<u>Convertible Note "*Outcomes Map*"</u>

John O. Huston, Chair Emeritus, Angel Capital Association & Ohio TechAngel Funds – updated October 2017.

<u>INTRODUCTION:</u> When analyzing the appropriateness of convertible notes as a financing tool for any funding round, the various constituencies should be considered. At the minimum, these include the entrepreneur, her/his BOD, the Directors who will currently own other notes or will/will not purchase the new notes, the prior holders of the venture's debt and equity, and the targeted buyers of the new notes. (See my "***Convertible Notes: Advantages and Disadvantages"*** for a discussion of the disparate viewpoints of each of these constituencies.)

One immediate concern is tax treatment. For instance, angels attuned to the benefits of IRC 1244 for C Corps qualifying for QSBS treatment know buying notes that never convert into equity preclude them from ever enjoying the tax benefits of this section (i.e. taking their loss against ordinary income, within limits). Likewise, the holding period "clocks" for IRC 1045 and 1202 do not start when notes are bought. Only the conversion to equity commences the holding period clock.

Furthermore, buyers who presume that the ownership of the notes will never change in the future are setting themselves up for a potentially painful surprise. Compared to equity shares of C Corps (or membership units of LLCs), note documents often place fewer restrictions upon the sale of the notes to others. The original note buyers might die and the company finds itself dealing with heirs (or worse, a bank trust department!) having little concern about the venture's future. They could refuse to be placated when a default occurs (especially when the final maturity passes) because they seek to liquefy their inherited asset.

The best tool I have found for evaluating how noteholders will be treated in various future scenarios is the ***"Outcomes Map."*** The columns for LLCs and C Corps (presuming they qualify for QSBS treatment under the Internal Revenue Code) help identify tax nuances attendant to these two common legal structures for young ventures. However, the goal of this template map is not to force the decision of which legal form is superior for the investment under consideration. That requires legal counsel.

The bullet points in the Outcomes Map below cover the range of most likely outcomes that note issuer face. Obviously, the two main factors are 1) Does the issuer ever raise more capital, and 2) Does it ever exit, thereby providing its note buyers with a gain or tax-deductible loss?

Using this guide to consider each possible outcome can soften surprises. At the minimum, it helps focus document reviewers on the critical issues.

<u>OUTCOMES MAP FOR CONVERTIBLE NOTES</u>

<u>LLC</u> ***<u>C Corp/QSBS</u>***

- **<u>What if the Venture never raises more capital…….and then has this outcome:</u>**
  Loss Exit: Venture fails/ceases operations

  No Exit: Venture becomes a Zombie/won't die
  Venture is successful but can not or will not exit

  Lucrative Exit: M & A/IPO
  Venture has generated the cash to repay the notes

- **<u>What if the Venture subsequently raises more capital…….and then has this outcome:</u>**
  Loss Exit: Venture fails/ceases operations

  No Exit: Venture becomes a Zombie/won't die
  Venture is successful but can not or will not exit

  Lucrative Exit: M & A/IPO
  Venture has raised another round of debt
  Venture has raised equity but no more debt
  Venture has raised both more debt + equity
  Venture has generated the cash to repay the notes

Here are some issues to consider in each scenario:

- What voting blocs exist to force an issue (e.g. note prepayment or conversion into equity; Sale of the company; Approve Terms & conditions of future financing rounds)? How will you feel if you do not have an Inter-creditor Agreement (ICA) in place in each scenario? Often notes are sold via rolling closes and this makes an ICA difficult. While some notes will include some of the details of an ICA, rarely do the earlier buyers have any veto over who subsequently buys notes, which exposes them to "Stranger Danger."
- What if at the notes' expiry the company cannot repay noteholders? Can you guess how each and every co-lenders will behave? Noteholders can demand payment, so whose note expires first? The clout of the lenders increases exponentially when they have an all asset lien. Being comfortable with how each lender will behave at expiry is vastly more essential than knowing all those sitting around an equity cap table (since equity holders have far less individual clout). Might any secured lenders be sharks who "Loan to Own" meaning they will refuse to be persuaded to help the company continue operating?
- If the noteholders do not have a perfected security interest in the venture's assets, do they have a negative pledge by which they have veto power over giving a lien to future lenders? This can stymie a restructuring (or extort others to approve granting of liens to others).
- What are the tax consequences of loss, zombie, and gain outcomes, depending upon whether the venture is an LLC or QSBS C Corp? Contrast the loss of principal versus a capital loss arising from having bought equity instead of notes. Too often angels who bought membership units of an LLC that restructures its debt are stuck paying federal income taxes due to taxable income generated via debt forgiveness.

- One of the benefits of owning debt is that in a liquidation noteholders are paid first. However, if the venture's liquidation proceeds are likely to be minimal, then the advantages of having a first lien (or being a creditor versus shareholder) might be close to zero in terms of minimizing your loss.

SUMMARY: *It is wise to avoid approaching any financing round with a preference for notes or equity. Each can be the optimal financing vehicle in a particular circumstance. Too many angels simply eschew **all** convertible notes. However, would they not be thrilled to buy them when a Letter of Intent is in hand and a quick inside round is needed to be able to live through protracted due diligence by the acquirer?*

My view is that notes, like dynamite, are neither always "good" nor "bad." Their pulchritude hinges on the probability we assign to each outcome and whether we are the seller, a Director of the seller, a holder of the venture's prior debt or equity, or the buyer of new notes being offered.

(John O. Huston: jh@OhioTechAngels.com; (614) 578-8483)