



Initial and Early Round Financing: Convertible Notes

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Convertible debt (identified in market parlance as “convertible notes” or “bridge notes”) is a common strategy for initial and early stage financing for startup companies. Convertible notes are loans with the right of the holder to convert the debt into equity when the startup consummates a subsequent equity financing (a “qualified financing”).

Convertible notes are used for initial smaller funding rounds that do not justify the costs of negotiating and documenting a preferred equity round. The financing may also defer the more detailed and complex discussions of valuation to the qualified financing. The more detailed provisions demanded from equity investors such as protective provisions on future corporate action, anti-dilution protections, board seats, information rights, or rights of first offer on future financings are typically not included in convertible note financings.

To compensate the investor for the risk of investing in the earlier round, convertible notes often include conversion discounts and/or valuation caps that permits the investor to participate in the later qualified financing on terms more favorable than the new investors in the qualified financing. The conversion discount permits the note holder to convert the principal amount of the note loan (plus any accrued interest) into shares of preferred stock at a discount to the per share purchase price paid by investors in the qualified financing. Discounts range from 0% to as high as 35% with 20% being common.

A valuation cap assures the investor that the note will convert based on a valuation which is the lower of the cap amount set forth in the note or the pre-money valuation upon which the qualified financing is priced. For notes that include both a valuation discount and a cap, the note will typically specify that the conversion price will be the lower of the price per share determined by the discount to the qualified financing price per share or the price per share determined by dividing the valuation cap by the company’s fully diluted capitalization immediately prior to the qualified financing. The investor receives the better of the two possibilities (lower conversion price per share means that the note converts into more shares in the qualifying financing). The valuation cap appropriately prices the equity value of the business at the time of the investment, although it often includes a projection of the valuation range of the qualified financing.

Convertible notes generally pay the holder interest at anywhere from 2% upwards to 5%, with the lower part of the range more typical. The investor, however, is not generally looking for a cash flow that the startup needs instead to build the business.

Unlike an equity security, a convertible note must be repaid on its maturity date with unpaid accrued interest if it has not been converted to equity. Notes generally have a maturity date of 12 to 18 months. Most investors, however, view convertible notes as an investment, and have only a limited expectation that the debt will be paid back. However, the maturity date and the debt-nature of the note are often responsible for exerting pressure on founders to find a qualified financing perhaps at the expense of losing focus on building value in the business. In practice, in most situations, investors will not call for a note to be repaid at the maturity date, and will instead amend the note to extend the note’s maturity date, typically for a period of another year. The investor is in a tough position. If the startup cannot complete a qualified financing (or another financing to allow repayment), it may have burned through the proceeds from the convertible notes and may be technically bankrupted. Even if there is excess cash to enforce payment, by providing the founders more time to find financing or an acquisition, the investor preserves its investment stake and upside option. One alternative for the startup is to permit the investor to convert the debt into equity at a predefined price (or valuation) if an equity financing has not been consummated by the maturity date.

A startup on an accelerated growth curve and/or with valuable intellectual property may be a target for an acquisition before consummating a qualified financing. Without protection the investors who took an initial risk in financing the startup could lose out on the appreciated value of the business. Convertible notes will delineate what is to occur on a “change of control” of the business (generally defined to include a merger, sale of substantially all the assets or a transfer in excess of 50% of the voting power). The most favorable outcome for the founders is to accelerate payment of the principal and accrued interest on the note and repay the investor. Investors may demand, however, that on or prior to a change of control the note convert into common shares at a pre-set price or the price per share as determined in the change in control transaction, or sometimes at the lower of the valuation cap or the change of control value per share. Another approach is for the note



holders to be paid back their principal plus interest, plus a premium amount, generally 0.25-3x. Still other note terms give the note holder the option of choosing between such outcomes.

This is only a brief summary of some of the issues involved with convertible notes. There are some other methods to reduce the impact of note conversation discounts and valuation caps. Moreover, other strategies including seed preferred many offer more efficient means at reduced legal costs to achieve or exceed the objectives sought with a convertible debt financing. Therefore, consultation with an experienced advisor is highly recommended before embarking down the road of a convertible note structure.



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