Convertible Note Decision Tool

A very simple convertible note will contain the following basic provisions:

1. Term – when does the note mature? This is usually 18 months to five years. In Silicon Valley deals, it is rarely more than two years. This can be stressful because the pressure is on to raise equity before the end of the convertible note term.
2. Interest rate – this is usually simple interest calculated annually – it generally is not paid in cash to the investor, but accrued. Another thing to consider is whether you want accrued interest to automatically convert into equity or would you rather pay the interest back in cash?
3. What triggers a conversion of the note balance to equity? The trigger event is usually when the company raises equity investment at or above a certain amount. Raising that amount will generally trigger the conversion of the convertible notes (both principal and possibly accrued interest) to equity automatically.
4. What is the conversion discount? In exchange for the risk they take by investing in the hopes that they will be able to get equity in the future, convertible noteholders generally get a discount on the price of the equity they purchase when their note converts. This is usually a ten to twenty percent discount on the price that the equity investors pay.
5. What happens if the conversion trigger doesn't occur before the note term ends? This usually will mean that the principal and accrued interest become due and payable on the maturity date. However, some convertible notes either require or provide the option for the principal and interest to convert into common equity instead at a pre-determined price.
6. What happens if the company is sold during the term of the note? There are various ways that this can be handled. It is common to provide the investor the option to be paid back or to convert into shares of the surviving entity.

There are a lot more variations that can be included in a convertible note. For example, professional Silicon Valley investors will often want a "valuation cap" included in the note. This means that when the company raises equity, the price paid for the equity by the convertible note holders is the lower of (1) the discounted price discussed above (usually a 10-20 percent discount) and (2) the price they would pay if the company was valued at the valuation cap at the time of the conversion. This can result in a very big windfall to the noteholders if the equity investors agree to a valuation that is much higher than the valuation cap.

You can also get creative with what triggers a conversion. For example, maybe you want your convertible noteholders to be converted into equity if you achieve a certain milestone like the purchase of a building or a certain amount of revenues. This conversion trigger could be automatic or optional. If it is optional, it could be at the option of the company, the investor, or both. If conversion is triggered by anything other than a "priced round," i.e. the sale of equity, you will have to be determined how much equity the noteholders will be able to purchase. This could be based on a valuation done at the time of the conversion trigger or it could be based on a pre-agreed price. The pre-agreed price could be a set amount or it could be an amount arrived at by doing some sort of calculation – for example it could be some multiple of gross revenues from the most recently completed calendar year quarter.

Another term you can include is called "most favored nation" status – this means that if you raise more money in the future in the form of convertible notes and the future investors get better terms than the current investors that the current investors have the right to switch to the more favorable note terms.

Your Convertible Note Terms

1. Term (i.e. years to maturity): ______________________

2. Interest Rate: ______________________

3. Conversion Trigger
   a. Raise $_____________________ equity round
   b. Other

4. Is conversion
   a. automatic when triggered
   b. at the option of company
   c. at the option of investor
   d. other

5. Choose one of the following:
   a. Both interest and principal convert into equity
   b. Only principal converts, interest paid in cash
   c. Interest converts at option of company
   d. Interest converts at option of investor
   e. other: ____

6. Conversion discount: ______________________

7. If conversion trigger does not occur during note term
   a. principal and interest are due and payable
   b. principal and interest are automatically converted into common equity at $______________ (valuation)
   c. principal and interest are converted into common equity at $______________ (valuation) at company's option (otherwise payable in cash)
   d. principal and interest are converted into common equity at $______________ (valuation) at investor's option (otherwise payable in cash)
   e. other: ____

8. Valuation cap? Yes/No
   a. If yes, amount: $______________________

9. Any other terms?