

BRIDGING THE (WORKING CAPITAL) GAP: AN ANNOTATED CONVERTIBLE PROMISSORY NOTE TERM SHEET

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In a troubled economy, when raising capital to fund operations may seem like a Herculean challenge, convertible debt may present an attractive alternative to equity financing for early stage businesses and their prospective investors. Convertible debt financings may be applied in a variety of contexts and may avoid some of the cumbersome issues of early stage equity financings.

Convertible debt financings may be an ideal investment vehicle for raising capital to fund startup ventures during the friends/family round of financing, especially in high-growth businesses where issues of valuation may prove particularly difficult. Operating businesses may also use convertible debt financing (sometimes called “bridge financings”) to satisfy working capital needs between rounds of capital stock offerings. In this context, they are often viewed as providing a “bridge of capital” between rounds of equity financings and subsequent (often preferred) equity financings.

In a typical convertible debt financing, the borrower issues convertible promissory notes to investors for a limited term. These convertible promissory notes often mature within one to two years from the date of issuance of the note. Parties commonly negotiate alternative structures relating to the note’s maturity, for example, providing for acceleration of the note’s maturity upon consummation of an equity financing. Upon maturity or some other negotiated event, the note holder may have the option of calling the convertible promissory notes (with accrued but unpaid interest) or converting the convertible promissory notes into capital stock of the borrower based on a pre-determined formula. To compensate the investors for the investment risk they are assuming, convertible promissory notes are often secured against all of the assets of the borrower.

Convertible debt financings offer several advantages—and a few disadvantages—when measured against typical equity financings, including the following:

- **Valuation.** Equity financings necessitate a valuation of the business. Valuation of startup businesses is especially difficult because such ventures often have short operating histories, limited or no revenues, unproven technologies and other considerable risks, notwithstanding their potential for dramatic growth. Moreover, business valuation is a specialized and expensive service—a cost that early stage businesses may be reluctant, or unable, to bear. Frequently, founders with no experience in finance but great enthusiasm for their technologies assign a value to their businesses that is significantly greater than the “market rate” and raise seed capital at that value from family and friends. What often happens next is that the equity positions of



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the founders (and their families and friends) are appreciably diluted by subsequent rounds of equity financing with more sophisticated investors. The latter often reassess and write down the founders' arbitrary and inflated valuation of the business. By contrast, in a convertible debt financing, the business and its prospective investors avoid valuation pitfalls: the business gets the capital it needs, and the issue of valuation is postponed until the business is further along in its growth and both better equipped to afford an appraisal and easier to appraise reliably. Moreover, convertible debt financings tend to put the founders and the note holders on the same side of the table in determining the business's valuation with later rounds of equity investors.

- **Cost-Effective and Efficient.** Equity financings, particularly preferred equity financings, require the negotiation and documentation of a legally complex financial relationship between the business and its prospective investors, often including stock purchase agreements, amendments to charter documents setting forth preferred stock rights, shareholder agreements, voting agreements, registration rights agreements, and other documents unique to early stage equity financings. This translates into higher legal costs for businesses. On the other hand, convertible debt financings may eliminate much of the legal complexity and unwieldiness of equity financings, as well as the time required to negotiate and document such transactions. The cost-effective nature of convertible debt financings often appeals to both early-stage businesses with limited capital resources and better established businesses looking to contain costs and access capital sooner. Further, because convertible debt financings are relatively common financing structures, they will not create impediments to future preferred equity financings with more sophisticated investors.
- **Equity "Sweeteners" – Conversion Discounts and Warrant Coverage.** Because of their speculative and risky nature, convertible debt financings by early stage businesses often include a little something extra, i.e., a feature of the investment that "sweetens" the deal for prospective investors. For example, the convertible promissory note may convert into preferred stock at a discount relative to the price to be paid by other investors in a succeeding round of equity financing, or the note holder may receive a warrant to purchase capital stock of the borrower. The ratio of the capital stock that may be purchased to the principal of amount of the convertible

debt is often expressed as a percentage, commonly referred to as the "warrant coverage."

- **Advantages of Being a Creditor.** A significant advantage of convertible debt financings to early stage investors is that they are treated as creditors of the business and, in the event of a liquidation (or bankruptcy) of the borrower, note holders receive preferential treatment to shareholders in the distribution of the borrower's assets. In some instances, however, courts have treated convertible debt financings with significant equity security features as equity.

Some of the risks of convertible debt financings are:

- **Disadvantages of Being a Creditor.** A hazard of investment in convertible debt financings for investors, however, is that they will not have many of the significant legal protections afforded to shareholders. For example, debt holders do not have statutory rights to examine the books and records of the borrower (however, such rights may be negotiated into the contract). Also, although a borrower's board of directors owes fiduciary duties of loyalty and care to its shareholders, the point at which a borrower's board of directors must begin to consider the interests of convertible or other debt holders is less clear. Generally, the borrower's board of directors owes a fiduciary duty to the holders of convertible or other debt when the business becomes insolvent. This is because the creditors will have the first claim on the borrower's assets if the business becomes insolvent.
- **Disadvantages to the Borrower.** Convertible debt financings do present hazards for borrowers as well. Foremost, if the conversion event does not occur, the convertible promissory note remains payable. With limited available capital, startup businesses whose convertible promissory notes are secured against the assets of the business can wind up in a foreclosure in which the holders may take ownership of the assets and liquidate them to make payment on the convertible promissory note.
- **Original Issue Discount.** A convertible promissory note with warrants attached can present tax issues for investors – investors are taxed on "phantom" interest because of a revenue recognition concept called original issue discount recognition. Such promissory notes require a certain amount of the face value of the debt to be allocated to the warrants. The investor is required to amortize this resulting "discount" on the note's face value into income as if the investor is receiving cash payments even though no actual cash is paid to the investor. As a result, the investor must pay taxes on this "phantom" income.

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Often the terms of a convertible debt financing are negotiated in the summary form of a term sheet, which sets forth the material terms of the proposed financing between the borrower and its prospective investors. Some key terms of a typical Secured Convertible Promissory Note term sheet are discussed below.

TERM SHEET FOR THE OFFERING OF UP TO \$[DOLLAR AMOUNT] [PERCENTAGE]% SECURED CONVERTIBLE PROMISSORY NOTES OF [NAME OF BORROWER]	
<p>This Term Sheet summarizes the principal terms of the proposed convertible debt offering of [Name of Borrower] (“Borrower”) and [Investor Names] (together with all other investors, the “Investors”). This Term Sheet is not intended to be a binding agreement between the Investors and Borrower with respect to the subject matter hereof, except for the paragraph immediately below regarding confidentiality. A binding agreement will not occur unless and until all necessary approvals have been obtained and the parties have negotiated, approved, executed and delivered the appropriate definitive agreements. Until execution and delivery of such definitive agreements, any party shall have the absolute right to terminate all negotiations for any reason without liability therefor.¹ This Term Sheet does not constitute an offer to sell or an offer to purchase securities.</p>	
Confidentiality	
<p>The terms and conditions described in this Term Sheet, including the fact of its existence, shall be confidential information and shall not be disclosed to any third party. If any party determines that it is required by law to disclose information regarding this Term Sheet or to file this Term Sheet with any governmental or quasi-governmental authority, it shall, a reasonable time before making any such disclosure or filing, consult with the other party regarding such disclosure or filing and seek confidential treatment for such portions of the disclosure or filing as may be requested by the other party.²</p>	
Secured Convertible Promissory Notes	
Security:	[Percentage]% Secured Convertible Promissory Notes (the “ Notes ”).
Minimum Principal Amount: Maximum Principal Amount:	[\$Dollar Amount] [\$Dollar Amount] ³
Closing:	An initial closing shall be held on or before [Date] (the “Closing Date”), and subsequent closings, up to the maximum principal amount, may be held up to [Number] days thereafter. ⁴

1 Term sheets are generally intended to be non-binding. This is because the parties often have not yet undertaken any due diligence investigation but want to outline their basic understanding of the terms of the financing. However, if the parties wish to commit to the financing on the basis of the term sheet, the term sheet should be revised to reflect this understanding.

2 Although term sheets are generally non-binding, the parties often negotiate a binding confidentiality provision to protect against improper disclosure of information.

3 Investors may require that a minimum (or “floor”) principal amount be committed to the financing before they deliver any capital; therefore, it is common for the financing terms to include minimum and maximum (or “ceiling”) principal amounts. This is typical when the financing is structured as a private offering to a limited number of investors. This concept should be omitted if the transaction is with a single investor.

4 It is common to provide for an initial closing upon raising the minimum principal amount, if applicable, to be followed by additional closings until the maximum principal amount is raised. The period allowed for additional closings (i.e., to raise the maximum amount of debt) may also be limited (e.g., “additional closings for up to 90 days following the initial closing”). This concept should be omitted if the transaction is not structured as an offering to multiple investors.

Interest:	<i>[Percentage]</i> % ⁵ ; provided, however, that upon an “Event of Default” (as defined below), the outstanding balance of the Notes will thereafter bear interest at the default rate of <i>[Percentage]</i> % per annum until such Event of Default is cured. ⁶
Pre-Payment:	Borrower shall not be permitted to pay all or any part of the principal or any accrued interest on the Notes before the Maturity Date. ⁷
Maturity Date:	All unpaid principal and accrued but unpaid interest on the Notes shall be due and payable on <i>[Date]</i> (the “Maturity Date”). ⁸
Use of Proceeds	The proceeds from the sale of the Notes will be used for working capital and general corporate purposes. ⁹
Security Interest:	The Notes shall be secured by all of the assets of Borrower and shall be senior in priority to all subsequent security interests, except for the working capital and asset security interests normally required as collateral to facilitate Permitted Borrowings (as defined below). Borrower shall cooperate in the immediate perfection of the security interest by a UCC-1 financing statement and any other document or instrument necessary to perfect Investor’s security interest. ¹⁰

5 Interest rates and features may vary, e.g., simple interest versus compound. Generally, interest rates on convertible promissory notes range from 4% to 10%, and vary with the complexity and perceived risk of the transaction. For example, a secured convertible promissory note may offer lower interest rates relative to an unsecured convertible promissory note. Further, terms concerning the payment of interest may vary. It is not unusual to provide for repayment of accrued interest and the principal at maturity or upon another negotiated event; some financings also provide for periodic interest payments (e.g., monthly, quarterly, or annually), with repayment of principal at maturity. Counsel should be mindful of the applicable usury laws.

6 Often a default rate of interest is included – this is the applicable rate during any periods of default, which may include any period during which the promissory note is due but not paid. The default interest rate is often 12 to 15%. See the discussion under “Events of Default.”

7 Investors typically negotiate restrictions on the borrower’s ability to pre-pay the principal (and accrued interest) on the promissory notes before the maturity date. This is because investors typically want to achieve a minimum rate of return on their investment, which may require the promissory note to be outstanding for a minimum amount of time.

8 Terms concerning the maturity date vary depending on the specific circumstances. Convertible promissory notes can include specifically defined terms and provide for maturity on a certain date. Alternatively, maturity may be tied to an equity financing or satisfaction of milestones (e.g., if the company secures a credit facility or exceeds pre-determined EBITDA targets).

9 As previously noted, bridge financing often bridges the capital needs of businesses between rounds of equity financing. As such, the proceeds raised from a convertible debt financing are typically used to fund working capital and general operating expenses. It is not unusual, however, for investors to negotiate specific uses of the convertible note financing proceeds (e.g., the acquisition of facilities or the development of technologies).

10 Investors usually require a lien on the borrower’s assets to secure the borrowed funds. Counsel should be mindful of the proper protocol required to perfect the grant of a security interest under applicable laws, which generally include specific grant language in the definitive agreement and filings with the proper agencies. A comprehensive discussion of perfecting security interests is outside the scope of this paper and counsel should investigate proper filings. Counsel may also want to consider restricting the ability of the borrower to grant additional security interests (senior to the investor’s security interests) except for security interests created in the ordinary course of business.

Permitted Borrowings:	Borrower may enter into secured or unsecured borrowing from commercial banks and comparable commercial credit institutions to finance inventory and fixed assets, subject to the approval of a majority of Borrower’s Board of Directors, without the consent of the Note holders. All other borrowing shall require the approval of the holders of a majority in original principal of the Notes. ¹¹
Conversion:	All principal and accrued but unpaid interest on the Notes shall immediately convert into shares of the preferred stock of Borrower on the same terms and conditions, including per share price, as such shares of preferred stock, if a minimum of \$[Dollar Amount] of preferred stock Borrower is issued in one issue or a series of related issues (not including the value of the converted Notes) in a private offering to “Accredited Investors” (a “Qualified Financing”). If no Qualified Financing shall have been consummated before the Maturity Date, the holders of a majority in original principal of the Notes shall have the right, immediately upon written demand, to require repayment of all unpaid principal and accrued interest on the Notes or to convert all unpaid principal and accrued interest on the Notes into common stock of Borrower at the fair market value per share of the common stock. ¹² Notwithstanding the foregoing, all principal and accrued but unpaid interest on the Notes shall immediately convert into common stock of Borrower at the fair market value per share of the common stock if any of the following shall occur before the Maturity Date: (a) a sale of all or substantially all of the assets of Borrower, the sale of a majority of Borrower’s voting securities, or a merger of Borrower as a result of which Borrower is not the surviving party; or (b) a public offering of the equity securities of Borrower or a combination of Borrower into a publicly-traded corporation.
Anti-dilution:	The Conversion Shares shall have anti-dilution protection on customary terms, or such more favorable terms as any other class of Borrower equity. ¹³
Events of Default:	The principal and any accrued but unpaid interest on the Notes shall become immediately due and payable if an Event of Default shall occur. An “ Event of Default ” shall include: <ul style="list-style-type: none"> • Breach of any material term of the Notes, which is not cured within 30 days of written notice, including Borrower’s failure to pay the Notes when they become due and payable; • Borrower’s failure to pay its debts as they come due if such failure is not cured within 60 days of written notice; and • Insolvency, bankruptcy, receivership, or any similar proceeding is instituted involving Borrower and is not dismissed within 60 days of being instituted.¹⁴

11 Counsel should consider restricting the ability of the borrower to incur additional debt without prior consent. Such restrictions often exclude debt incurred by the borrower in the ordinary course of business relating to trade payables or borrowings from commercial banks or comparable credit institutions.

12 The terms and conditions of conversion vary depending on the transaction. In a bridge financing, typically all principal and accrued but unpaid interest immediately convert into shares of the borrower’s preferred stock issued in the anticipated preferred stock financing on the same terms and conditions available to other investors in the same preferred stock financing. This assumes the satisfaction of other conditions, e.g., consummation, on or before a specified date and a minimum offering size. If no such financing is consummated, the convertible promissory note is usually due and payable immediately, but sometimes the holders retain the right to convert all principal and accrued but unpaid interest into common or preferred stock.

13 The terms of the convertible promissory note typically include anti-dilution provisions protecting against any dilution in borrower’s capital structure caused by issuances of borrower equity at less than the conversion price of the Notes. They also generally include adjustments in the borrower’s capital stock in connection with stock dividends, stock splits, and similar transactions affecting borrower’s common stock.

14 Some standard events of default are included in this term sheet. Additional events of default may include the borrower’s failure to complete a preferred stock financing by a certain date or the use of proceeds in an unauthorized manner.

Investor Representative(s):	The holders of a majority of the then outstanding principal amount of the Notes shall be entitled to appoint a board observer, who shall be entitled to attend all meetings of Borrower's board of directors and otherwise receive all information disclosed to all members of Borrower's board of directors in their capacity as directors. ¹⁵
Information Rights:	Borrower shall deliver the following to holders of the Notes: (a) annual financial statements within 90 days after the end of each fiscal year; and (b) quarterly financial statements within 45 days of the end of each fiscal quarter. ¹⁶
Registration Rights:	The Conversion Shares shall have registration rights on customary terms or such more favorable terms as any other class of Borrower equity. ¹⁷
Common Stock Purchase Warrants	
Security:	Common Stock Purchase Warrants (the "Warrants").
Warrant Coverage:	Each Note holder shall receive warrants to purchase <i>[Number]</i> shares of Borrower common stock (the "Warrant Shares"). ¹⁸
Exercise Price:	The Warrants shall be exercisable by payment of an exercise price per Warrant Share of \$ <i>[Dollar Amount]</i> . ¹⁹
Net Exercise/Cashless Exercise:	The Warrants shall provide for net exercise/cashless exercise on customary terms. ²⁰

15 Investors often require access to meetings of the borrower's board of directors (or comparable governing body) and any information usually available to the borrower's directors. They also provide for this right with a provision such as this one. Often the right is limited to "observation rights" and does not result in the investor's representative assuming any additional rights or duties unique to directors under applicable law, including fiduciary duties. However, it is not unusual for investors to negotiate a seat on the borrower's board of directors instead of observation rights or once their interest in borrower is converted from debt to equity, i.e., if the note is converted into the borrower's equity or upon exercise of any warrants issued in connection with the note. The ability of investors to negotiate for and obtain such rights will vary depending on the amount of debt involved and borrower's specific circumstances.

16 In addition to board observation rights, the borrower may be required to deliver to the note holders certain financial information, typically annual and quarterly financial statements. The borrower may also be required to deliver information concerning its operating budget on an annual or other periodic basis.

17 If the borrower is a public company, or if a public offering by borrower of its equity securities is anticipated during the term of the notes, counsel to the investors should consider negotiating for registration rights with respect to any borrower equity issued upon conversion of the notes in order to facilitate any future sale of the Conversion Shares.

18 As noted, convertible debt financings may include a "sweetener" as additional incentive to investors. For example, investors may receive warrants to purchase common stock of the borrower, often equal to 10%-30% of the aggregate principal of the debt (such percentage often being referred to as "warrant coverage"). The warrant coverage will vary from transaction to transaction depending on the amount of debt involved and the borrower's specific circumstances.

19 Exercise price varies depending on the transaction. In the most basic structure, the exercise price is set at the price per share on the date of grant, but sometimes "penny warrants" are granted, which set the exercise price at a nominal amount as a further incentive to investors. Occasionally, exercise price is determined with reference to the satisfaction of milestones to incentivize grantor's performance, e.g., the more profitable the grantor becomes at specified future dates, the higher the exercise price will be. Tax consequences vary with structure.

20 It is common for warrants to provide for "net exercise" (also sometimes called "cashless exercise") whereby the warrant holder essentially borrows enough money from the issuer to exercise the warrant and purchase the resulting shares while simultaneously selling enough shares to pay for the purchase.

Expiration:	The Warrants shall expire [<i>Amount</i>] years from the date of issuance if not exercised sooner.								
Anti-dilution:	The Warrant Shares shall have anti-dilution protection on customary terms, or such more favorable terms as any other class of Borrower equity. ²¹								
Registration Rights:	The Warrant Shares shall have registration rights on customary terms or such more favorable terms as any other class of Borrower equity. ²²								
Miscellaneous									
Current Capitalization:	Borrower's current capitalization is set forth in the table attached hereto as <u>Exhibit A</u> .								
Closing Conditions:	Completion of satisfactory due diligence and mutually acceptable definitive documentation.								
Legal Fees and Expenses:	Each party shall bear its own fees and expenses, provided that Borrower shall pay at the Closing the reasonable fees and expenses of counsel to the Investors, not to exceed \$[<i>Dollar Amount</i>] plus expenses. ²³								
<p>The undersigned have executed this Term Sheet intending to be bound by the confidentiality provision hereof.</p> <table style="width: 100%; border: none;"> <tr> <td style="width: 50%; vertical-align: top;"><i>Borrower</i></td> <td style="width: 50%; vertical-align: top;"><i>Investors</i></td> </tr> <tr> <td>Signature: _____</td> <td>Signature: _____</td> </tr> <tr> <td>Print Name: _____</td> <td>Print Name : _____</td> </tr> <tr> <td>Title: _____</td> <td>Title: _____</td> </tr> </table>		<i>Borrower</i>	<i>Investors</i>	Signature: _____	Signature: _____	Print Name: _____	Print Name : _____	Title: _____	Title: _____
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21 Such warrants typically include anti-dilution provisions protecting against any dilution in the borrower's capital structure caused by issuances of the borrower's equity at less than the exercise price of the warrants or adjustments in the borrower's capital stock in connection with stock dividends, stock splits, and similar transactions affecting the borrower's common stock.

22 If the borrower is a public company, or if a public offering by borrower of its equity securities is anticipated during the term of the convertible promissory notes, counsel to the investors should consider negotiating for registration rights with respect to any borrower equity issued upon exercise of the warrants, in order to facilitate any future sale of the resulting shares.

23 The borrower typically reimburses the investors for the fees and expenses of one legal counsel to all investors. The reimbursement is typically capped and is sometimes contingent upon closing. ■