Convertible Note Glossary

To supplement the summary of Convertible Notes Advantages & Disadvantages, below are listed some of the most prevalent aspects of convertible notes that angels encounter. They are grouped into categories, although obviously some note terms span several categories.

**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 set number of years (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 because the shares received are junior to the preferred shares.

**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 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 note holders 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.
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: Note holders 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 ventures redeems the notes prior to the sale of the company or conversion into the next equity round.

Collateral: The borrower might give note holders a perfected security interest in all of its assets (a “blanket lien”), or only in specified assets (e.g. IP, cash, and 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: The note issuer promises that if it sells any notes in the future on more “investor friendly” terms than the current notes, then all notes will enjoy identical 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. Because convertible notes are 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 might arise as 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.

Optional Conversion at Maturity: To protect note holders from an outcome of having the company bootstrap and eschewing ever selling more equity, this clause gives the note holders 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.

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 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 hammer so expect that if subsequent note are sold their buyers will require the notes with earlier maturities to 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 implications of non-compliance.

Minimum Note Size: Stating the smallest dollar amount a note holder can buy can avoid dealing with many small note holders. Sometimes all notes are in the same size (e.g. $50,000) which becomes the minimum amount. Then buyers can purchase multiple notes.

Repayment Prohibition: This means that note holders can never be repaid against their will, which they might be able to leverage in some circumstances (such as a pending acquisition).

Mandatory Conversion: The opposite of a repayment prohibition, this feature requires all note holders to convert when the next equity round is raised.

Events of Default: Unlike stock of C Corps or membership units of Limited Liability Corporations, notes always have at least one Event of Default (non-payment at maturity). However, there can be others, such as non-delivery of financial statements, violating voting and approval rights, etc. Once an Event of Default has occurred note holders can decide whether to declare a Default, which triggers the stated remedies.

Acceleration: This refers to declaring a Default and demanding that the loan be repaid in full. Note holders need to be aware of which, if any, Events of Default cause an automatic acceleration.

Inter-Creditor Agreement: Since each note has a stated maturity, each note holder is holding a hammer at that time if payment is not made. This can result in one note holder single handedly scuttling a restructuring agreement (and pursuing their collateral if they are secured). To preclude this, sometimes an Inter-creditor Agreement is crafted that determines how the signatories (ideally all lenders) will comport themselves. For instance, if 80% of signatories agree to extend a maturity or waive an Event of Default then all lenders must comply.

Voting Rights: This refers to the issues that note holders 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 agree. This would mean that each note holder possesses singular clout in any restructuring discussions.

Protective Provisions: Typical documentation for a preferred stock financing round gives the holders protection by requiring voting 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. Note holders might consider adding 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.

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