

Convertible Notes Overview

Convertible debt is a way for companies to raise capital in their early stages of development. Generally, convertible debt facilitates capital investments from friends and family, incubators, angel groups, seed funds, some venture capital funds, and more.

What Is a Convertible Note?

A convertible note is a short-term debt agreement that converts into equity at a future date. Usually, this happens when one of these events takes place:

- The company raises enough capital to reach a pre-determined benchmark.
- The term of the loan expires.
- The company is sold.

Practically speaking, investors loan money to a startup company in an early round of financing. The company can either pay the loan back with interest or give the investors equity in the company later on after it has had time to grow.

These notes enable a company to raise capital without making an explicit public valuation. In the agreement, the parties make their own estimate of the company's value. This gives the company and the investor more flexibility to set their own terms for repayment and conversion.

Companies that issue convertible notes benefit from reduced cash interest payments on their business loans. Additionally, when the note converts, the debt is retired.

Convertible notes are popular with smaller companies and familiar to many investors. They are simple and inexpensive. However, they can lead to unintended outcomes and uncertainty about future control and company ownership. Consult a lawyer as you negotiate any convertible debt financing.

How Do I Use This Material?

Review the convertible note form document below. Some sections are standard legal provisions that protect the parties; others are items that the parties will have to negotiate and customize for their particular deal as they design the financing, the maturity term, the conversion details, and other items to meet their goals. Be sure to reference the endnotes to become familiar with all the items.

Begin by filling out a Term Sheet.

- A term sheet is usually a non-binding agreement outlining the basic terms and conditions of the investment. It serves as a template for the convertible note for both parties. It also allows companies to design their own deals when working with investors who rely on their own standardized documents.
- Putting together a term sheet will allow the company to get a better idea of what it wants to see in the note. Review it carefully and reference the annotations to understand the key issues and terms.

Make sure your convertible note reflects all the agreed-upon terms.

Consult a lawyer to make sure your documents protect you and meet your goals.

Disclaimer

These documents were created and vetted by students and supervising attorneys at the University of Pennsylvania Law School's Entrepreneurship Legal Clinic applying Pennsylvania law. They are intended to educate and inform the early stage start-up. As such, they are designed to be simple and accessible and may omit terms or language relevant to your specific circumstances. Please carefully read through the documents and any instructions and annotations included therein.

You acknowledge that your use of these documents does not create an attorney-client relationship between you and the Clinic or you and the individual members of the Clinic and does not constitute the provision of legal advice or other professional advice. You should seek advice from a licensed attorney before using or relying on these documents. Additionally, none of the documents created constitute tax advice. By using and relying on these documents, you assume all risk and liability that may result.

Term Sheet
For Convertible Promissory Note Financing of
[Company Name]
[Date]

This term sheet summarizes the principal terms of the convertible note financing of [company name], a [state of incorporation] [entity form]. No legally binding obligations will be created until definitive agreements are executed and delivered by all parties. This term sheet will be governed in all respects by the laws of the Commonwealth of Pennsylvania.

Offering Terms	Proposed Language
Issuer	[Company Name], a [state of incorporation] [entity form] (the “Company”).
Financing Amount	Up to \$[_____] from investors identified by the company (the “Investors”, each an “Investor”). Amounts may be funded in multiple closings.
Promissory Notes	<p>The company will issue promissory notes (the “Notes”) in exchange for amounts invested by the investors. The notes will have the following principal provisions:</p> <p>Maturity. Unless repaid or converted earlier, outstanding principal and unpaid accrued interest on the notes will be due and payable upon request of the majority holders made on or after the date which is 24 months from the initial closing (the “Maturity Date”).</p> <p>Interest. Simple interest will accrue on an annual basis at the rate of [_] % per annum based on 365 days in a year.</p>

<p>Conversion</p>	<p>In the event the company consummates, prior to the maturity date, an equity financing pursuant to which it sells shares of its preferred stock (the “Preferred Stock”), with an aggregate sales price of not less than \$[____], excluding any and all indebtedness under the notes that is converted into preferred stock, and with the principal purpose of raising capital (a “Qualified Financing”), then all outstanding principal, together with all accrued but unpaid interest under the notes, will automatically convert into shares of the preferred stock at the lesser of:</p> <ul style="list-style-type: none"> ▪ [__]% of the price per share paid by the other purchasers of preferred stock in the qualified financing;ⁱ and ▪ the price obtained by dividing \$[____] by the company’s fully-diluted capitalization immediately prior to the qualified financing (which in all cases excludes any shares issued upon conversion of convertible debt).ⁱⁱ
<p>Sale of the Company</p>	<p>If the company is acquired prior to the qualified financing, investor will receive cash repayment equal to the outstanding principal and accrued but unpaid interest.</p>
<p>Prepayment</p>	<p>The principal and accrued interest may be prepaid in whole or in part at any time prior to the maturity date without penalty and without the consent of the holder, provided that the company provides the holder 30 days’ prior written notice of its intent to prepay.</p>
<p>Security</p>	<p>The Notes will be unsecured obligations of the company.</p>

Documentation	The investments will be made pursuant to documentation prepared by the company. The Notes may be amended by the company and the holders of a majority (by unpaid principal amount) of the Notes (the "Majority Holders").
Expenses	The company and investors will each bear their own expenses with respect to the Note's financing.

Company: [Company Name]
By:
Name:
Title:

Investor (if an entity): [Entity Name]
By:
Name:
Title:

Subscription Amount: \$_____

Investor (if an individual): [Name]

Signature: _____

Subscription Amount: \$_____

**Convertible Promissory Note of
[Company's Legal Name]**

This note has not been registered under the Securities Act of 1933, as amended (the "Act"), and may not be sold, transferred or otherwise disposed of except in accordance with the act, as amended, and unless a registration statement under the act with respect to this note has become effective or unless lender establishes to the satisfaction of maker that an exemption from such registration is available.ⁱⁱⁱ

US \$ [Principal Amount]^{iv}

Date [Issuance Date]^v

For value received, [Company's legal name], a [State of incorporation and entity form] (the "Company"), hereby promises to pay to the order of [name of Holder], (the "Holder"), or its permitted assigns, the aggregate principal sum of \$[Principal Amount] (the "Principal Amount"), together with interest on the unpaid principal balance of this convertible note (this "Note") at a rate equal to [number written in words] percent ([number]%) (computed on the basis of the actual number of days elapsed in a 365-day year) per annum (the "Interest Rate"). Interest will accrue from the date of execution and will continue to accrue on the outstanding principal balance of this Note until paid in full or converted as provided in this Note. Except as expressly provided, all payments of principal and interest by the Company under this Note will be made in United States dollars in immediately available funds to the account specified by the Holder.

Terms and Conditions

1 Payment of Principal and Interest

- 1.1 **Maturity.**^{vi} Unless earlier repaid or converted, outstanding principal and unpaid accrued interest on the Note (the "Debt") will be due and payable upon request of the Majority Holders made on or after the date which is [Number] months (24 months if not indicated) from the Issuance Date (the "Maturity Date"). The Debt will be payable in [Number] () equal monthly installments.
- 1.2 **Prepayments.**^{vii} Except as otherwise indicated in this Note, this Note may be prepaid in whole or in part at any time prior to the Maturity Date without penalty and without the consent of the Holder, provided that the Company provides the Holder 30 days' prior written notice of its intent to prepay at the below-specified address.

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- 1.3 Application of Payments.** All payments made by the Company under this Note will be applied first to the interest accrued and unpaid on the unpaid principal balance, and the remainder to the principal.
- 1.4 Cancellation of Note.** Upon payment in full of the outstanding principal balance of this Note and accrued and unpaid interest and any premiums thereon, or upon conversion of this Note pursuant to Section III, this Note will be automatically cancelled and the Company's payment obligations will be extinguished.
- 1.5 Payment Process.** All payments to be made by the Company will be made without set-off, recoupment or counterclaim and free and clear of and without any deduction of any kind for any taxes, levies, fees, deductions, withholdings, restrictions or conditions of any nature.

2 Conversion^{viii}

- 2.1 Qualified Financing.^{ix}** In the event the Company consummates, prior to the Maturity Date, an equity financing pursuant to which it sells shares of its preferred stock (the "Preferred Stock"), with an aggregate sales price of not less than \$[____], excluding any and all indebtedness under the Notes that is converted into Preferred Stock, and with the principal purpose of raising capital (a "Qualified Financing"), then all principal, together with all accrued but unpaid interest under the Notes, will automatically convert into shares of the Preferred Stock at the lesser of:
- (A) [__]% of the price per share paid by the other purchasers of Preferred Stock in the Qualified Financing; and
 - (B) the price obtained by dividing \$[____] by the Company's fully-diluted capitalization immediately prior to the Qualified Financing (which in all cases excludes any shares issued upon conversion of convertible debt).
- 2.2 Sale of the Company.^x** If the Company is acquired prior to the Maturity Date or the Qualified Financing, Holder will receive cash payment equal to the outstanding principal and accrued but unpaid interest.
- 2.3 Maturity.** In the event that neither a Qualified Financing nor a Sale of the Company has occurred by the Maturity Date, the Holder may elect to either:

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- (A) have the Outstanding Balance repaid by the Company in cash;
or
- (B) convert such Outstanding Balance into equity securities of the Company having substantially the same rights as the most senior class of stock of the Company outstanding immediately prior to the Maturity Date. If no class of stock senior to the Company's common stock is outstanding, then the Outstanding Balance will be converted into common stock. In either case, the price per share will be implied by the \$[_____] pre-conversion valuation of the Company.

2.4 Conversion Mechanics. Upon conversion, the Holder will surrender the Note at the principal office of the Company. Company will issue and deliver to the Holder a certificate (or certificates) for the equity securities, together with a check payable to the Holder for any cash amounts payable as described in subsection (E) below. Holder agrees to execute and deliver to the Company all transaction documents necessary for the conversion.

2.5 No Cash in Lieu of Fractional Shares.^{xi} No fractional share of common stock will be issued upon conversion of this Note. Instead of issuing any fractional shares of common stock which would otherwise be issuable upon conversion of this Note, the Company will pay to Holder a cash adjustment in respect of such fraction in an amount equal to the same fraction of the fair market value per share of such common stock (based upon the valuation set forth in Section III. A.) above.

3 Fundraising Ceiling and Floor^{xii}

The Company may enter into other convertible notes substantially similar to this Note (collectively with this Note, the "Notes") with other holders. The maximum aggregate principal amount of all the Notes may not exceed \$[____]. Additionally, the Company must raise a minimum aggregate amount of capital fundraising as a condition to the Holder's obligation to close on their funding amounts. The Company must fundraise, as a minimum, \$[____] of capital in order for this Note to become effective.

4 Transfer^{xiii}

This Note is transferable and assignable by the Holder to any person or entity previously approved by the Company. The Company agrees to issue replacement Notes to facilitate such approved transfers and assignments. Approval is not required for transfers or assignments to an Affiliate of the Holder done in compliance with applicable securities laws.

5 Defaults^{xiv}

5.1 Event of Default. The occurrence of any of the following events will constitute an “Event of Default”:

- (A)** the Company fails to make any payment of principal or interest on this Note when due, whether at maturity, upon acceleration or otherwise; or
- (B)** the Company undergoes proceedings related to bankruptcy, including but not limited to the following:
 - i.** the Company or a subsidiary of the Company (a “Subsidiary”) makes a determination to discontinue (or does cease to conduct) business, makes an assignment for the benefit of creditors or admits in writing its inability to pay its debts generally as they become due;
 - ii.** an order, judgment or decree is entered adjudicating the Company or a Subsidiary as bankrupt or insolvent;
 - iii.** any order for relief with respect to the Company or a Subsidiary is entered under the U.S. Bankruptcy Code or any other applicable bankruptcy or insolvency law;
 - iv.** the Company or a Subsidiary petitions or applies to any tribunal for the appointment of a custodian, trustee, receiver or liquidator of the Company or a Subsidiary or of any substantial part of the assets of the Company or a Subsidiary commences any proceeding relating to it under any bankruptcy, reorganization, arrangement, insolvency, readjustment of debt, dissolution or liquidation law of any jurisdiction; or
 - v.** any such petition or application in (iv) above is filed, or any such proceeding is commenced, against the Company or a Subsidiary and either:
 - (a)** the Company or such Subsidiary by any act indicates its approval thereof, consents thereto or acquiesces therein; or
 - (b)** such petition, application or proceeding is not dismissed within sixty (60) days.

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5.2 Default. Upon the occurrence of an Event of Default, Holder will have the right by written notice to the Company to either:

- (A) accelerate this Note and to declare all of the obligations of the Company under this Note immediately due and payable, and to take all action permitted by law to collect all amounts due; or
- (B) to convert the outstanding principal balance of this Note, together with all accrued and unpaid interest thereon, in accordance with terms of Section III.

6 Major Holder Right of First Offer^{xv}

The Company hereby grants to each Major Holder a right of first offer to purchase up to such Major Holder's pro rata share of Qualified Financing Securities (in addition to the amount such Major Holder receives as a result of conversion of such Major Holder's Note).

A Major Holder's pro rata share, for purposes of this right of first offer, will be equal to the ratio of:

- the number of shares of common stock issued or issuable upon conversion of the Qualified Financing Securities owned by such Major Holder upon conversion of this Note (assuming full exercise and/or conversion of all outstanding convertible securities, rights, options, and warrants directly or indirectly, into Common Stock held by such Major Holder) to
- the total number of shares of common stock outstanding immediately prior to the Qualified Financing (assuming full exercise and/or conversion of all outstanding convertible securities, rights, options and warrants, directly or indirectly, into common stock).

7 Miscellaneous Provisions

7.1 Waivers. The Company hereby forever waives presentment, demand, presentment for payment, protest, notice of protest, notice of dishonor of this Note and all other demands and notices in connection with the delivery, acceptance, performance and enforcement of this Note.

7.2 Information Rights.^{xvi} For as long as this Note and any amounts owed under it remain outstanding, proper and complete books of account of the Company, including (without limitation) copies of the Company's federal, state and local tax returns for each fiscal year, will be kept under the supervision of the Board of Directors of the

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Company at its principal office. Such books and records will be open to inspection by each Major Holder, or its designated representatives, at any reasonable time during normal business hours after reasonable advance notice. In addition, each Major Holder will have the right, to be exercised in each such Major Holder's reasonable discretion, to ask questions of the Company's management and Board of Directors, during normal business hours after reasonable advance notice.

- 7.3 No Rights as a Stockholder.^{xvii}** This Note does not entitle the Holder to any rights as a stockholder of the Company. This includes voting rights. In the absence of conversion of this Note, no provision(s) or enumeration(s) in this Note regarding the rights or privileges of the Holder causes the Holder to be a stockholder of this Company for any purpose.
- 7.4 Amendments.** No amendment or waiver of any provision of this Note, nor consent to any departure by the Company from it, will in any event be effective unless the same will be in writing and signed by Holder and then such waiver or consent will be effective only in the specific instance and for the specific purpose for which given.
- 7.5 Severability.^{xviii}** If any term, covenant or provision contained in this Note, or the application thereof to any Person or circumstance, will be determined to be void, invalid, illegal or unenforceable to any extent or will otherwise operate to invalidate this Note, in whole or part, then such term, covenant or provision only will be deemed not contained in this Note; the remainder of this Note will remain operative and in full force and effect and will be enforced to the greatest extent permitted by law as if such clause or provision had never been contained in it; and the application of such term, covenant or provision to other Persons or circumstances will not be affected, impaired or restricted by that occurrence.
- 7.6 Governing Law.^{xix}** This Note, and all matters arising directly and indirectly from it ("Covered Matters"), will in all respects be governed by, and construed and interpreted in accordance with, the internal substantive laws of the Commonwealth of Pennsylvania without giving effect to the principles of conflicts of law thereof. The Company irrevocably submits to the personal jurisdiction of the courts of the Commonwealth of Pennsylvania and the United States District Court located nearest the Company's principal place of business for the purpose of any suit, action, proceeding or judgment relating to or arising out of the Covered Matters.

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7.7 Notices.^{xx} Any notice, request or other communication required or permitted hereunder will be in writing and be deemed to have been duly given (a) when personally delivered or sent by email (the receipt of which is confirmed in writing); (b) one business day after being sent by a nationally recognized overnight courier service; or (c) five business days after being sent by registered or certified mail, return receipt requested, postage prepaid, to the parties at their respective addresses set forth below:

If to the Company: [Name of the Company]
[Address Line 1]
[Address Line 2]
[Email Address of the Company]

If to the Holder: [Name of the Holder]
[Address Line 1]
[Address Line 2]
[Email Address of the Holder]

8 Successors and Assigns

This Note will be binding upon the successors or assigns of the Company and will inure to the benefit of the successors and permitted assigns of the Holder.

9 Tax Treatment^{xxi}

The Company and the Holder agree to treat the Notes as [debt/equity] of the Company for U.S. federal, state and local tax purposes unless required otherwise by applicable law or administrative determination.

10 Security

This Note and all amounts due and payable hereunder are unsecured obligations of the Company.

[Name of the Company]

[Date Signed]

By: _____

Name: [Name]

Title: [Title]

Holder

By: _____

Name: [Name]

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ⁱ This is the “Discount”: the value amount below the market price that the shares will be reduced to—usually a fixed discount rate reducing the price the investors pay for the equity securities when they convert.

ⁱⁱ This is the “Valuation Cap”: the value of the company that the parties will use to determine how much the noteholders will pay for the new stock when the debt converts. The parties can assign a hypothetical maximum valuation to the company (“Valuation Cap”). When qualified financing occurs, it sets a price per share by dividing the valuation cap by the number of shares of common stock outstanding right before qualified financing occurred. If the value of the company is determined to be far less than the valuation cap, the cap may not be used.

ⁱⁱⁱ Usually, when you offer an ownership stake in your company for sale to the public, you have to file a lot of regulatory documents with the federal government. There are exemptions to this requirement, and a convertible note offered to a private party generally qualifies for an exemption. This section makes it clear that this note is exempt from the filing requirements because it is a small, private offering.

There are also state laws on this issue known as “blue sky” laws that you may need to comply with. Also, if you have foreign investors, you will need to review the applicable laws in their country.

^{iv} The dollar amount that you receive from the investor for this note.

^v The date the agreement takes effect.

^{vi} The date when the note is due or converts from debt to equity. Generally, the maturity date is set for either one or two years from the issuance date.

^{vii} The parties will need to agree on whether the company may prepay any of the initial principal amount. Sometimes, investors will not allow prepayment or will charge fees or interest for prepayment.

^{viii} This section outlines what events cause the note to convert from debt to equity. Generally, the note converts when one of three things happens:

1. The company raises enough capital to provide a certain degree of assurance that it will continue to grow (“Qualified Financing”);
2. The maturity date arrives; or
3. The company is sold.

^{ix} This is one of the main events that will cause the note to convert. When the company raises a certain amount of capital—usually a benchmark set by the parties signing the agreement—then the note automatically converts into equity. This is good for the company because it allows the conversion to take place without getting any approvals from the investor.

This section also contains language that sets the conversion price. There are two ways to set this price:

1. Fix the price to the future value of the company, which can vary (see Valuation Cap).
2. Set a fixed discount rate (see Discount).

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^x Usually, when the company is sold before qualified financing, it simply repays the outstanding balance of the loan plus unpaid interest, rather than offering any equity securities to the noteholder. Alternatively, you could choose to give the Holder shares of stock in the company.

You will want to decide whether “sale of the company” here means sale of the entire company or sale of a controlling share. Be sure to update this provision to reflect that business decision.

^{xi} This section prohibits the company from awarding fractional shares of stock, and instead requires the company to pay the noteholder cash value for any adjustments in stock.

^{xii} Often, investors will insist that the company raise a certain amount of capital before the convertible note will take effect. They do this to minimize the risk that they will lose their investment if the company doesn’t get off the ground. On the other hand, they also want to minimize the risk that their ability to purchase shares in the company will be limited by other convertible noteholders who will also have priority purchasing rights when the company succeeds. A fundraising ceiling that limits the total amount of capital that the company may raise using convertible notes is sometimes requested.

^{xiii} This provision specifies whether the noteholder can transfer this agreement to another person or party, and what would be required if that were to happen. Depending on the nature of the transfer, federal securities laws may apply.

^{xiv} This section outlines the events that would constitute a default. Generally, default events include the failure to make payments, a decision to close the company, and breach or non-performance of the duties in the agreement. Default events allow the noteholder to order immediate repayment of any outstanding debt.

^{xv} This provision gives the noteholder first priority on certain future sales of the company’s stock. Sometimes, investors fear that the future success of a company will mean they will lose the value of their initial investment, which will be diluted down by future financings. This provision gives the investor the opportunity to continue to benefit as the company continues to succeed.

^{xvi} This provision gives the investor the right to access and review some of the company’s documents, such as their financial statements and tax returns.

^{xvii} This makes clear that the investor is not a stockholder just because of this agreement.

^{xviii} This says that the agreement as a whole will remain valid even if one of the parts or provisions is later found to be unenforceable or void.

^{xix} This provision specifies what state or jurisdiction will govern any future litigation related to this agreement.

^{xx} This outlines how official communications between the parties must take place and when certain communications become effective.

^{xxi} Convertible notes can be considered either debt or equity for tax purposes. (Generally, they are characterized as debt before they convert. Consult a tax attorney if you believe you may have reasons to characterize the note as equity).