Convertible Note Glossary

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As a supplement to the Convertible Notes Advantages and Disadvantages and the Convertible Note Outcomes Map, provided below are the most prevalent aspects of convertible notes that angels encounter. To facilitate crafting the optimal negotiation strategy, it is helpful to separate the terms and conditions that affect note buyers' economics, from those that affect their control.

Economic Issues (i.e. affect potential financial returns):

Conversion Discount: The note's outstanding principal balance (plus usually all accrued interest) convert into the next equity round at a discounted price per share. The discount might be flat (e.g. 20%), or it can be tied to the passage of time (e.g. only 10% in the first year and 20% thereafter), or tied to a milestone (e.g. sales, patent issuance, landing a marquee customer, gaining regulatory approval).

Liquidation Multiple: This is a premium note holders receive if the company is sold prior to the next equity round being raised (can often be 1.5X to 2.5X). Its purpose is to protect note purchasers from receiving a return consisting mainly of their accrued interest in the event the company is swiftly sold.

Warrant Coverage: Refers to providing a percentage of the note's principal amount to noteholders as a right to buy common shares at a set price. For instance, one who purchases $100,000 of notes with 25% warrant coverage at $1.00 per common share would have the right to buy $25,000 of common shares over a specified time period (often 10 years). This equity kicker enhances returns. And, it may be less likely to be contested by the leaders of the next equity round than the conversion discount. This is because the shares received are junior to the preferred shares into which the notes convert.

Valuation Cap: This is a valuation ceiling set on the next equity round to provide some protection against that round's price been so grossly above market that the conversion discount is almost meaningless. The cap may state that "regardless of the valuation of the next equity round the notes will convert at a maximum valuation of $X million."

Pro Rata Rights: This gives noteholders the right to purchase their pro rata share (as specifically defined) of the next equity round (in addition to their conversion shares) or even future rounds.

Interest Rate: The interest rate for Convertible Notes over the last two decades has been in the 6 – 10% per annum range and is generally accrued (i.e. no cash payments are received prior to conversion). The accrued interest is merely added to the outstanding principal balance at the time of conversion. Occasionally the interest is only paid in common shares instead of preferred shares. (***n.b.***: Noteholders should seek tax advice regarding whether they should report their interest that is accruing prior to conversion.)

Penalty Interest: If the notes are not paid at maturity an additional interest rate (often 5- 10%) is applied on top of the stated rate.

Prepayment Penalty or Prepayment Prohibition: Noteholders want to defend against taking an equity risk but only receiving a debt return so convertible notes often prohibit prepayment, or require a significant penalty fee if the venture redeems the notes prior to the sale of the company or conversion into the next equity round.

Collateral: The borrower might give noteholders a perfected security interest in all of its assets (a "blanket lien"), or only in specified assets (e.g. IP, cash, or Accounts Receivable). And, these liens can be shared equally with other creditors (on a pari passu basis) or can be allocated on a senior/junior basis.

Most Favored Nation Clause (MFN): The note issuer promises that if it sells any notes in the future on more "investor-friendly" terms than the current notes, then all noteholders will enjoy identical terms. MFN treatment can be important when notes are sold over many months to buyers who might attempt to extract preferential terms.

Key Person Life Insurance: Equity buyers routinely require life insurance on the founder, but debt holders rarely do. However, if a policy is already in place with the company as beneficiary (as is the usual case) then, due to their priority of payment, debt holders benefit from this insurance. Convertible notes are generally viewed to be a bridge to the next equity round whose participants will require this insurance. Putting the policy in place when convertible notes are sold should be a point of negotiation.

Minimum Round Size: To preclude entrepreneurs selling notes piecemeal as needed (which diverts their attention from growing their business) some notes stipulate that they are but one of a total amount of notes of $X dollars with these terms. Ideally, the note proceeds would be put in escrow until the minimum round size is met.

Optional Conversion at Maturity: Noteholders should be wary of the outcome in which the company bootstraps and never sells more equity. Therefore there is never an equity round into which the notes can convert. This optional conversion clause gives the noteholders at maturity the option of converting into the last round of common stock sold, or continuing to hold an expired note. Of course, they can always demand payment. But, if the company can retire the notes at maturity noteholders have displayed their financial literacy (defined as taking an equity risk but only getting a debt return).

Control Issues (i.e. enable note holders to determine how they are treated)

Common Maturity Date: If notes are sold over several months then those who were the first buyers typically have the earliest maturity (meaning they hold the expired note hammer first). It is wise to compress the note sales into a few weeks, holding all checks until they are deposited on the same day, thereby resulting in a common maturity date. This also makes the bookkeeping of each note's accrued interest (and therefore conversion amount) much simpler.

Tenor: Clearly the holder of the note with the earliest maturity is the first to hold the expired note hammer. Some subsequent note buyers might require that the notes with earlier maturities be extended to match the new notes' tenor.

Buyer Qualifications: Company counsel must provide advice regarding the verification of "accredited status" of the note buyers, as well as compliance with general solicitation rules. Recent crowdfunding legislation and SEC interpretations make this more important than ever.

Information Rights: Even though the notes are designed to convert into an equity round whose participants will require at least quarterly updates, notes should mention reporting requirements, along with the penalties for non-compliance.

Minimum Note Size: Stating the smallest dollar amount of each note will preclude dealing with many small noteholders. One approach is to make all the notes identical in terms of size and maturity (e.g. $50,000) which becomes the minimum amount. Then buyers can purchase multiple notes.

Repayment Prohibition: This means that noteholders can never be repaid against their will, which they might be able to leverage in some circumstances. One is when an acquirer wants to pay off the notes. Another is when the founder decides to pivot into a lifestyle company and wants to cease the interest burden. The following simple statement can provide enormous clout: "This note cannot be repaid without the noteholder's approval."

Mandatory Conversion: The opposite of a repayment prohibition, this feature requires all note holders to convert when the next equity round is raised, or some other event occurs (e.g. sale of the company).

Representations and Warranties: Typically notes require both the seller and buyer to provide certain representations and warranties as of the time of the note sale. For instance, the company will represent and warrant that it has provided financial statements, has received all the necessary approvals for selling these notes, and is not in default of its obligations under any significant contracts. The critical issue is which of the company's representations and warranties need to be accurate only at the time of the note sale, or on an ongoing basis.

Events of Default: Unlike stock of C Corps or membership units of Limited Liability Corporations, notes always have at least one Event of Default which is non-payment at maturity. However, there can be others, such as non-delivery of financial statements, violating voting and approval rights, etc. Notes may provide for a stated grace period (often 30 days) to give management time to cure an event of default (such as delivering overdue financial statements. Once an Event of Default has occurred and any grace period has expired, note holders can decide whether to declare a Default, which triggers the stated remedies. However, bankruptcy usually triggers an automatic Default without a grace period.

Acceleration: This refers to declaring a Default and demanding that the loan must now be repaid in full. Noteholders need to be aware of which, if any, Events of Default cause an automatic acceleration (such as bankruptcy).

Inter-Creditor Agreement (ICA): Since each note has a stated maturity, each note holder is holding a hammer at expiry if pay-off does not occur. This can result in one noteholder single-handedly scuttling a restructuring agreement (and pursuing their collateral if they are secured). To preclude this, sometimes an Inter-creditor Agreement (ICA) is written to stipulate how the signatories (ideally all lenders) will comport themselves when certain events occur. For instance, if 80% of signatories agree to extend a maturity or waive an Event of Default then all lenders must comply. Likewise, to confound "Loan to Own" sharks, the ICA require that any and all proceeds from the liquidation of any noteholder's collateral must be distributed pro rata among all noteholders.

Voting Rights: This refers to the issues that noteholders must approve, the most common ones being any sharing of collateral and the issuance of other debt (unless it is junior). Absent an Inter-Creditor Agreement each noteholder has a vote and all must approve any request. This would mean that each note holder possesses singular clout in any restructuring discussions (i.e. a unilateral veto).

Protective Provisions: Typical documentation for a preferred stock financing round gives stockholders protection by requiring approval for, among other items, an increase in the number of Directors, selling or pledging any assets, declaring any dividends, redeeming any stock, and, merging, selling, or liquidating the company. Some notes might add some of these provisions to their usual veto right regarding selling more secured debt.

Board or Observer Seat: Generally sellers of notes do not offer boardroom access to creditors, but might provide a seat for the largest note buyer. And, sometimes the occurrence of any Event of Default entitles a representative of the noteholders to join the BOD.