Q: What Is Convertible Debt?
A: Convertible debt is a debt security that's structured to convert into equity at some point in the future, usually during an equity capital raise (such as a Series A financing). Your investors own debt until it converts to equity. If the company is sold or closes, it’s the convertible debt holders (if they haven’t converted to equity yet) who will get paid back any money first.

Q: How does it work?
In a convertible debt financing, the Company prepares a simple convertible promissory note purchase agreement that contains the same basic representations about the company that would be contained in a common stock purchase agreement (discussed above) and the statement from the investor that he or she understands that this is a risky investment and has had the opportunity to evaluate the opportunity. The convertible promissory note purchase agreement also contains the form of promissory note that would be given to each investor. Each investor signs the same purchase agreement, and the company simply "peels off" the form of note for each investor and inserts the investor's name, amount of the loan, and date of the investment. Companies often leave these financings open over a period of time – often over 1 year – and will pull in new investors on a rolling basis. Eventually the Company will mature to the point of being able to raise a preferred stock (Series A) round from a venture capital fund or other institutional investor, at which point the outstanding debt will automatically convert into the Series A round.

Q: What rights do the note holders have?
A:Convertible debt holders do not own stock in the Company – so they do not vote as shareholders and are not entitled to the protections afforded to shareholders of a Company (such as shareholder inspection rights and fiduciary duties). Debt is more senior to equity on liquidation, placing the investor in a better position should the Company shut down with distributable assets. Investors receive interest on their investment and the opportunity to receive preferred stock upon conversion, which will likely have significant preferences over common stock. For all of these reasons, convertible debt is the preferred financing choice for start-up companies and early state investors.

Q: How does the note “convert?”
A: If the Company completes a “qualified” equity financing prior to maturity - often at least 1M of new capital from investor in exchange for preferred stock - the debt will automatically convert into the new financing shares. The price at which the debt converts is often the lesser of (i) a discount on the price per share of the preferred stock (typically a 20% discount) and (ii) the “Cap Price”. The Cap Price is an agreed upon maximum company valuation that is locked in for the convertible debt investors. This way, if the Company takes off and completes a qualified financing raise at a $25M valuation, and the Cap Price is based on a $5M valuation, the debt will convert at the Cap Price. This is because a price per share that is based on a $5M valuation will be significantly less than a 20% discount on a price per share that is based on a $25M valuation.

Q: What is Interest rate?
A: Typical convertible debt terms provide for interest on the loan - often 6-8% - that accrues and is payable in one lump sum at maturity or conversion, in which case it simply converts into shares along with the principal as discussed below. The debt will have a term of 1-3 years. If the debt is outstanding at maturity, it is typically due and payable upon the request of the holders of a majority of the debt then outstanding under this facility. This is a very important provision and one that should ripple throughout the convertible debt arrangement. By requiring debt holders to act by majority approval, it can prevent a rogue investor from demanding payment from the Company at a time when the funds are not available and such demand could potentially shut down the Company.

Q: What is Pre-payment option?
A:This determines whether the note can be prepaid to the convertible debt holders.

Q: What is Term of note?
A:This addresses when the note expires, which is when the note (principal and interest) should be paid back if no additional capital is raised.