The Great Convertible Note Debate...What New Angels Need to Know

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Types of Notes

Bank Loans

Asset Based Loans

Mezzanine Debt

High Yield Notes

Venture Debt

Revenue Participation Notes

Convertible Notes (This session's focus)

Convertible Notes Defined

Capital raised by early stage ventures via selling notes that convert into the next equity round:

- Originally just bridge notes
- Often bought by those who were buying the equity later
- No cash interest is paid (accrued)
- Buyers expected notes to convert, not be paid at maturity
- Economics may include a conversion discount, a valuation cap, and/or warrant coverage

5 Convertible Note Issues to Consider

- 1) Convertible Notes are not "BAD" or "GOOD".....just "BETTER" in some instances than others
- 2) Key components affect economics vs. control
- 3) 3 viewpoints: entrepreneur, Board member, angel purchaser
- 4) Honoring the terms & conditions: "Inside" or "Outside" round?
- 5) What are the venture's likely outcomes ("Outcomes Map")?

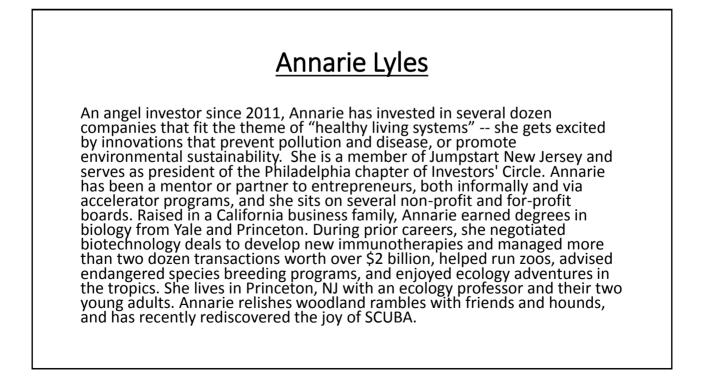
"Inside" versus "Outside" Rounds

One important factor that affects the appropriate terms and conditions is whether the next equity round into which the notes will convert will be an "inside round" (comprised of current noteholders and shareholders) or an "outside round" (requiring a significant number of new investors to fill out the financing). With inside rounds the odds that the conversion discount will be honored are probably higher than with an outside round.

Outcomes Map.....the company might.....

- 1) Go out of business
- 2) Bootstrap, never raising any more capital prior to the exit
- 3) Sell more debt
- 4) Sell more equity
- 5) Sell more debt & equity (in which order?)
- 6) Be bought prior to ever raising more capital
- 7) Be eventually bought/IPO-ed after subsequent rounds of capital
- 8) Become a zombie (surviving, but incapable of luring an acquirer)

<u>4 Handouts (14 pages)</u>			
 Checklist of the 18 basic terms for debt term sheets (2 pages) 			
 Glossary of 26 Convertible Note Ter Economics issues Control issues 	rms (4 pages): = 13 = <u>13</u> 26		
 40 Advantages + 38 Disadvantages The Entrepreneur's viewpoint The Angel Purchasers' viewpoint The Director's viewpoint 	of convertible notes (7 pages): = 32 = 32 = <u>14</u> 78		
• "Is it wiser to buy convertible notes	or preferred stock?" (1 page)		



David J. Sorin

- Dave Sorin is a partner at McCarter & English, Chairing the Venture Capital & Emerging Growth Companies practice. He focuses primarily on privately- and publicly-owned startup, early stage, emerging growth, and middle market technology, tech-enabled and life science enterprises, as well as the investors, executives, and boards of directors who support and lead them. Dave has a long track record of successful representation of growth companies, having been repeatedly recognized by well-known periodicals for a unique combination of legal acumen and sound business judgment. He also brings to bear his broad range of knowledge and experience in counseling enterprises and investors in diverse emerging growth markets, technology industries (including software, information technology, e-commerce, cybersecurity and communications), and life sciences. Many of the companies he represents are well-known names throughout the Mid-Atlantic region.
- One industry-leading publication has recognized Dave as one of New Jersey's top 100 business people, categorizing him within an "elite group" of executives who "are the voices of their industries." He was later identified by another industry publication as one of the region's "top deal makers." *Chambers USA*, an international guide to lawyers and law firms, called Dave the State's top corporate lawyer. Most recently, *SmartCEO* Magazine named McCarter the New York region's large law firm of the year in the tech and tech-enabled industry sector and named Dave the leading lawyer in that category. He has been named a Super Lawyer in each of New York, New Jersey and Pennsylvania.



- Advantages & disadvantages of convertible notes
- Experiences with convertible notes
- Q & A

QUESTIONS & REBUTTALS

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