CONVERTIBLE PROMISSORY NOTES: A FINANCING MODEL FOR TECH STARTUPS IN NIGERIA

INTRODUCTION

According to Bloomberg, about 80 percent of startup businesses fail within the first 18 months. A major reason for this is limited access to finance and Nigeria is not left out of these statistics. In fact, recent study suggests this numbers have risen to a whopping 90 per cent. The prohibitive interest rate and inability of business owners to satisfy conditions precedent to drawdown of loan facility granted by financial institutions, result in stillbirths of many small businesses. Can banks really be blamed for the high interest rates given the cost and time it takes to conclude loan recovery exercise and the delays associated with the dispensation of justice in this clime? In our last issue, we discussed various financing models used by tech startups in Nigeria and proposed an alternative funding model. This paper examines the practicalities and relative benefits of deploying Convertible Promissory Note (CPN) as an alternative or additional funding model for tech startups desirous of breaking new grounds that are unable to access conventional financing. Put simply, CPN is a tool for an investor to gain the advantages of two worlds in that an investor is able to seamlessly transit from a lender to an equity investor and vice-versa. For the issuer of CPN, immediate access to cash to fund necessary growth plan is guaranteed.

THE MODUS OPERANDI OF CPN

A CPN is a bridge between equity financing and debt financing usually deployed by start-up companies to generate capital in anticipation of Series A fund raising exercise. With CPN, the investor lends money to the company and rather than collecting the principal sum and interest at maturity, as would be the case with a typical loan, he converts the loan to equity in the company. The conversion happens at a heavily discounted price in a company that is fast growing and developing. He takes the risk of investing in the company with the hope that the investment would yield a good return when the note matures.

Due to the relative ease of securing capital through CPN, many startup companies may be tempted to raise capital using this model. Although CPN may not result in immediate dilution of equity, founders must be careful not to dilute their equity in exchange for fund that is not required for the short time plan of the company because future CPN can be issued at a higher valuation. Founders must also be careful not to issue too many CPN and lose the management, control and administration of their companies to people who are not familiar with the vision of the company.

An investor (the noteholder) who intends to invest in CPN would typically enter into an agreement with the company (the note issuer) to lend money to the company at an interest. Parties draft, negotiate and execute a **Convertible Note Purchase Agreement** to document their understanding. The agreement contains the amount an investor agrees to lend to the company and the commitment of the company to issue notes to the investor as acknowledgement of debt. The noteholder would usually insist on including a valuation cap[1], interest on the principal sum[2] and discount on the price per share, he does this to obviate a situation where his note will convert to shares at a very high price. The company should however ensure that the interest and discount rate are not too high and the valuation cap is not too low so as to prevent the purchaser's note from converting at a discounted price thereby diluting the company's share capital.

The agreement would also contain terms of conversion of the Note to Equity and the maturity date amongst others. The **maturity date** is the pre agreed date the company must repay the principal sum and the accrued interest if the notes have not been converted to equity or the principal sum and interest previously repaid. The maturity date is however an assurance to the investor that the notes would not be held indefinitely, and even if conversion does not happen, the holder is certain of getting the principal sum and the accrued interest.

Conversion of notes to equity would usually take place upon the occurrence of a **qualified financing**[3] or a **non-qualified financing**[4] depending on the circumstances. Also, the note holder would be entitled to the principal sum and accrued interest upon **maturity** or the occurrence of an **event(s) of default.**[5] The noteholder is usually anxious as to the price the notes would eventually convert into equity and the determination of the **conversion price** is usually based on an agreed matrix.[6] The note may also contain some standard **covenants.**[7] The company

[1] The **valuation cap** has become a very important term of a convertible note. In reality, no real valuation is taking place but a range is agreed based on some estimations and a cap, which is the maximum price at which the note will convert to equity is arrived at. This is calculated as a percentage of the possible amount to be raised in a future series A funding. Without a cap, the investor basically gets a fixed discount at which it will acquire the shares at the occurrence of a series A funding event.

[2] The note purchase agreement would provide for an annual **interest rate** pending conversion, repayment or maturity as the case may be. Interests paid on debt financing by the company are allowable deductions before payment of corporate tax in Nigeria by virtue of **Section 24(a) of Companies Income Tax Act, Cap. C21 L.F.N. 2004,** this is also applicable in most other jurisdictions.

[3] Qualified Financing is one of the events that could trigger the conversion of the purchaser's note to equity. Qualified financing occurs where the company makes, prior to the maturity date, an equity financing pursuant to which it sells shares of its preferred stock, with an aggregate sales price of not less than a pre- agreed amount of money. When qualified financing occurs, mandatory conversion would take place.

[4] This is a financing that does not meet the requirement of a qualified financing. In this case, conversion would not be mandatory

[5] The convertible note agreement would provide for some **events of defaults**, the occurrence of which would make the principal sum become immediately due and payable. Usually, the note agreement would also provide that interest would accrue at a default rate which is higher than the original interest rate upon the occurrence and during the continuance of an event of default. Parties would agree on the events that would constitute events of default.

[6] The **conversion price** is usually the lesser of either:
(a) The price per share paid by the other purchasers of Preferred Stock in the Series A Financing minus the discount per share, if any, given to the note holders; or
(b) the price obtained by dividing the pre-agreed valuation cap by the company's fully diluted capitalization immediately prior to the qualified financing or the non-qualified financing as the case may be. (Which would exclude any shares issued upon conversion of convertible debt).

[7]These **covenants** may require the Issuer to continue its corporate existence, comply with applicable law, pay taxes, protect its intellectual property etc. The investor may insert restrictive covenants which may forbid the company from

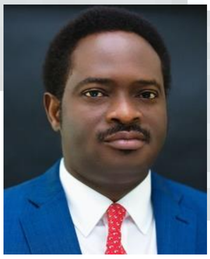
should ensure that the terms are not too restrictive or too strict so as not to affect seamless administration.

Parties may also agree to subordinate the interests of some categories of debtors to the interest of the noteholder in the event of liquidation. It should be noted that the order in which assets of the company are applied in liquidation is regulated by the Companies and Allied Matters Act and the Companies Winding Up Rules. We are of the view that parties' agreement must comply with the provisions of insolvency statutes otherwise the agreements would be void. Please note that a noteholder is not a secured creditor and consequently, his interest is not registrable. Nigerian law places the interests of secured creditors above the interests of unsecured creditors in liquidation. Sometimes, the company might intend to **repay** the principal sum and interest instead of converting the note to equity.[8] Parties can agree that the note may be transferable to another person.

CONCLUSION

Parties to a CPN are advised to seek legal advice in the process of negotiating their agreements to avoid unintended outcomes as some of the terms of the agreement are technical and may be difficult to understand. Also, parties should always include a valuation cap in the agreement to avoid undue negotiation tension in the likely event of conversion. We also recommend that CPN be employed by tech companies with sound corporate governance structures to raise needed capital without diluting the share capital of the company.

CONTRIBUTORS



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doing certain things that may affect the interest of the investor.

[8] To do this, the company would insist on inserting a repayment clause, this would empower the company to exercise the option of paying back the principal sum and interest to the noteholder any time before maturity date upon giving the noteholder a notice of an intention to repay.