Now we're going to talk about all the different ways your convertible debt can or might not convert in different situations and how that actually works.

Clint: Under what circumstances do notes convert into preferred stock?

Brad: There are two different ways to think about it. One is an automatic conversion, and one is a voluntary conversion. The notes and the terms of the note will typically be written in a good note to define both cases. In not-so-good a note, it might be ambiguous, and then you'll have a negotiation.

An automatic conversion generally occurs when something has happened. Either a financing of a certain amount occurs, a certain amount of time passes. Those things trigger an automatic conversion.

Remember, when you have an investor who invests in a convertible note, they're trying to invest in the company so they actually want that note to convert versus them getting the debt paid back. They should be willing to agree to situations where you raise a certain amount of money, that counts as an equity financing; or a certain amount of time passes, and that counts as well. Those are automatic situations.

Voluntary situations usually occur when those terms that are for an automatic conversion aren't satisfied. For example, the note doesn't ever convert because you don't ever raise that next round. Or a certain amount of time passes and the note comes due. In those situations there are voluntary conversions where the investors might have reason, in those cases, to automatically convert because they're happy to convert at a predetermined valuation.

Or, they might not take advantage of the voluntary conversion opportunities, and the note stays outstanding. For all practical purposes in those situations, you simply have a negotiation. These are presumably early stage investors who want to be supportive and want to help you succeed. If you've spent the money and the business now needs more capital, them calling the note doesn't actually serve any purposes for them because they can't get anything back in that context usually.

They'll generally either work with you because they've gotten to know you for a while to convert the note into equity, or they'll roll over the note and extend the period and extend the term, maybe add some additional warrants, maybe change something in the characteristic of it, but essentially allow you to have more time to go get those activities happening, whether it's raising more money or having more time pass to automatically convert.

Clint: Let's talk about the "calling the note" part. Are there ever circumstances where the entrepreneur pays back the money to the VCs?

Brad: There are cases where the entrepreneur pays back the money. The most common ones are situations where you raise a financing that's at a higher valuation and the note is written in such a way that you the entrepreneur have the ability to either have the note convert or pay it off. Sometimes, depending on the dynamics of what the note is, you might pay it off.

Another situation is where the company becomes cash-flow positive, you end up in what looks like a bootstrapping situation, you decide not to raise any more money, and you still have this note outstanding. In situations where you don't trigger the automatic conversion provisions, one of the options would be for you to pay the note back.

Finally, there are some cases where the entrepreneur actually wants to pay the note back because they don't want the dilution from when they took the note. This is a case where you might be paying the interest on the note, but the actual note itself is going to get paid back, rather than convert into equity in the company.

Those cases do happen. Interestingly, even though there's a lot of conversation about how convertible notes are so much simpler to think about than equity, most of the time these different edge cases are not contemplated in the crafting of the note or the expectation around it. So you find yourself in a position, both as an investor and an entrepreneur, where you might be at cross-purposes because what your expectation was going in on the front end of the note does not sync up with reality that you find yourself at that moment in time, when the note comes due.

Clint: Let's talk about one of those circumstances. Let's say you've given me a note, I'm an entrepreneur. I'm fully expecting to raise a big Series A later on, and Google comes in and buys me before that happens. Now what happens to the note?

Brad: It used to be the case that most angel investors and seed investors didn't think hard about that situation, so what you'd end up with would be a situation where there's no language in the note for the situation where the company gets acquired, and as a result, as an entrepreneur, you'll do the math and it's likely that—assuming than the proceeds are meaningful—you'll simply pay off the note. So the investor who invested in the note, which essentially gave you the capital to make progress, doesn't get equity-like characteristics associated with the outcome.

They get debt-like characteristics associated with the outcome. They just lent you their money and got back 8% or 10% interest. Not very satisfying to the investor, and frankly, if you're an entrepreneur, not a particularly balanced way to treat the investor.

What's happened over time is that most investors that are investing in notes have now defined what happens in the context of an acquisition. A lot of those terms are very simple. They're things like if the company gets acquired, we get 2X our note value, or if the company gets acquired, we have the option of getting paid the note back in interest, or it converts into the company at some pre-determined valuation.

A common example would be that last case is the note language be written so it says "We get our note back with interest or the note converts into the company at a post-money valuation of $5 million." If your company gets sold for $20 million, the investor would get a 4X return on their note versus 8% interest on their note if the note's been outstanding for a year. Big difference.

That sort of language has now found its way into notes. It makes the note look more like equity in some ways, and it also makes the negotiation a little more complicated, but it does create a better sense of alignment in those situations.

Student: In the situation you described where you said the entrepreneur and the company find themselves in a cash-flow positive situation and it's their discretion to pay back the note holder. Is that at the sole discretion of the entrepreneur of the company, or are there situations in which that's explicitly defined? I imagine from an investor's perspective, that might not feel very good.

Brad: Yes to both. It depends entirely on how the note is written. I'll give a personal example. I was an angel investor in a company that never raised an equity round. They planned to, but they decided not to. The company became cash-flow positive. The note was written in such a way that the investors didn't really have any ability to determine what happened in that case. It was ambiguous.

The entrepreneur decided to pay back the notes over time. So the entrepreneur just took from cash flow and paid off the notes, plus the interest. The investors were fine, because we got our notes back, plus interest. A couple of years later the entrepreneur sold the company for about $50 million. Entrepreneur did extremely well, and as investors, we got our notes back with interest.

Most of the people who invested in that round were friends and family—friends of the entrepreneur—so none of us felt bad about it, but none of us felt great about it. I certainly didn't. I felt like, "Eh, that was okay. That was an okay experience." Versus a situation where I would've had some equity so when the company got sold for $50 million, I would've gotten some benefit for having invested at that point.

If you ask that entrepreneur why he paid off the notes the way he did, he would've said, I think—knowing him and believing he's a rational thinker—"The investors invested early. We didn't ever really agree on what would happen if I ended up paying off the notes early. I paid them off early and we kept building value in the business. They weren't really entitled to anything in the exit."

Totally true because of the way it was written. So it comes back to what the expectations are and how the deal was actually documented. But the answer is, it can go both ways.

Student: When a note does become due and say the company doesn't have sufficient capital to pay it, is there recourse? Is there collateral?

Brad: There's rarely any kind of recourse, like a personal guarantee, or where you'd have collateral for something else. Although, depending again on the notes and the dynamics with the investors, you could be in a situation where if the note comes due and the terms are written in a certain way, and the business is not performing, the note holders potentially could foreclose on the business.

The more typical thing that happens in those situations is the note holders simply roll over the note. They convert into a new note with a new term, and there's often a negotiation around that point in time.

As an entrepreneur, if you raise equity, it's completely defined what happens in any of the situations. If you raise debt, often in the situation where the company is not succeeding, it's not as well-defined and your note holders can be in a position where they can do things that impact the long-term dynamics of the company in ways that might be at cross-purposes with what you as the entrepreneur want.

Student: Let's say you have an automatic conversion and you're in-between financings, can you just start paying off that note right away, or do you have to wait for the financing?

Brad: If you don't have any money, you can't pay the note off. If you have money, then you can. It really depends on the liquidity of the situation, and the dynamic of the automatic conversion, again, has to do with the way those terms are written.

Did you trigger something that caused that note to be converted into equity automatically, in which case you don't pay it off, and it becomes equity? If you don't trigger those things, and you have cash, you have the potential to pay it off.

A lot of new investors may not want you to pay it off. If you're a seed investor in a company and I'm coming in with new money, I don't want my new money to go out to pay the old notes, I want the old notes to convert.

Typically, in a financing, you'll actually see the old notes converted to equity. There are cases, however, where the entrepreneur may not want that or the investors may not want that, so it ends up becoming again a negotiation with the new investors, the entrepreneurs and the company, and then the old investors to get to a place where the financing works.