discount to that valuation (typically 20-30%).

If the company does not achieve a 'qualifying' funding round prior to the maturity date of the CLN or if there is otherwise an event of default or sale of the company, the CLN will become repayable to the investor in full and together with any accrued interest. The CLN may include an option for only part of the loan to convert into shares, with the rest being repaid in cash.

Additional protections for investor note holders can be provided in CLNs, which are not available in ASAs. These can include (amongst other things) (i) the ability for the debt represented by the notes to be secured over the company's assets; (ii) operating/restrictive covenants (iii) an adjustment event provision (anti-dilution); and/or (iv) a redemption "premium" should the debt reach maturity without a conversion event having been achieved. Such protections are typically bespoke provisions, tailored to the specific circumstance of the company and the bargaining power of the parties.

CLNs can be structured as transferrable instruments, but any transfer of CLNs issued by a UK company will be subject to UK stamp duty.

Other key legal terms of ASAs and CLNs

Conversion shares – usually, the ASA or CLN will prescribe that the funds shall convert into the "most senior class of shares" issued in the capital structure. Note however that if the ASA is S/EIS qualifying, they must be ordinary shares.

Warranties – ASAs will usually only include very short form warranties given by the company, limited to the company's ability to issue the shares. CLNs may include a fuller set of warranties covering compliance with law, IP ownership and litigation, but the warranties are generally only confirmatory in nature (ie., no disclosure) and are simple in form when compared to the warranties you would typically find in an equity investment agreement.

Most favoured nation (MFN) – investors may request that an MFN clause is included, which provides that, if the company issues another ASA or CLN (as applicable) to another investor on better terms (e.g., higher discount), the prior investor should be notified and have the right to benefit from those better terms as well. This is an investor-friendly position but is not normally contentious, as it ensures equality amongst the company's investors. However, it does add complexity to a process if there are multiple investors negotiating different terms for themselves.

Rights in the priced equity round – given the ASA and CLN investors are "passive", they may insist on particular rights in the priced round documentation such as a board observer seat, major investor status (for information rights, pre-emption rights etc) and subscription rights before conversion if there is a non-qualifying equity round.

Corporate approvals required prior to the issue of ASAs and CLNs

Although less onerous than the process for approving a full equity round (which would include the adoption of new articles of association), some corporate approvals will be required to approve the entry into ASAs or CLNs with investors. The board of the company should approve entry into the funding documents and depending on the shareholder base, and whether there is an existing investment or shareholders' agreement in place, some shareholder approvals may also be required before the rights to subscribe for shares are granted. This is often overlooked and may need to be factored into the timetable.

What are the drawbacks?

We have touched on the advantages of using ASAs or CLNs for fundraising, but it's also worth raising a few potential drawbacks.

Although there is typically far less negotiation than on a fully priced equity round, some immediate negotiation is sometimes required, particularly if a valuation cap or floor conversion price needs to be agreed. Valuation caps and deep discounts can also have negative consequences, potentially deterring investors in future funding rounds and driving down valuations for future rounds, as investors may not want to invest at a significantly higher price than the discounted ASAs or CLNs.

Whilst investors and fast-growing companies may be attracted to ASAs and CLNs to avoid the need for immediate decision-making, there is potential for ambiguity and the need for re-negotiation down the line.

ASAs v CLNs: A snapshot of the takeaways

	ASA	CLN
Structure	Equity only. There are no rights of repayment.	Debt instruments. Note, therefore, that investor note holders rank ahead of shareholders on a liquidation.
Document	Short form document that requires minimal negotiation. If the ASA is intended to be S/EIS qualifying, advice should be sought.	CLNs are usually longer and require more negotiation.
Are funds invested repayable?	No.	Yes, provided the CLN has not already converted.
Interest bearing?	No.	Usually (but not always). CLNs can be issued as a 0% (discounted or non-discounted) CLN. Where interest-bearing and term is longer than a year, care should be taken as to whether withholding tax will apply on any interest payments by the borrower.
S/EIS Relief?	Yes, provided strict requirements are met including: • Longstop date of 6 months maximum. • No loan element. • No downside investor protection. • No variation.	No.

Hannah Cordwell and Bethany Johnson
RW Blears LLP
4 December 2023