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What Startups Should Know About Lender Warrants

By Aaron Sokoloff

Venture debt can be a powerful resource for early stage companies, allowing them to access significant capital without the dilution of ownership that comes with equity financings. However, venture debt deals do often include an equity component: the lender will often receive a warrant to purchase stock of the borrower, so as to get some upside in addition to receiving interest payments on the loan itself.

The term sheet for the venture debt transaction may only spend a sentence or two describing the warrant, and the warrant is typically a much shorter and simpler document than the loan agreement. However, certain terms in a lender warrant can have unexpected consequences for the borrower. Here are some issues that borrowers should be aware of in lender warrants:

- **What happens to the warrant in a sale of the borrower?** From the borrower's perspective, it's important that the warrant automatically terminates in a sale of the borrower. Such an "automatic termination" provision will usually allow the lender to get cashed out if the warrant is in the money when it terminates. If there is no "automatic termination" provision, then the buyer may require the borrower to go back to the lender to terminate the warrant, which could put in the lender in a "holdup" position, and which can be particularly frustrating for the borrower if the loan has already been repaid and the lender's remaining economic stake in the borrower is relatively small. Alternatively, while this is an unusual outcome, the warrant can continue to remain outstanding after the sale closes; the complexities of that scenario are beyond the scope of this article but suffice it to say that companies typically prefer to avoid that situation altogether by ensuring a lender warrant contains an "automatic termination" provision.

- **What kind of stock is the warrant exercisable for?** The warrant will often be exercisable for shares of either Common Stock or an existing series of Preferred Stock of the borrower. If the warrant is going to be exercisable for a future series of stock (for example, the series of Preferred Stock that the borrower issues in its next equity financing), the borrower should take care that this is clearly defined, and should also understand what happens if the future series of stock never comes into existence (for example, if the borrower is sold before undergoing another equity financing). If the warrant is vague, or allows the lender to elect what type of stock the warrant is exercisable for, it can create uncertainty on the borrower's cap table, which can in turn make it difficult to price the borrower's stock in future financings.

- **Stockholder-type rights.** Sometimes, a lender will require that its warrant contain rights that are typically associated with Preferred Stock, such as information rights (separate from the information rights the lender may have under the loan agreement), registration rights, or rights to participate in future financings, which create a variety of compliance obligations for the borrower. Depending on how the loan agreement is drafted, the failure to comply with a term under the warrant may result in a default under the loan agreement. Thus, the borrower should be aware of additional obligations under the warrant, and keep in mind that a warrant does not exist in a vacuum, but may have consequences with respect to the underlying loan agreement.

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