OUTCOMES MAP (Convertible Note Example)

When analyzing the appropriateness of convertible notes as a financing tool for any funding round, the various constituencies need to be considered. These include, at the minimum, 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 these constituencies.)

For instance, angels attuned to the benefits of IRC 1244 know that buying notes which eventually convert into equity preclude them from ever enjoying the tax benefits of this section (i.e. taking their loss against ordinary income). Likewise, the holding period "clocks" for IRC 1045 and 1202 are not started when notes are bought until conversion to equity occurs.

Furthermore, buyers who presume that the ownership of the notes will not change in the future are setting themselves up for a potentially painful surprise. Compared to shares, notes often place fewer restrictions upon their sale to others. As with equity shares, the original owners can expire and the company finds itself dealing with bank trust departments or heirs with little concern about the venture's long term prospects. They might simply refuse to be placated when a default occurs (such as the final maturity passes), demanding repayment in full.

This is why it can be helpful to use an "Outcomes Map" to prompt discussion of how noteholders will be treated in various future scenarios per this template. Both LLC and C Corp structures are included below although the point of this map is not to force the decision of which legal form is superior for the investment under consideration.

	LLC	***C Corp/QSBS***

- **Venture never raises more capital:**
  Loss Exit: Venture fails/ceases operations

  No Exit: Venture becomes a Zombie/won't die
  Venture is successful but cannot/won't exit yet

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

- **Venture subsequently raises more capital:**
  Loss Exit: Venture fails/ceases operations

  No Exit: Venture has become a Zombie/won't die
  Venture is successful but cannot/won't exit yet

  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

Issues to consider in each scenario:

- What voting blocs exist to force an issue (e.g. note prepayment or conversion into equity; Sale of 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 state many of the details of an ICA in their terms, 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 all co-lenders will behave? (i.e. to what extent are you exposed to "Stranger Danger" or sharks who "Loan to Own" so cannot be persuaded to help the company continue operating?)
- What are the tax consequences of loss/zombie/gain depending upon whether the venture is an LLC or C Corp? Contrast the loss of principal versus a capital loss arising from having bought equity instead of notes.
- One of the benefits of notes is that in a liquidation they 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.

(Obligatory Reminder: This discussion is not legal or accounting advice, but merely is aimed at arming the reader with some of the questions to ask professionals in these disciplines.)

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 certain set of circumstances. Neither security is always "good" nor "bad." Their pulchritude hinges on the probability you assign to each outcome and the constituency to which you belong.*