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to maintain accurate records of the convertible notes, including interest accrued and conversion terms. Use a reliable accounting system or software to track these details. Keep the investor informed about the progress of your business. This may include sharing financial statements, operational updates, and any significant events that may impact the convertible notes.

Remember, this information is provided as general guidance and is not intended to constitute legal advice. Each startup's situation is unique, and you should consult with legal counsel to ensure compliance with applicable laws and regulations. Consulting professional advice is highly recommended to ensure compliance and mitigate potential risks. While there are many benefits that can come with convertible debt financing, there are important considerations to keep in mind too:

Interest and Conversion Terms: Startups must carefully consider the interest rate and conversion terms associated with convertible notes. Balancing the interest rate to attract investors while not burdening the company with excessive debt is crucial. Additionally, negotiating favorable conversion terms, such as a discount or a valuation cap, can protect the interests of both the company and investors.

Future Financing Rounds: Convertible notes typically convert into equity during subsequent funding rounds. Startups should plan for these conversions and ensure alignment with their long-term growth strategies. It's essential to evaluate the potential impact on ownership and control as new investors come on board.

Investor Relationships: Maintaining strong relationships with early stage investors is vital for startups. Regular communication and transparency regarding the company's progress and future plans can help foster trust and support from investors, potentially leading to follow-on investments in subsequent funding rounds.

Once you issue convertible notes, you're likely to have questions about how they work. Here are some of the most frequently asked questions about convertible notes:

When do convertible notes convert into equity?Convertible notes typically convert into equity when your startup raises its next round of funding, like a Series A. The notes convert at a discount to the Series A price per share. For example, if your Series A values the company at \$10 million and issues shares at \$1 each, holders of convertible notes may get shares at \$0.80 each. Do convertible notes accrue interest? Most convertible notes do, usually at a fixed rate between 6% and 8%. Interest is typically paid periodically, often quarterly or semi-annually. If your startup doesn't make scheduled payments, the interest will be added to the principal balance, increasing the amount that converts into equity upon maturity.

What happens if my startup fails before the maturity date of the convertible notes, the notes typically become due and payable. You'll have to repay the principal plus any accrued interest to the noteholders. This scenario is known as a "maturity default." To avoid defaulting, startups often extend the maturity date to give them more time to raise cash. Can convertible notes be converted before the next funding round?Yes, convertible notes usually contain provisions allowing early conversion at the option of the note holders or the startup. The conversion terms, like the discount rate and valuation cap, are the same as if the notes converted at the next equity round. Allowing early conversion gives note holders more flexibility and the startup more control over its capital structure.

Do convertible notes have voting rights?Convertible note holders typically do not have voting rights before the notes convert into equity. Once converted, the new equity shareholders (the former note holders) gain voting rights in the startup. The lack of voting rights is one reason why convertible notes are considered "bridge financing." The notes bridge the gap between seed funding and a Series A round that establishes equity ownership and more formal governance.

Hope this helps clarify some of the most common questions about how convertible notes work! Let me know if you have any other questions. This article is designed and intended to provide general information in summary form on general topics. The material may not apply to all jurisdictions. The contents do not constitute legal, financial or tax advice. The intent is not intended to be a substitute for such advice and should not be relied upon as such. If you would like to chat with a lawyer, please get in touch and we can introduce you to one of our very friendly legal partners. Startups often need funding before generating revenue, and one way they secure it is through convertible notes. These short-term loans from investors later convert into equity under specific conditions. They allow startups to postpone valuation discussions until a future financing round, offering founders a less risky path to raising capital. However, convertible notes also carry risks, particularly around dilution and interest. Understanding the mechanics and implications of convertible notes is crucial for entrepreneurs seeking alternative funding options.

Early-stage risk. For example, if a note has a 20% discount and the startup later raises funds at \$5 per share, noteholders convert at \$4 per share, giving them more shares for the same investment. Discount rates typically range from 10% to 30%, with the percentage negotiated based on the startup's risk and expected conversion timeline. Valuation CapA valuation cap sets a maximum company valuation at which a convertible note converts into equity, ensuring early investors receive a favorable price if the company grows quickly. For instance, if a note has a \$5 million valuation cap and the startup later raises funds at a \$10 million valuation, noteholders convert as if the company were worth \$5 million, resulting in a lower share price and a larger ownership stake. Unlike a discount rate, which provides a relative price reduction, a valuation cap can significantly increase investor returns if the company's valuation rises sharply. Investors push for lower caps to maximize their upside, while founders prefer higher caps to limit dilution. Interest

ProvisionsConvertible notes accrue interest, which is added to the principal before conversion. Unlike traditional loans, they usually do not require periodic interest payments. Interest rates generally range from 4% to 8% per year. If an investor lends \$100,000 at a 5% annual interest rate and the notes convert after two years, the total conversion amount would be \$110,250 with compounded interest or \$110,000 with simple interest. Interest increases investor returns while also affecting the final ownership percentage when the debt converts into shares. Conversion EventsA convertible note remains debt until a specific event triggers its conversion into equity. The most common trigger is a "qualified financing round," where the startup raises a certain amount of money from outside investors. Other triggers include reaching a specific milestone, such as a product launch or revenue target. Automatic conversion clauses specify that the debt will automatically convert upon the occurrence of a defined event, such as the startup closing a financing round or achieving a revenue goal.

Maturity DateThe maturity date is the deadline by which the startup must either convert the notes into equity or repay the principal plus accrued interest. Failure to meet this deadline constitutes a "maturity default." Startups often negotiate extensions or alternative repayment structures. If a note matures after 24 months without a financing event, investors might convert at an agreed-upon valuation set at issuance. Repayment OptionsWhile convertible notes are designed to convert into equity, repayment may be required if conversion conditions are not met. If a startup reaches the maturity date without a financing round or acquisition, it may need to repay the principal and accumulated interest. Some agreements allow for extensions, but investors may demand repayment if they see no clear path to growth. If a startup has enough cash flow, it may choose to repay the note instead of issuing equity, avoiding dilution. However, this requires careful financial planning, as startups often operate with limited liquidity. Some agreements allow for partial repayment, where a portion of the debt is settled in cash while the rest converts into shares. If a company struggles financially, investors may renegotiate repayment terms, such as extending the maturity date or lowering the interest rate. In cases of severe financial distress, investors might accept a discounted payoff to help the startup avoid bankruptcy.

Tax FactorsThe tax treatment of convertible notes depends on whether they are classified as debt or equity under IRS guidelines. Typically, they are considered debt until conversion, meaning investors may need to report accrued interest as taxable income even if no cash payments are made. Founders should consult a tax advisor to understand the implications. SAFE NotesSAFE (Simple Agreement for Future Equity) notes are a type of convertible note that simplifies the process and reduces legal costs. They typically lack the complex provisions found in traditional convertible notes, such as automatic conversion or interest. Instead, they rely on a single triggering event (e.g., the startup raising a qualified financing round) to convert the notes into equity. Like traditional loans from banks and lending institutions, a convertible note is a contract with set terms that must be agreed upon between all parties involved. Convertible notes must sufficiently reward the investor considering these capital providers took on the most risk by investing in the startup the earliest by setting terms giving them the option to buy discounted shares. The most common terms are the following:

Maturity Date: The agreed-upon date at which the note comes due most often 12 to 24 months post-issuance at which the security converts into equity or must be repaid in cash. **Interest Rate:** The coupon rate is typically lower than that of traditional loans due to the conversion feature and often accrues to the principal amount rather than being paid in cash. **Valuation Cap:** The ceiling value of the company used to determine the conversion rate, i.e. the upper maximum parameter. **Discount Rate:** The discount at which the note holder can convert their investment at a price per share lower than those paid by other investors (and usually ranges around 20%).

Convertible Notes Interest Rate (%)Convertible notes are a hybrid between debt and equity. Like debt, interest (i.e. the coupon) on convertible notes must be paid periodically. The lender will most likely be seeking the majority of their returns to stem from the equity upside rather than cash interest, so they typically will not charge high interest rates in cash to allow the startup with more breathing room. The flexibility of convertible notes, such as avoiding the cash interest component, is a distinct feature but it does not come without a price, e.g. the interest accrues to the principal amount instead of being paid in cash. Because of this, the interest on convertible notes is typically a significant factor in the overall cost of capital for the startup. When calculating the effective interest rate, you must consider the discount rate and the valuation cap. The discount rate effectively lowers the price at which the notes convert, while the valuation cap limits the maximum value of the company that can be achieved. Both factors contribute to the overall cost of the financing. In the absence of a cap or discount, the notes would convert into the issuing company's shares at the same price as the participating investor in the round. In such a case, there is no real incentive for the noteholder, i.e. no benefit to being an early investor. Benefits of Convertible NotesOption to Raise Capital without Valuation: Startups often opt to use convertible notes to raise capital because the startup can obtain funding without establishing a specific valuation. Time to Mature: Early-stage companies can mature i.e. adjust their business model and implement changes using outside capital before determining the valuation at which the startup decides to raise capital in their next round of financing. Lower Interest Rate: Convertible notes represent a more straightforward, cheaper source of financing than traditional financing which is primarily due to the equity-like upside of convertible securities. If applicable, mandatory cash payment obligations can be a significant drawback to the issuer, but the potential upside in returns on equity enables them to negotiate lower interest rates. Removal of Mandatory Repayment: In addition, another reason for raising funding by issuing convertible notes is the removal of the mandatory principal repayment at maturity, avoiding the risk of default. Accrued Interest Option: Given the uncertainty surrounding the startup's future, agreeing to a regular schedule of cash interest payments is often unreasonable. Aligned Long-Term Interest (Flexibility): If the startup were to default and be liquidated, there is no real incentive for the investor (i.e. convertible note provider) to force the company to undergo liquidation hence, the investor often gives the company the option to extend the notes maturity or adjust the terms. While, of course, the adjustments are going to favor the investor, the startup gets the opportunity to continue operating in these cases. Risks of Convertible NotesDilution: Because of the valuation cap, the noteholder can estimate whether the money will convert from loan to equity at or below a specified price per share set by the valuation caps parameters. In the absence of a cap or discount, the notes would convert into the issuing company's shares at the same price as the participating investor in the round. In such a case, there is no real incentive for the noteholder, i.e. no benefit to being an early investor. 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