Convertible Note Checklist

This checklist is designed to help you check the quality of a convertible contract. You may have received a proposal from an investor, or you found a contract online. If you go through the checklist below it will give you a sense of how solid the contract is.

First some general advice:

- Setting up a good convertible contract is hard! Normally you *have* to involve an experienced professional to avoid mistakes.

- Getting it wrong can be very costly: it may literally ruin your company, if future investors won't like what you have done.

- Boring is good: usually you want to go with a legal structure that is standard and common in your jurisdiction. Later investors like to see standard stuff: it's easier.

In short: you probably shouldn't be checking a convertible contract on your own. Having said that, below are some things to watch out for.

If a contract that you are using has some of the problems below: you can usually get free advice from Leapfunder through online training sessions. That could be a next step.

Convertible Checklist:

1. **What are the qualifying events?**

A good first thing to look at is what the qualifying events are. A qualifying event is an occurrence that causes the convertible to turn into shares. Usually there are at least three types of qualifying event defined: i) an equity investment round of at least a certain minimum size, ii) a 'change of control' which is just a take-over in which someone else takes over the company, and iii) the natural expiration of the convertible when it has reached its maximum maturity.

Let's go through each qualifying event:

1.1. Equity investment round. Here you should check that:

1.1.1. Only a cash investment counts as a qualifying event. (In-kind investments are normally too difficult to use, since the exact value of the in-kind contribution is often a matter of opinion and not very clear.)

1.1.2. The cash investment is in return for newly issued shares, so a buyout of existing shares does not count.

1.1.3. The minimum size of the cash investment is specified. It should be so high that not every little equity deal causes a conversion. Also, it should not be so high that the qualifying event is delayed for years and years. Usually a E100k qualifying event is good for Seed and Pre-Seed. While a E500k qualifying event makes more sense when doing a convertible as a bridge round between VC equity rounds.

1.1.4. How is the size of the cash amount for the qualifying event measured? What does that mean? Well: if the qualifying event is set as a E100k cash investment for new shares, then you should check whether the E100k means a) the total value of all investors in the round OR does it mean b) the total value of any *single investor* in a round? It is common for funding rounds to be syndicated. So if you have a funding round that has 3 investors for E50k then the total value is above E100k, but no single investor is above E100k. That means this is a qualifying event for a), but not for b). The biggest practical difference is that a) allows an equity crowdfunding round to be a qualifying event, while b) excludes an equity crowdfunding round, except if it contains at least one E100k investor.

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1.2. Change of control. The language of this clause is usually pretty standard. You should check that a change of control is declared not just when a new party acquires the majority of the shares, but also when all the assets of the company are sold into a new company. Both those actions have the same effect, after all.

1.3. Expiration. Normally a convertible should have an end date. At that date the conversion is implemented, even if there was no qualifying event or change of control. Otherwise the investor in the convertible might have to wait forever until there is a conversion.

2. **What happens on the end date?**

As mentioned a convertible normally has an end date when the conversion will be implemented, even if there is no qualifying event otherwise.

It's important to check in what way the conversion will be carried out. Who determines the share price for that conversion?

Sometimes the conversion share price on the end date is already fixed when the convertible is signed. Sometimes you are required to agree a price with the investors, and failing that the matter will escalate to an independent valuation expert.

It happens surprisingly often that a convertible reaches its end date without a qualifying event. So you should be comfortable with whatever is agreed for that situation. For example, if the contract says that conversion will take at a very low fixed valuation then you will likely come to regret that!

3. Does the contract contain milestones?

Sometimes an investment contract contains milestones. More cash will be released when certain future results are achieved.

Be careful with that!

Your business will likely change radically over time. What you agree as milestones today, may not make any sense next month. It happens very often that milestones are not met because they are no longer relevant. If that happens your contract should still be reasonable. So ask yourself: if I don't make any more milestones after today, will I still be happy with the deal that I got today, or is this only a reasonable deal if at least some of the future milestones are realised?

4. What equity class does the convertible convert to?

A convertible can be set up to convert to common shares. However, it can also be set up to convert to whatever kind of shares are issued in the qualifying event. Often the qualifying event will be a VC round. And VCs will often want so-called preferred shares. Those preferred shares give loads of extra rights to an investor. Often VCs can block funding rounds, determine management salaries, etc. etc. Ask yourself: do you want to give those kinds of extra rights to these convertible investors? If not, you may determine that the convertible should convert to common shares.

5. **Is there a cash repayment option?**

Do you have the right to repay the convertible in cash? If so, that may seem like it's good for you. After all, if the company is doing well you may have the option to just give these investors their cash back with interest and keep your shares.

But is that reasonable for the investors? They have taken a lot of risk. If at the end they just get their shares back with interest then they may well feel cheated. So generally, if the contract gives the startup the right to repay in cash then the investors will not find that contract very attractive.

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6. Does it contain a pooling vehicle?

In the early stages of a company it is common that investment rounds will be built around several investors. These syndicates allow each investor to spread their risk, while still putting together a substantial total investment round.

However, it is generally not a good idea to have too many individual shareholders. If you have too many shareholders later investors may find the discussions between shareholders too complicated and they won't want to invest.

Therefore, as a rule of thumb: if you have more than 3 investors you should create an investor pooling vehicle. This is a separate legal entity that brings together the smaller shareholders together into one legal entity. This legal entity forces them to decide amongst each other, and then vote and acts as a single block.

Does your convertible specify that the investors will go into a pooling vehicle during conversion? If you have more than 3 investors you should specify this in the contract. Otherwise you will be creating a problem for later. Ideally you already define the exact legal form of the pooling vehicle in the convertible contract. That way there are no surprises later.

7. Does it contain a form of majority rule for a possible restructuring?

If you are using a convertible with a syndicate of more than 3 investors: have you agreed that there is a form of majority decision making amongst these investors? It is common that the convertible will need to be restructured at some point. If that happens: do you have to get consent from each individual investor? It is more practical if you can vote, and the majority rules. Common changes that require later approval of the investors are i) an extension of the end date of the convertible, ii) an approval of a conversion share price if the convertible has reached the end date without a qualifying event, or iii) agreeing to a shareholders' agreement during a conversion. These are all common, and so a form of majority rule is very practical to have.

8. Does it require a notary?

In some jurisdictions you need a notary to sign a convertible. However, if you make sure the convertible is written right this can usually be avoided. Particularly in Germany a notary is absolutely mandatory, unless the contract is written just right. It is critical that the convertible doesn't make it legally inevitable that the shares will eventually go to the investor. If there are some circumstances under which this doesn't happen then the notary is normally not yet necessary. These are technical legal questions: you probably need to go find an experienced expert to check this.

9. Is it legal?

It may sound odd but sometimes, and in some jurisdictions, it is actually illegal to offer a convertible note. Depending on how the contract it is written it may be seen as a debt agreement. Most countries make it quite clear that no one can be in the business of taking or giving out debt without some kind of banking license. There are usually exceptions, such as taking on debt within your private sphere, such as parents and friends. The way to avoid these kinds of restrictions is normally to make sure your convertible is not seen as a debt, but as a bond. Bonds are tradeable, where debt is not. It is also possible that in your jurisdiction your type of legal entity is now allowed to issue a convertible. In any case: these questions are so technical you will likely need expert advice to avoid accidentally breaking the law.