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FARALLON LAW GROUP NEWSLETTER

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Convertible Promissory Note Financings

Convertible promissory notes are often used as a debt financing tool by "angel" or other private investors in early stage start-up companies. They are viewed as "bridge" investments for companies to continue operating until an equity investment. The alternative is an equity investment as a "Series A" preferred stock financing (with limited rights and preferences). Investors generally prefer one structure over another.

➢ **What are Convertible Promissory Notes?** Convertible promissory notes are debt instruments by which an investor loans funds to a company for a specified period at a specified interest rate. However, they also contain a convertibility feature such that it can be converted into shares upon certain events. The company will issue a series of notes with the same terms if there are multiple investors.

➢ **Terms** Convertible promissory notes may have terms such as:

• A maturity date of 1-3 years, an interest rate of between 5-12%/annum and are not prepayable.

• Principal and accrued interest automatically convert into equity upon a "next qualified equity financing" (a minimum amount of aggregate proceeds and/or a minimum company valuation). Investors can choose to convert into a non-qualified equity financing.

• Principal and accrued interest convert at a discount to the per share price paid by the new equity investors (often between 10-30%, and perhaps increasing over time). Or the price paid for the next equity shares may be capped, based on a current valuation.

• A company may also provide a warrant to purchase shares of a next equity financing, with an exercise price based on a current company valuation.

• If the company is sold prior to conversion, the investor receives a specified multiple return (e.g., 3-6x on the original investment). The investor would be paid first and prior to any equity holders.

• May sometimes be secured by a senior lien on all of the assets of the company (the investors have priority claims).

➢ **Advantages of Convertible Notes** There are several advantages to using convertible notes to finance a start-up company:

• Convertible promissory notes do not require the investor and company to determine the value of the company (which is particularly difficult for start-up companies with no revenue or significant operations). The notes will automatically convert into equity in the next equity round at the valuation that is determined at that time. This avoids any awkwardness if the investor is a friend or family member of the founders.

• Convertible promissory notes are simpler documents to prepare and negotiate as there are minimal rights and preferences (unlike an equity financing).

• Investors in convertible promissory notes are creditors to the company which is preferable in the event of a bankruptcy to being an equity holder.

➢ **Disadvantages of Convertible Notes** There are also some disadvantages to using convertible notes in these situations:

• Convertible promissory notes are not shareholders and lack certain rights as to voting, access to information and fiduciary duties.

• If the company is sold prior to conversion, then a convertible promissory note investor is only entitled to receive the principal and accrued interest but not any company appreciation (unless a company sale premium is negotiated- see above).

• The interest of a convertible note investor and the company are not necessarily aligned in the next equity financing (the investor prefers a lower valuation since it translates into more equity).

• Issuance of convertible promissory notes does not start the long term capital gains tax holding period (until converted into equity).

Please feel free to contact Boris Z. Lieberman or Mario M. Kashou at 415-255-2450 if you have questions about convertible promissory note financings.