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For Attorneys Advising a New Tech Startup: An Introduction to Convertible Notes, What They Are and Why You Should Consider Using Them

By Brenton Twitchell

What are Convertible Notes?

A convertible promissory note is a debt instrument that is convertible into equity at a future date. The conversion can be structured to occur automatically upon the occurrence of a certain event and/or at the election of the holder/investor. The all-important conversion features aside, a convertible promissory note is not all that different from a normal promissory note: there is a principal sum, an interest rate, and a maturity date.

Why Convertibles Notes?

If your client is no longer able to "bootstrap," it can raise capital in a number of different ways. Each method of raising capital has its pros and cons, and a convertible note offering is no exception. It is always the case that you should clearly understand your client's business, its specific capital needs, and its expectations before you recommend a particular form of financing. That said, a convertible note offering is one of the most commonly used early-stage financing devices because it offers startups some distinct advantages.

For starters, a convertible note offering is comparatively cost effective because the deal documents are relatively concise and easily prepared. The typical core offering documents include:

(1) a term sheet (summarizes the most significant deal terms in outline form);
(2) a convertible promissory note;
(3) a subscription/note purchase agreement (includes representations and warranties of the startup); and
(4) a private placement memorandum.

The preparation of these documents requires close coordination with your client, but isn't technically difficult.

Second, a convertible note offering doesn't require a valuation. It's hard to value a company during its beginning stages. Usually a startup has no revenue, no demonstrable proprietary technology, no sales, etc., so there is no objective way to measure its value. A convertible note offering allows a startup to kick the valuation can down the road to when it has built something of value (i.e., when it has a basis for valuation and can start looking to raise money through an equity offering).

Third, investors in convertible notes aren't expecting to be "repaid" at the maturity date. Investors are hoping that the startup will be successful and that their debt will convert into equity that is worth a lot more than their principal plus the "measly" interest they are promised in their note. For this reason, convertible notes typically aren't secured (mostly because there are no meaningful assets to be used as collateral) and there are no personal guarantees on the part of the startup's founders. If the startup goes belly up, convertible note holders are creditors and have priority over equity holders (i.e., the founders) when it's time to divide up the startup's assets. Unlike a bank loan, which is commonly personally guaranteed, the founders aren't personally on the hook.

Fourth, investors in convertible notes don't typically get control provisions (e.g., blocking rights on a sale or future financing) or board seats. Investors in equity rounds, especially VC firms, typically ask for these sorts of things.

Conclusion

In summary, because convertible notes provide some distinct advantages over a bank loan or an equity offering, they merit serious consideration. Convertible notes, however, aren't without some disadvantages. *See* For Attorneys Advising a New Tech Startup: Disadvantages of Convertible Notes.

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