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For Attorneys Advising a New Tech Startup: The Basic Terms of a Convertible Note Offering

By Brenton Twitchell

The Basic Terms of a Convertible Note Offering

There are many possible variations and tweaks, but the following are considered to be the basic terms.

Aggregate Subscription Amount

The aggregate subscription amount is the amount of money the company hopes to raise in the offering. Offerings can range from a couple hundred thousand dollars to a couple million dollars. Knowing the aggregate amount helps investors measure the risk of default. If a startup is taking on a ton of debt that will be due in 1-3 years, depending on its business model and plans, it may be more likely to fail. In conjunction with other disclosures, it helps investors gauge the desirability of the investment.

It's also typical to set a minimum offering amount. This is the "floor" of the offering. If the startup raises less than the minimum offering amount during the offering period (see "Offering Period" below); it will refund the money of anyone who had invested. This is something investors want because it protects them from losing all of their money. Essentially, the startup is saying that if it can raise at least the minimum offering amount and it will have received enough capital to create value for its investors. How would you feel if you invested $50,000 in a startup looking to raise $4,000,000, and over the course of the year-long offering period it could only raise $200,000? You'd probably want your money back, and in a hurry, because clearly you missed some fatal flaw that everyone else saw in the disclosure documents, and $200,000 will not allow the company to accomplish even its most minimal business objectives.

Another typical feature is a minimum individual investment amount. Every additional investor represents one more person who may have questions or concerns (before and after investing), one more person who needs paperwork and records, one more person who may become irritated with the startup's progress or management, etc. To ensure your client only gets serious investors, who can be less of a hassle, you want to set a minimum investment amount. For example, you'd require investors to put in $50,000 at a minimum. When someone is investing $50,000, they have typically done their homework and genuinely believe in the mission of the startup.

Offering Period

The offering period is the designated period of time in which the startup will attempt to raise the aggregate offering amount. It's typically 6 months to 1 year. Depending on the startup's need for capital, the startup can arrange for multiple closings as investments are made (after the startup has raised enough money to satisfy the minimum offering amount). In other words, the startup doesn't have to wait until the end of the offering period to receive investor funds.

Maturity Date

The maturity date is when the convertible notes are due. For administrative simplicity, and to prevent a situation where new investors are paying off "old" investors (who invested at the beginning of the same offering round), all of the convertible notes have the same maturity date. Typically, convertible notes will mature 18 months to 2 years from the start of the

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offering period. The term of the notes can be longer, but it's rarely shorter than 12 months. This is because any period of time shorter than 12 months is usually too short to enable the startup to use the capital to create something of value and put together a round of equity financing.

Interest Rate

The interest rate is typically 4-8%. As mentioned previously, investors aren't investing to get this return. Usually interest isn't paid over the term of the loan because startups don't have the cash flow to make these kinds of payments. Instead, interest accrues over the term and either becomes payable on maturity or converts into an eligible equity round (see "Conversion Features" below).

Prepayment

A prepayment isn't usually allowed, unless the majority of investors, by dollar amount, consent to it. This is because a prepayment more or less defeats the entire purpose of making a convertible note investment because it takes away the potential upside. Again, convertible note investors aren't investing because they like the note's interest rate.

Conversion Features

Conversion features are where the money is, so understandably this is the area of primary concern for investors. These provisions determine how the note investors will share in any upside. There are a number of different ways to configure a convertible note's conversion features. The following are the most common options:

> **Mandatory Conversion** – If the startup raises a certain threshold amount (e.g., $2,000,000) in its next offering of an equity security (e.g., an offering of Series A Preferred Stock), and it raises the money during the term of the convertible notes, then the convertible notes will automatically convert, at a discount, into the type of equity security issued to the investors in the equity financing. The type of offering that would trigger a conversion (i.e., raises the threshold amount) may be called a "qualifying offering" or "eligible equity financing."
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> The threshold amount is typically a large number, like $500,000 or more. This is because it's unlikely one of the founders would have a relative willing to invest $500,000 to help the startup put one over on its convertible note investors. If there was no threshold amount, or if it were too low, then said relative could buy one share of preferred stock at $1,000 and convert all of the convertible note debt into a paltry amount of equity. This is because convertible note debt (principal plus accrued interest) usually converts into equity at a price per share equal to 70% to 80% of the price paid by the new investors for, say, Series A Preferred Stock. That 20% to 30% discount to the Series A Preferred Stock price is to compensate them for being early investors (see the example below).
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> EXAMPLE: Suppose an investor in a startup bought a $200,000 convertible note, the note bears an 8% interest rate, matures in 2 years, and automatically converts at a 25% discount if the startup raises $2,000,000 in a qualifying offering during the term of the note. Now, let's suppose the company raises the $2,000,000 in a Series A Preferred Stock offering a year later, and the equity investors are paying $1.00/share for 2,000,000 newly issued shares of Series A Preferred Stock. At the year mark, the startup owes the note investor $200,000 plus $16,000 in interest. Thus, the investor's $216,000 converts into Series A Preferred Stock as follows: $216,000/0.75 (because of the 25% discount on the $1.00/share price the equity investors are paying) =

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288,000 shares. A normal Series A investor would pay $288,000 for 288,000 shares. Incorporating our founder's corrupt relative situation from the previous paragraph, without the threshold amount, when the bad relative pays $1,000 for 1 share, the note holder would receive a mere 288 shares in the same startup.

Voluntary Conversion – If there is a provision allowing for voluntary conversion, it typically allows the majority of note holders, by dollar amount (e.g., if there are 3 investors, 2 invested $50,000 each and 1 invested $200,000, then the 1 could elect to convert all 3 notes even if the other 2 didn't want to convert), to convert their notes into shares of common stock at a conversion price equal to a certain pre-money valuation that is fixed. The valuation here is a somewhat arbitrary number. This type of provision is attractive to note investors because it protects them in the event the startup decides it doesn't need to raise money in a future equity offering. It allows the note investors to participate in upside.

EXAMPLE: Assume the same facts from my example in "Mandatory Conversion Features" above, except the startup has decided it doesn't need to raise money in an equity round. If there wasn't a voluntary conversion feature, the note investor would receive his 8% return, or $232,000 in total, at the end of the two years, but nothing more. Now let's suppose he can voluntarily convert his notes into equity at a $3,000,000 pre-money valuation and there are 5,000,000 common shares outstanding. $3,000,000 divided by 5,000,000 = $0.60/share. Thus, if our note investor converted one year from buying his notes, he would receive $216,000/0.60 = 360,000 shares.

Valuation Cap – This feature allows investors to convert into equity at the lesser of the valuation cap or the price in the subsequent qualifying offering (as described above in "Mandatory Conversion Features" above). The valuation cap operates a lot like the voluntary conversion feature described above in "Voluntary Conversion" above. It's a valuation that is divided by the aggregate number of outstanding shares of the Company's common stock. A valuation cap can result in an investor converting into a greater number of equity shares than he otherwise might have, especially if the startup does a priced equity financing round that has a high pre-money valuation (i.e., above the cap). In essence, valuation caps protect investors' "upside risk" by setting a floor on their purchase price. This is why valuation caps can annoy venture capitalists: the more money they pay, the better the note holders do.

EXAMPLE: Suppose an investor has purchased a $200,000 convertible note from a startup. Let's suppose the convertible note converts upon a $1,000,000 qualifying offering, there is no conversion discount, and there is a valuation cap of $5,000,000. Let's also suppose that there are 5,000,000 outstanding common shares and the startup raises $2,000,000 as part of a qualifying offering of Series A Preferred Shares on a $10,000,000 pre-money valuation. The Series A investors are paying $2/share. Without the cap, the note investor would be receiving $200,000/$2 = 100,000 shares (again, assuming no discount). With the cap, the note investor receives $5,000,000 cap/5,000,000 shares outstanding = $1/share, so 200,000 shares. Without the cap, the investor would have received half as many shares, which makes sense given the valuation cap was exactly half of the pre-money valuation in the qualifying offering.

Change in Control – If a startup is acquired before the convertibles notes' maturity date, the note investors are at risk of being treated unfairly if there isn't a provision in the note that accounts for this situation. Instead of participating in any upside (presumably the startup is being acquired because it has value), the notes are either paid off immediately as part of the deal or the acquirer waits until maturity to pay them off in cash. For this reason, it's typical for investors to want a provision that gives them the option to receive payment upon demand at the closing of an acquisition and/or allows them to redeem their notes for a payment equal to the amount each note holder would have received had the note converted into preferred stock prior to the transaction (if a financing is pending) or common stock at a fully-diluted pre-money valuation of a certain amount, which would then be paid from the cash/stock received by the equity holders.

Conclusion

Acknowledging that all terms are important and should be carefully considered, the conversion features are really the meat of any convertible note deal. When it comes to conversion terms, your client needs to be realistic and strategic. A word of caution: The conversion features and investor protections summarized above have become fairly standard features in most convertible note deals: Investors expect to see them and will be wary if they aren't present.

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