<u>Term Sheet Checklist for Notes</u>

When Boards of Directors (BODs) of Angel Backed Companies (ABCs) are asked to approve the term sheet for a note round they might find this checklist below helpful. Not all these items need to be included, and the many unique special aspects of several types of debt instruments (e.g. Asset-Based Loans, Revenue Participation Notes, Venture Debt, and Convertible Notes) are not covered herein. But, reviewing this general checklist could make it easier to field likely questions from prospective note purchasers. Naturally counsel <u>must</u> be consulted, but this list will help frame the discussion of which terms and conditions may be needed to complete the note round in current market conditions.

1) <u>Ability to repay:</u> Unless the notes are designed to convert into the next equity round (i.e. "convertible notes") buyers generally expect a minimum Debt Service Coverage Ratio (DSCR) of 1.25X. Therefore this level of cash generation available to service the debt should be convincingly portrayed in the financial forecasts provided to prospective note purchasers.
2) <u>Ability to repay prior to maturity:</u> Buyers might request a special fee or prepayment penalty if the notes are redeemed early, especially if this occurs due to the sale of the company.
3) <u>Total amount to be sold:</u> The size of the round should be adequate to enable the ABC to either generate the cash flow needed to service the debt, or to de-risk the company so that the next equity round can be raised.
4) <u>What is the minimum amount of the round?</u> Some note buyers want to be assured that the capital they are providing the company is one piece of a business plan mosaic, and not merely being used to fund next week's payroll. Such angels prefer to see a minimum amount of the round, which might be provided in a first close. Note buyers may provide the law firm their paperwork and money to be held in escrow until the minimum is met. Having all notes be issued on the same date simplifies the recording of interest.
5) <u>What is the minimum amount any one note holder must buy?</u> Instead of having buyers suggest their level of interest, sometimes it is wise to set a single, uniform note size (e.g. $50,000) and sell multiple notes to buyers.
6) <u>Receipt of payment:</u> Will checks be accepted or only wire transfers? Many investors prefer to send checks to avoid the wire transfer expense, especially for smaller notes.
7) <u>Will any notes be sold to those who are not "Accredited investors?"</u> Counsel <u>must</u> be consulted regarding crowd funding and general solicitation rules.
8) <u>Interest rate:</u> The rate often depends upon whether there are equity kickers/sweeteners (e.g. warrants, or conversion discounts) and whether the notes will be re-paid or converted into equity. Will the interest be in cash or PIK (Payment in Kind, i.e. accrued)? What is the penalty interest rate that becomes operative upon an Event of Default?
9) <u>Collateral:</u> Creditors will ask about their relative seniority in terms of having the ability to offset their potential loss of principal by selling off the ABC's assets pledged to them. Regardless of whether they have a perfected security interest in the venture's assets, note holders obviously are senior to shareholders in any liquidation. However, they will want to know with what other creditors they will have to share their distribution if the venture fails. Will buyers of unsecured notes request a "Negative Pledge?"
10) <u>Tenor:</u> What is the final maturity of the notes? Will all the note holders have the same maturity? This would avoid giving undue power to the creditor who bought the first note sold in the round

(meaning his/her note expires first). Should there be a mechanism to extend the maturity without the approval of all note holders?

11) Most Favored Nation Clause: If buyers think eventually completing this note round might span many months they could request that if the terms of any subsequently sold notes are more investor favorable than the current notes, then the early buyers will be granted the same terms.
12) Amortization: Will any principal be repaid prior to final maturity?
13) Information rights: What financial reports must be sent to the note holders and how often?
14) Pro Rata Investment Rights? Most preferred stock purchase agreements include pre-emptive rights that enable investors to avoid dilution by granting them the right to purchase their pro rata portion of future financing rounds. It is rather uncommon that ABC note issuers will provide this right, but buyers might ask (especially for convertible notes).
15) Events of Default: In what circumstances can the note holders call their notes, thereby threatening bankruptcy or a restructuring?
16) What happens at maturity? The BOD should not presume that investors will merely extend if the notes cannot be paid at maturity. Since note holders have vastly more power than stockholders, when selling notes the BOD should apply a heightened level of scrutiny regarding noteholders' likely behavior at maturity. The level of "Stranger Danger" is much higher whenever selling debt versus equity.
17) Is an Inter-Creditor Agreement Needed? The purpose of this document is to set forth on a collective basis the rights and remedies of the note holders so that one of them cannot unilaterally attempt to extract preferential terms if the notes need to be restructured. For instance, consider a case in which the company cannot repay the notes in full at maturity. This is an Event of Default giving note holders the right to demand payment upon penalty of pursuing a bankruptcy proceeding. The basic concept of an Inter-Creditor Agreement is to set the rules to be followed by all signatories regarding such events as extending maturities, amortization schedules, or sharing distribution of collateral. These agreements can be complex to negotiate but are wise if the BOD is concerned about possibly predatory behavior by any note holder.
18) Sale and Co-Sale Rights? In light of the power that creditors possess the BOD should be cautious about allowing any note holders to sell their notes to others, thus exposing the company to potential "stranger danger."

Submitted May 7, 2016 by John O. Huston (jh@OhioTechAngels.com)