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Navigating Convertible Notes During and After COVID-19

There are several ways startups raise funding – one of the most prevalent is a convertible note. A convertible note is issued to investors, often in the early stages of a company's life, and is typically an uncomplicated instrument for investing in high-growth companies. With a convertible note, the investor loans money to the startup in return for equity in the company (rather than repayment of the principal plus interest) at a later time, such as the closing of a priced financing round. Established venture-backed companies also use convertible notes to solve for immediate working capital needs as a bridge to a future priced round.

The outbreak of coronavirus and its resulting illness, COVID-19, has had a considerable impact on commercial and financial markets all over the world. One indisputable disruption of COVID-19 is the volatility in global securities markets. Early-stage companies also face unprecedented disruption due to the global pandemic. Non-essential commercial activity in most developed economies has slowed or stopped due to the crisis, resetting go-to-market plans and revenue projections. And while the prices of shares held in venture-backed companies do not move with the public markets, deal activity and company valuations do rise and fall in response to economic conditions. The uncertainty caused by COVID-19 has required company leaders across every sector to decide whether to stay the course, or layoff, furlough or terminate personnel to reduce staffing overhead and extend the company's runway. Early-stage companies are assessing how the pandemic will affect everything from their day-to-day operations and purchasing behavior to closing the next round of funding.

As a result of the uncertainty, many emerging companies will miss internal growth targets and fall short of investor expectations. The impact of a depression, even a temporary one, on a company's outstanding equity-linked securities, like convertible notes, may be less apparent, particularly in connection with any near-term settlement. Further, the volatility caused by COVID-19 has

accelerated fundraising plans for many emerging companies during this period of great uncertainty. As we experienced during and following the dot.com bust and Great Recession, uncertainty often leads to more investor-friendly terms. Companies should, therefore, be mindful of how convertible notes terms may be affected by COVID-19.

Conversion Triggers

The discount rate and valuation cap (or val cap) give investors two economic controls at the point of conversion. Notes typically convert to equity at a price equal to the lesser of (a) the price per share times (1 – minus the discount rate) or (b) the val cap at the price per share on a pre-money basis. As the conversion price decreases, noteholders receive more shares for dollars invested and, as a result, a greater percentage of ownership.

The discount rate represents the valuation discount the noteholder will receive relative to investors in the subsequent financing round. For example, if a company's shares are priced at \$1.00 per share, a 20% discount would mean that the noteholder would pay 80 cents per share. Typically, the discount rate ranges from 10–30%, with movement up the range reflecting greater pricing risk on the investment. Discount rates for bridge rounds, for example, occasionally land above 20% in the Midwest. Given that investors may have more leverage due to uncertainty in the market, we could see these discount rates shift toward the high end or even exceed the typical range.

The val cap limits the price at which a note will convert into equity by placing a maximum pre-money valuation on the company at the time of conversion. If set thoughtfully, the val cap should contemplate the company's projected pre-money valuation on its priced round. A val cap shields noteholders from price inflation, the presence of which would not adequately compensate noteholders for investing before the company gained sufficient traction.

Before COVID-19, we saw a considerable increase in the use of uncapped notes, which are very founder-friendly. As the market readjusts during and after COVID-19, we may see substantially

fewer uncapped notes. We also expect downward pressure on val caps as investors look to compensate for increased risks in an environment where demand exceeds supply in some geographies.

Interest Rate

Interest provides investors with a minimum level of return should the note reach maturity. Some noteholders leverage interest accumulation to increase their return on investment, while others use interest to cover their cost of capital. What is “market” for the interest rate on a convertible note differs by geographic region. For example, on the West Coast, interest rates tend to fall between 2–5% with the goal of exceeding the then existing federal rate. Interest rates in the Midwest, however, typically range from 8 to 10%.

For notes negotiated during the uncertainty of COVID-19, we expect to see interest rates increase. In the near term, noteholders might look to off-set the risk of their investments using economic levers such as higher interest rates. In the Midwest, specifically, interest rates may trend higher as investors in the region move to immediately leverage a shift in demand.

Maturity Date

The maturity date is the date on which the company needs to repay the loan or convert the note to equity. Often the maturity date will be the earlier of an agreed upon date or the closing of a ‘qualified round.’ For example, if a note had a maturity date of two years from the date of investment and the company did not close a qualified round within two years, the investor could demand payment of the principal and interest outstanding on the note. In calling a note, investors may push a company into insolvency, triggering a default under their note and other related notes.

Investors are typically amenable to extending the maturity date to avoid pushing a company into insolvency. At least one leading accelerator has already moved to support companies within their portfolio during the COVID-19 crisis. With approximately 1,000 convertible note investments outstanding, [Techstars](#) has committed to automatically extend maturity dates by twelve

months on outstanding convertible notes. Additionally, through March 31, 2021, Techstars will not call or demand payment on any of its outstanding convertible notes. Importantly, companies should work with all holders of notes issued under a common note purchase agreement, which usually requires investors of the majority of the dollars invested to agree to amend the terms. During these uncertain times, companies must monitor the maturity date on outstanding notes and work with investors to extend terms as needed.

Companies looking to raise capital with a convertible note should carefully consider how COVID-19 may impact the timing of a qualified financing in negotiating maturity dates. In light of COVID-19, the company may require more time to hit critical milestones in order to attract the investors needed to close a qualified financing round.

Crises create challenges and opportunities. With all the market volatility and uncertainty of when it will end, companies should develop a COVID strategy to ensure they have the capital needed to weather the crisis. In doing so, companies should consider whether raising angel or venture capital, pursuing funding through the Paycheck Protection Program, and/or managing overhead through staff reductions is in the best interest of the company and, most importantly, its stockholders. If the company opts to raise funds, convertible notes provide a simple, efficient tool to do so.

For more information, please contact [Terrence Reeves](#), [Brittany Bradshaw](#) or any attorney in Frost Brown Todd's [Venture Capital Team](#).

To provide guidance and support to clients as this global public-health crisis unfolds, Frost Brown Todd has created a [Coronavirus Response Team](#). Our attorneys are on hand to answer your questions and provide guidance on how to proactively prepare for and manage any coronavirus-related threats to your business operations and workforce.

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