Here’s the basic outline of how convertible debt works:

(1) Angel invests $100,000 in Startup.

(2) Startup issues 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 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.

**Note:** The example above excludes interest assumes that a parallel series of Series A Stock is not being issued here and that a price cap has not come into play.