How Convertible Debt Works.

Source:
http://startuplawyer.com/convertible-notes/how-convertible-debt-works

Convertible debt is a type of security frequently issued by startups when raising seed capital. With convertible debt, the startup issues the seed investor a promissory note, for the investment amount, that contains a conversion feature. The conversion feature is the mechanism by which the debt (the promissory note) will convert to equity (new shares for the investor) upon a future event.

The Qualified Financing

Most (if not all) convertible promissory notes contain an Automatic Conversion clause that dictates the automatic conversion of the convertible debt upon a "Qualified Financing." The Qualified Financing is typically defined as an equity financing by the startup, for the purpose of raising capital, in which the aggregate of $1,000,000 (this amount can vary per deal) is purchased by investors. Thus, the Qualified Financing event is the trigger by which the convertible debt will automatically convert to equity. The conversion is considered "automatic" because it does not require the vote of either the startup or the investor.

The Qualified Securities

The equity raised in the Qualified Financing (the $1,000,000 above) is typically termed "Qualified Securities." Think of this as the Series A round. The convertible debt held by the investor will convert to the Qualified Securities. The amount of shares of the Qualified Securities issued to the convertible debt investor is dependent on the conversion discount per the terms of the convertible promissory note.

The Conversion Discount

As a sweetener to the convertible debt investor, convertible promissory notes have a conversion discount feature by which the convertible debt holder will exchange the debt for Qualified Securities at a price per share equal to 80% (this amount can very per deal) of the price per share paid by the Qualified Financing investors (the investors with the new $1,000,000 above).

Example

Here's the basic outline of how convertible debt works:
(1) Joe Angel invests $100,000 in Startup.
(2) Startup issues Joe Angel a convertible promissory note for $100,000. The convertible promissory note has an automatic conversion feature at $1,000,000 (the "Qualified Financing") with a conversion discount equal to 20%.
(3) Startup closes $1,000,000 Series A Preferred Stock round (the "Qualified Securities") by a VC at a Series A Preferred Stock price of $1.00 per share.
(4) Since the Automatic Conversion feature in Joe Angel's convertible promissory note is triggered by the Series A round, Joe Angel's convertible debt will be converted to Series A shares at a per share price of $0.80.
(5) The Startup issues Joe Angel 125,000 shares ($100,000/$0.80 per share) of its Series A Preferred Stock. The convertible promissory note is cancelled.

About The Author

Ryan Roberts is a startup lawyer and represents technology companies through all phases of the startup process, including incorporation, seed & venture financings, and exit transactions. Click here to learn more about his practice.