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Structuring and Negotiating a Convertible Note Offering

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Early stage companies often raise money from friends and family and angel investors in order to launch their businesses or bridge the gap to a larger raise. These companies sometimes assume the advisable financing structure is to sell stock. One of the key considerations in structuring a stock financing is how much equity the company will sell in order to raise the necessary funds. This depends on the valuation assigned to the company at the time of the financing. In the case of a startup, the valuation typically is low compared to the valuation the company hopes to achieve in the future. The lower the valuation, the more stock the company will need to issue in order to secure funds. When faced with a need for capital in order to launch or hit key milestones, many companies do not feel they have a choice but to give up a significant ownership stake to investors.

One method of raising funds without selling stock is to issue convertible promissory notes to investors. Although a debt instrument, a convertible promissory note converts to stock at a later date upon the occurrence of certain specified events; typically the closing of a larger capital raise where the company sells stock. The price per share on conversion would be determined based upon the valuation assigned to the company in this "triggering financing." A convertible promissory note offering allows companies to defer the valuation process and avoid issuing stock at a low valuation.

A convertible promissory note offering also is typically less expensive and less time consuming than a stock financing. Stock financings, and particularly preferred stock financings, require companies to negotiate and document complex terms, including liquidation preference, anti-dilution protection, registration rights, board representation and other protective provisions for investors. Legal fees are higher than a convertible note offering because multiple transaction documents must be negotiated and drafted, including stock purchase agreements, amendments to charter documents, stockholder agreements, voting agreements, registration rights agreements and other related documents. Convertible promissory note offerings typically require only the negotiation of the terms of the promissory note which eliminates the expensive and time-consuming documentation process.

The following discussion highlights the primary terms of a convertible promissory note offering and particular issues for companies to consider in structuring such a transaction.

Triggering Financing

A triggering (or "qualifying") financing is an equity financing that occurs subsequent to the issuance of a convertible promissory note, where a stated minimum amount of capital is raised. Upon a triggering financing, all principal and interest under the convertible promissory note converts to stock based upon the valuation of the company assigned at the time of the triggering financing. Most commonly, the conversion is "automatic," meaning the investor does not have the ability to seek repayment of the loan at the time of the triggering financing, but must convert the note to stock.

A company should be careful to set the triggering financing high enough so it can be assured it will have sufficient time to achieve milestones and build valuation. If the triggering financing is set too low, a convertible promissory note will convert prior

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to the time the company will have built value. The amount of the triggering financing also should exclude the value of the convertible promissory notes to be converted, so as to not artificially lower the amount of funding required to trigger conversion.

Maturity Date

The company should set the maturity date of a convertible promissory note conservatively to ensure it will have the time to build value, and close on the triggering financing prior to the repayment obligation on the note. Setting the maturity date too soon pressures the company to close on a triggering financing prior to building its value, which would result in selling stock at a lower valuation than anticipated or desired.

Often, convertible promissory notes will provide that if the triggering financing has not occurred by the maturity date, the investor may choose to seek repayment or convert all principal and interest on the note at a set valuation – typically, an estimated valuation at the time the note is issued. In a forced conversion by the investor, the result of setting the maturity date too soon is the company will be forced to issue stock at a low valuation, which is the result meant to be avoided by the convertible note structure.

Without the forced conversion mechanism, the investor will have a choice whether to seek repayment or extend the note. Because the company likely will not have the funds to repay the note at that time, rather than forcing the company into bankruptcy the investor often will agree to extend the note but only in exchange for further concessions.

Interest Rate

The typical interest rate for convertible promissory notes is between 7% and 10%. In the most common structure, all principal and interest is paid at maturity. In the event of conversion, accrued interest would convert along with the principal into stock.

There are usury laws that limit the amount of interest that can be charged. In California, unless a loan is exempted from the California Usury Law, the maximum annual percentage rate cannot exceed the higher of (i) 10% per annum, or (ii) 5% per annum in the excess of the rate prevailing on advances by the Federal Reserve Bank of San Francisco to member banks on the 25th day of the month prior to the earlier of (i) the loan at issue, or (ii) the date of a written commitment to make the loan.

Exemptions from the California Usury Law include: (a) a loan of \$300,000 or more, or a loan as part of a commitment to lend \$300,000 or more, provided certain other requirements are met, and (b) the issuer of the indebtedness has assets of at least \$2,000,000 and certain other requirements are met.

Conversion Stock and Conversion Discounts

All principal and accrued interest on a convertible promissory note usually converts into the same class of stock issued in the triggering financing, and on the same terms of such financing. That means convertible promissory note investors often receive preferred stock, with preferred terms, because these investors essentially tag along with the larger investor(s) in the triggering financing.

More often than not, convertible note investors receive a discount to the valuation assigned to the company in the triggering financing. This results in a correlating discount to the price per share paid by investors in the triggering financing. For example, if the valuation of the company at the time of the triggering financing is \$5,000,000, a convertible note investor with a conversion discount of 20% will have his principal and interest convert as if the valuation of the company were \$4,000,000. Put another way, if the price per share to the investor in the triggering financing is \$1.00 per share, a note holder with a 20% conversion discount will pay \$0.80 per share. As a result, the note holder, upon conversion, will receive more shares (and, hence, a higher ownership percentage of the company) than if he directly invested his money in the triggering financing.

A typical conversion discount ranges between 10% and 25%, although it is possible in some situations to have conversion discounts of up to 50%. If there is a clear, and relatively short and certain path to the triggering financing, the conversion discount should be lower than if the company has a long runway to the next financing and/or if that triggering financing is uncertain. Some convertible note financings provide that the conversion discount increases over time, so that if the company secures the triggering financing quickly, the investor does not get what could be considered a windfall for just a short term loan.

Conversion Caps

A “conversion cap” provision provides that upon a triggering financing, the investor will convert at the option of the investor into stock at a valuation that is the lower of (a) the valuation after applying the conversion discount, or (b) a pre-set valuation. The pre-set valuation would be based upon a premium to the estimated valuation of the company at the time of the convertible note financing. The conversion cap is a method of ensuring early-stage, convertible note investors are rewarded for their early-stage investment. If the triggering financing does not occur for quite some time, or until the company’s valuation has substantially increased, a discount to the triggering financing may not be attractive to convertible note investors.

Companies are wise to insist that the conversion cap mechanism require the investor to convert into the company’s common stock. That is, if the investor chooses to convert based on the pre-set valuation rather than the triggering financing valuation, he or she must convert to common stock. The reason for this is due in large part to the liquidation preference afforded to the preferred stock issued in the triggering financing. The liquidation preference provides holders of the preferred stock a preferential return on a sale of the company. For example, if the company is sold for \$5,000,000 and the holders of the preferred stock owning 20% of the company collectively have a liquidation preference of \$3,000,000, the preferred stockholders are paid their \$3,000,000 before the holders of common stock receive anything. As a result, holders of common stock (including founders and employees) would not receive what they might typically expect on a liquidity event.

If the conversion cap allows convertible note holders to convert to preferred stock at the pre-set valuation, which is lower than even a discount to the valuation on the triggering financing, more preferred stock will be issued to the note holders, thus disproportionately increasing the amount of the liquidation preference.

“Selling” a Convertible Note Offering

Investors presented with a convertible promissory note offering often request that the company instead allow them to buy stock at the current valuation. From the investor’s perspective, they sometimes would rather “buy-in” at today’s, presumably low, valuation than wait until milestones are met with their money to buy-in at the valuation achieved through the use of their funds. While the conversion discount attempts to compensate for this, investors may not view this as preferable to investing at the startup valuation.

In response, companies can explain that the convertible note structure gives investors a “free look” at the company. Because a convertible note is a loan, and not a purchase of stock, if the company is unable to gain enough traction to close on a financing that equals or exceeds the amount of the trigger, the investor can have the principal and interest on the note repaid. Perhaps more convincing is that a convertible note structure allows small investors to acquire preferred stock rather than common stock. Most early stage, small stock financings through angels or friends and family involve the issuance of common stock, which will be junior in rights, preferences and privileges to the preferred stock issued later. By having an instrument that converts to preferred stock, these small investors will be able to invest along side the larger investor who has the leverage to obtain more beneficial terms for the preferred stock of a company.

John Cleary specializes in corporate and securities law, with an emphasis in representing companies seeking financing for their businesses through seed capital, venture capital, PIPE financings and public offerings. Mr. Cleary also regularly assists clients in mergers and acquisitions, advising both privately held and publicly traded companies in transactions involving the sale of assets, sale of stock, mergers, joint ventures, licensing, strategic alliances and other business combinations. His practice includes general corporate transactions and counseling, and he acts as outside general counsel for numerous local companies. He can be reached at john.cleary@procopio.com or 619.515.3221.