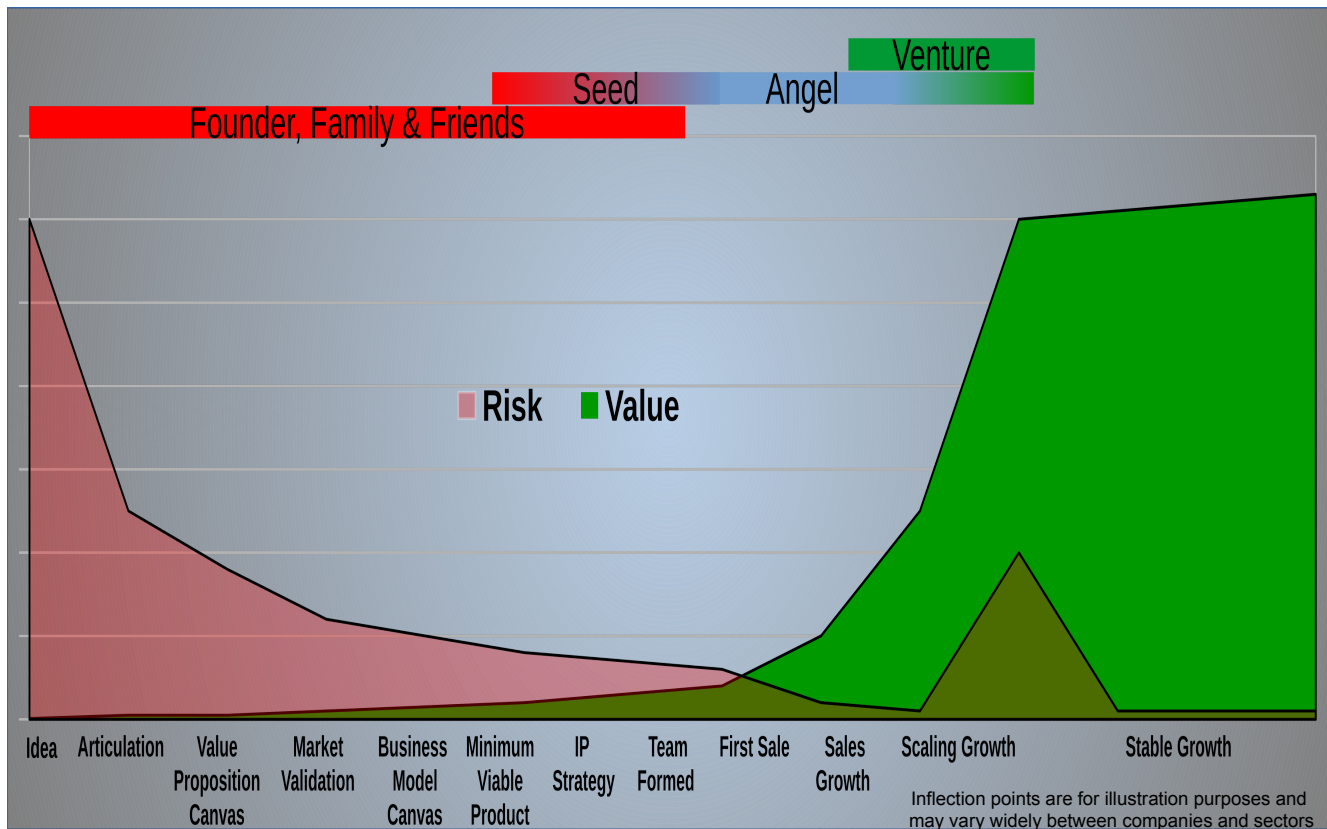


## Unsolicited Observations of the Untrained Observer Convertible Debt



### Fundamental Assumptions:

- Ideas are commodities and have NO value!
- Risk declines rapidly as the enterprise moves beyond idea and passes early inflection points.
- Value begins to build as risk declines, but usually only builds significantly as potential for revenue becomes demonstrable.
- Seed stage investment comes at a point in the cycle where risk remains high and value remains minimal.
- Seed stage investors are likely to suffer repeated and significant dilution during the life-cycle of the company.
- Valuation at seed stage is almost entirely art, almost no science.
- Strategic Seed / Angel Investors represent a critical resource for reasons beyond capital.
- Convertible Debt offers a much more fee efficient way to raise capital
- Capital resulting from the fee efficiency of a convertible debt offering can be spent developing the company creating more value for founders and investors than capital spent on legal fees for an equity offering

### Important Terms in a Convertible Debt Offering:

**Term: Amount of Raise**

**Preferred Language:**

Define minimum and maximum amount of raise

**Why It Matters:**

Investors need to feel assured that an adequate minimum amount of capital will be raised to execute the company's plan. Investors need to feel comfortable that capital in excess of what can be efficiently applied is not being sought.

**Term: Duration of offering**

**Preferred Language:**

Preference is 6-12 months overall with a second and possibly third tranche defined. Tranches should be priced at discounts

to the lesser of actual pricing or a conversion cap. Each tranche should have two tiered discount, the larger expiring 30 days after start of offering. Second tier should expire 90 +/- days after start of offering. Pricing subsequent tranches will be driven by the market but hopefully will be at some increment above the prior tranche. Just prior to offering that tranche to others, existing noteholders should be given an option to purchase at the pricing they received on their most recent investment.

**Why It Matters:**

- A *good* capital raise can be a worse experience for founders than a root canal. There are few *good* capital raises.
- The difficulty of raising capital is in a non-linear relationship to its size. (i.e. \$1mm raise is much more than twice as difficult as a \$500k raise.)
- Never raise money when your (enterprise's) life depends on it.
  - Desperation does not play well in a pitch
  - In aggregate, the investors who don't change their minds will take twice as long to write a check and will invest half as much as you expect from your conversations.
  - Smaller tranches are easier to raise, can be in lower increments and from fewer investors.
  - Getting enough capital to achieve milestones allows you to demonstrate progress, often in a very short time, making the next pitch far more compelling.
- Smaller tranches allow more realistic and achievable performance milestones.
- After a large raise founders may be tempted to spend for non-essentials. Measured capital raises keep founders focused, especially if their performance allows them to go back to the well of existing investors for follow-on capital.
- Raising in tranches avoids unnecessary dilution to founders and existing investors.
- By establishing milestones founders can prove themselves to existing investors. Proven founders will find their best prospects in existing investors satisfied with the company's progress. Existing investors impressed by founder performance can be invaluable testimonial sources and may bring other investor prospects.
- Planning for multiple tranches, leverages the Convertible Note fee efficiency by using a single document for multiple raises.
- Pricing caps should be generous relative to the development stage of the company. Capital is the oxygen of the enterprise and risk drops tremendously after a strong capital raise. Be kind to those who believed in you when others would not!
- Allowing existing noteholders limited time pricing preferences on subsequent rounds
  - recognizes and rewards for their earlier investment at a time of higher risk
  - mitigates the dilution of follow on money
  - should result in a much quicker and simpler effort to raise the tranche

**Term: Closing**

**Preferred Language:**

All funds should be escrowed and all closings in a tranche should be at the same time. When two tiered discounts apply, obviously there are separate closing dates for each tier but a single closing date for all funding in each tier.

**Why It Matters:**

If there are multiple closings, sign me up for the last one on the last day. Aside from the time value of the money the risk decreases with every dollar raised. Given an option, only a fool would want their money in before it becomes clear that the raise was successful.

**Term: Automatic Conversions**

**Preferred Language:**

When the company issues priced equity, note balances should convert into preferred shares. Maximum company pre-money valuation should be stated.

**Why It Matters:**

In theory, every day brings a higher value to the company. Noteholder's are thus diluted with each passing day. If the issuance of equity is delayed it can create a perception, real or imagined, that noteholders were treated unfairly. With a capped valuation, everyone is pulling for a home run to happen as soon as possible. In an uncapped scenario the perverse result could be the investors hoping for limited success until they have converted.

**Term: Discount to noteholders at Automatic Conversion**

**Preferred Language:**

Tranches should be offered with two separate closing dates. The first 30-45 days after the start of the offering, the second 90-120 days after the offering. The first offering should convert at 75% of the great of the priced equity or cap valuation. The second offering should convert at 85%.

**Why It Matters:**

Risk decreases with each dollar raised, the first investors deserve a risk premium over those later. Talk is cheap, don't count an investment until the check clears and is in escrow. The discount preference can get investors motivated to commit, bringing real money and important momentum early. Every minute spent raising capital is a minute not spent developing the company.

***Term: Optional Conversion at Note Maturity or Anniversary***

***Preferred Language:***

At the option of the noteholder, the note should be convertible at the discounted pre-money cap at the note's maturity date or 12-24 months.

***Why It Matters:***

Investors are not looking to be lenders, but owners. There are scenarios which could result in a note being repaid rather than converted. If investors were looking for high risk/high rate lending they would be in payday loans or pawn brokering.

***Term: Optional Conversion at Sale of Company***

***Preferred Language:***

Noteholder should have option to convert at lesser of valuation cap or purchase value in the case of a sale of the company.

***Why It Matters:***

Some notes allow for a 1.5x, 2x repayment of the note in the event of a sale. While this may be a great return, as stated above, noteholders want to be owners not lenders. Noteholders have signed on in the face of very high risk and their upside should not be limited.

***Term: Events of Default***

***Preferred Language:***

Failure to pay note, Bankruptcy, Breach of Agreement, Changes in Management – Holder may declare outstanding amounts owed payable immediately.

***Why It Matters:***

This is mostly boilerplate with the exception of Changes of Management. Most investors are investing overwhelmingly based on their faith in management. Changes to that management can materially alter the prospects for the company and should not be done without consultation and consensus of noteholders.

***Term: Waiver and Amendment***

***Preferred Language:***

Terms can be waived or amended with support of the holders of the majority of the debt.

***Why It Matters:***

Circumstances change and, with consensus, agreements should be flexible to address these circumstances.

***Term: Subordination***

***Preferred Language:***

Note shall not be subordinated without the agreement of noteholders.

***Why It Matters:***

Subordination induces greater risk which could not have been quantified at the time of the investment. There could be situations where this is in the best interest of all, but should be required to demonstrate this is the proper course forward.

SAMPLE – NOT FOR USE WITHOUT LEGAL COUNSEL

UNSECURED CONVERTIBLE PROMISSORY NOTE

\$ \_\_\_\_\_, 20\_\_\_\_

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XXXXXXXXXXXX, a Delaware corporation (the “Company”), is authorized to issue Unsecured Convertible Promissory Notes in an aggregate principal amount of up to XXXXX Dollars (\$XXXXX) (each, a “Note,” and collectively, the “Notes”). This Note is one of the Notes. The holders of the Notes are referred to collectively herein as the “Noteholders.” Neither this Note nor any other Note may be amended, nor may any term under this Note or any other Note be waived, except by the prior written consent of the Company and the Noteholders representing a majority of the aggregate principal amount of the Notes then outstanding.

FOR VALUE RECEIVED, the Company hereby promises to pay to \_\_\_\_\_ or its permitted assign (the “Holder”) the principal sum of \_\_\_\_\_ Dollars (\$ \_\_\_\_\_), plus simple interest thereon from the date of this Note until paid (or converted into equity as set forth below) at the rate of eight percent (8%) per annum (based on a year of 365 days), cumulative, but not compounded, and on the following terms and conditions.

1. Payment.

1.1 Payment upon Maturity Date. If not sooner paid pursuant to Section 1.2 hereof or converted pursuant to Section 2 hereof, the outstanding principal amount under this Note together with all accrued and unpaid interest on this Note shall be due and payable in one (1) single installment on XXXXX, 20XX (the “Maturity Date”). All payments shall be made in lawful money of the United States of America at the address of Holder, or at such other place as the Holder may from time to time designate in writing to the Company. Notwithstanding the foregoing, the outstanding principal balance and unpaid accrued interest on this Note shall be due and payable on demand of the Holder upon (i) the Company’s filing of a voluntary petition in bankruptcy, (ii) the Company’s making an assignment for the benefit of creditors, or (iii) the Company’s application for, or consent to the appointment of, any custodian, receiver or trustee for the Company’s property. All cash payments received by the Holder in respect of this Note, including those contemplated by Section 1.2 and 1.3 below, shall be applied first to the accrued interest then due and payable in respect of this Note and thereafter to the repayment of the outstanding principal amount of this Note.

1.2 Payment upon a Sale of the Company. Immediately upon the consummation of any Sale of the Company (as hereinafter defined) while this Note is outstanding, the entire outstanding principal amount of this Note, together with all accrued and unpaid interest thereon, shall become immediately due and payable and the Company shall pay the Holder in repayment thereof an amount equal to 1.5 times (1.5x) the sum of the then-outstanding principal of and accrued interest on this Note; provided however, that at the option of the Holder in its sole discretion, in lieu of such payment, the Holder may elect to convert this Note into shares of common equity immediately prior to such Sale of the Company pursuant to Section 2.3 below. Upon the Holder’s receipt of such payment in immediately available funds, this Note shall be deemed repaid in full and terminated. For purposes of this Note, the term “Sale of the Company” means (i) any sale, lease, license, transfer, distribution or other disposition of

all or substantially all of the assets of the Company, excluding the conversion contemplated by Section 1.3 of the Note Purchase Agreement pursuant to which this Note was issued, or (ii) any merger or consolidation of the Company with or into one or more other Person as a result of which the Persons holding a majority of the Company's outstanding voting securities immediately prior to such transaction cease to own a majority of the voting securities of the surviving Person.

1.3 Prepayment. The Company may not prepay in whole or in part the outstanding principal amount of this Note, or any accrued and unpaid interest thereon.

## 2. Conversion.

2.1 Automatic Conversion. At the closing of a transaction, or series of related transactions, in which the Company issues and sells equity securities resulting in gross proceeds to the Company equal to or exceeding XXXXX Dollars (\$XXXXX) (excluding the aggregate amount of principal represented by the Notes) (the "Next Equity Financing"), the outstanding principal amount of this Note together with any and all accrued and unpaid interest on this Note shall be automatically converted into shares of preferred stock issued in the Next Equity Financing (the "Next Equity Securities"), and such shares shall have the same terms and conditions as those given to the investors in the Next Equity Financing. The number of shares of such Next Equity Securities to be issued upon such conversion shall be determined by dividing (i) the total aggregate outstanding principal amount of this Note, plus all accrued and unpaid interest due on this Note on the date of conversion by (ii) the price per share of such Next Equity Securities sold to the investors in such Next Equity Financing multiplied by either (a) 0.75 if the closing of the Note takes place on or before June 30, 2013 (the First Discount Fraction) or (b) 0.85 if the closing of the Note takes place on or after July 1, 2013 (the Second Discount Fraction), with such quotient rounded down to the nearest whole number. In no event will the Note convert at a conversion price per share which equates to a pre-money valuation of the Company in excess of XXXXX Dollars (\$XXXXX) and any conversion price resulting from this paragraph (2.1) which equates to a pre-money valuation of the Company in excess of XXXXX Dollars (\$XXXXX) shall be reduced to the conversion price per share which would result from a pre-money valuation of the Company of XXXXX Dollars (\$XXXXX). The shares of Next Equity Securities to be issued upon conversion of this Note pursuant to this Section 2 shall be entitled to the same rights and subject to the same obligations provided in the purchase agreement and other financing documents entered into with the investors in the Next Equity Financing, and the Holder shall become a party to, and hereby agrees to execute, all related Next Equity Financing documents, including, but not limited to, any definitive stock purchase agreement and any investors rights agreement.

2.2 Optional Conversion upon one year anniversary. If this Note remains outstanding at the one year anniversary to the date of issuance, then at any time upon or after that date, in addition to the other conversion rights described in this Note, the Holder may, at its option in its sole discretion, elect to convert this Note into that number of fully paid and nonassessable shares of the Company's common equity determined by dividing (i) the outstanding principal amount of this Note, plus all accrued and unpaid interest thereon, at the time of conversion, by (ii) price per share which would result from a pre-money valuation of the Company of XXXXX Dollars (\$XXXXX). In order to convert this Note into common equity, the Holder shall deliver to the Company written notice of such exercise. Promptly (and in any event within five business days) thereafter, the Company shall issue and deliver to and in the name of the Holder a certificate for the number shares of common equity issuable upon such conversion; and against such delivery, the Holder shall surrender this Note to the Company, duly endorsed to the Company or marked as canceled.

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2.3 Optional Conversion upon a Sale of the Company. If a Sale of the Company is consummated while this Note is outstanding, then, in lieu of the payment provided for in Section 1.2 hereof, the Holder may, at its option in its sole discretion, elect to convert this Note immediately prior to the Sale of the Company into that number of shares of the Company's common equity determined by dividing

(I) the outstanding principal amount of this Note, plus all accrued and unpaid interest thereon, at the time of conversion, by

(ii) the price per share sold in the Sale of the Company multiplied by either (a) 0.75 if the closing of the Note takes place on or before June 30, 2013 (the First Discount Fraction) or (b) 0.85 if the closing of the Note takes place on or after July 1, 2013 (the Second Discount Fraction), with such quotient rounded down to the nearest whole number. In no event will the Note convert at a conversion price per share which equates to a pre-money valuation of the Company in excess of XXXXX Dollars (\$XXXXX) and any conversion price resulting from this paragraph (2.3) which equates to a pre-money valuation of the Company in excess of XXXXX Dollars (\$XXXXX) shall be reduced to the conversion price per share which would result from a pre-money valuation of the Company of XXXXX Dollars (\$XXXXX). The Company shall notify the Holder in writing not less than 15 days prior to the date on which the closing of any Sale of the Company is expected to occur and shall include in such notice the principal terms of the Sale of the Company, as well as the number of shares of common equity into which this Note is convertible as a result thereof. In order to convert this Note into shares of common equity, prior to the closing of the Sale of the Company, the Holder shall deliver to the Company written notice of the Holder's exercise of its option to convert this Note as provided herein. Thereafter, the conversion of this Note into common equity shall occur automatically immediately prior to the closing of the Sale of the Company, without any further action on the part of the Holder. Promptly after such closing, the Company shall deliver to the Holder the stock certificate representing the shares of common equity into which this Note has been converted (or the cash, securities or other property, if any, into which such shares of common equity have been converted in the Sale of the Company), registered in the name of the Holder, and the Holder shall surrender this Note to the Company, duly endorsed to the Company or marked as canceled.

### 3. Effect of Conversion.

3.1 Mechanics of Conversion; Holder of Record. At the closing of a Next Equity Financing, this Note shall automatically convert into the Next Equity Securities issued in such Next Equity Financing, without any further act of the Company or the Holder, in accordance with the terms of this Note, and at such time, this Note shall evidence solely the right to receive that number of Next Equity Securities as set forth in Section 2.1 above (the "Conversion Date"). In addition, upon any conversion of this note, Holder acknowledges and agrees to return this Note for cancellation promptly after receipt of notice of such conversion from the Company. The Company shall promptly issue and deliver to the Holder a certificate or certificates for the number shares to which the Holder shall be entitled as a result of such conversion at such time as this Note is so returned to the Company for cancellation; provided, however, that the Holder shall be treated for all purposes as the record holder of such securities on the Conversion Date.

3.2 Fractional Shares; Satisfaction of Note. No fractional shares shall be issued in connection with any conversion of this Note; rather, the Company shall pay the Holder cash in lieu of any fractional shares. The Company's (i) issuance of shares of Next Equity Securities to the Holder upon conversion of the principal amount and all unpaid, accrued interest thereon pursuant to the terms of this Note and (ii) the

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Company's payment of cash in lieu of any fractional shares of Next Equity Securities owed to the Holder upon conversion hereof, shall constitute satisfaction in full of this Note, and this Note shall thereafter be of no further force or effect.

4. Events of Default. The occurrence of any of the following shall constitute an "Event of Default" under this Note:

4.1 Failure to Pay. The Company shall fail to pay (i) when due any principal payment on the due date hereunder or (ii) any interest or other payment required under the terms of this Note on the date due, and such payment shall not have been made within ten (10) days of the Company's receipt of the Holder's written notice to the Company of such failure to pay;

4.2 Voluntary Bankruptcy or Insolvency Proceedings. The Company shall (i) apply for or consent to the appointment of a receiver, trustee, liquidator or custodian of itself or of all or a substantial part of its property, (ii) make a general assignment for the benefit of its or any of its creditors, (iii) be dissolved or liquidated in full or in part, (iv) become insolvent (as such term may be defined or interpreted under any applicable statute), (v) commence a voluntary case or other proceeding seeking liquidation, reorganization or other relief with respect to itself or its debts under any bankruptcy, insolvency or other similar law now or hereafter in effect or consent to any such relief or to the appointment of or taking possession of its property by any official in an involuntary case or other proceeding commenced against it, or (vi) take any action for the purpose of effecting any of the foregoing;

4.3 Involuntary Bankruptcy or Insolvency Proceedings. Proceedings for the appointment of a receiver, trustee, liquidator or custodian of the Company or of all or a substantial part of its property, or an involuntary case or other proceedings seeking liquidation, reorganization or other relief with respect to the Company or the debts thereof under any bankruptcy, insolvency or other similar law or hereafter in effect shall be commenced and an order for relief entered, or such proceeding shall not be dismissed or discharged within thirty (30) days of commencement;

4.4 Breach of Agreements. Unless waived by the Holder, the Company's material breach of any representation, covenant or agreement contained in this Note, which such breach is not cured by the Company within ten (10) days after written notice thereof is given to the Company by the Holder; or

4.5 Change of Management. Either XXXXXXXX or XXXXXXXX cease to be actively engaged in the management of the Company.

4.6 Rights of Holder Upon Default. Upon the occurrence or existence of any Event of Default and at any time thereafter during the continuance of such Event of Default, the Holder may declare all outstanding amounts owed under this Note payable by the Company hereunder to be immediately due and payable without presentment, demand, protest or any other notice of any kind, all of which are hereby expressly waived. In addition to the foregoing remedies, upon the occurrence or existence of any Event of Default, the Holder may exercise any other right, power or remedy granted to it otherwise permitted to it by law, either by suit in equity or by action at law, or both.

5. Miscellaneous.

5.1 Assignment. Neither this Note nor any of the rights, interests or obligations hereunder may be assigned, by operation of law or otherwise, in whole or in part by Holder to any person or entity without the prior written consent of the Company. Upon any transfer of this Note approved by the

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Company, the Company may require, as a condition thereto, the payment of a sum sufficient to reimburse it for any transfer tax incidental thereto. Any transfer shall be subject to (i) the transferee's agreement in writing to be subject to the applicable terms of this Note; and (ii) compliance with all applicable state and federal securities laws (including the delivery of legal opinions reasonably satisfactory to the Company, if such are reasonably requested by the Company).

5.2 No Stockholder Rights. This Note shall not entitle the Holder to any voting rights as a stockholder of the Company or to any other rights except the rights stated herein, and no dividend shall be payable or shall accrue in respect of this Note unless and until this Note is converted into equity securities in accordance with its terms.

5.3 Successors and Assigns. The terms and conditions of this Note shall inure to the benefit of and be binding upon the respective successors and assigns of the parties. Nothing in this Note, express or implied, is intended to confer upon any party other than the parties hereto or their respective successors and assigns any rights, obligations or liabilities under or by reason of this Note, except as expressly provided in this Note.

5.4 Governing Law. This Note, and any disputes arising under this Note, shall be governed by and construed in accordance with the laws of the State of Indiana, without giving effect to any conflict of laws principle to the contrary.

5.5 Titles and Subtitles. The titles and subtitles used in this Note are used for convenience and ease of reference only, and will not in any manner influence the construction or interpretation of any provision of this Note.

5.6 Notices. Unless otherwise provided, any notice required or permitted under this Note shall be given in writing and shall be deemed effectively given upon (a) personal delivery to the party to be notified, (b) upon confirmation of receipt by fax by the party to be notified, (c) one business day after deposit with a reputable overnight courier, prepaid for overnight delivery and addressed as set forth in (d) or (d) three days after deposit with the United States Post Office, by registered or certified mail, postage prepaid and addressed to the party to be notified at the address set forth in the Note, or at such other address as such party may designate by ten (10) days' advance written notice to the other party given in the foregoing manner.

5.7 Waiver and Amendment. Any term of this Note may be amended and the observance of any term of this Note may be waived (either generally or in a particular instance and either retroactively or prospectively) only with the written consent of the Company and Noteholders representing a majority of the aggregate principal amount of the Notes then outstanding.

5.8 Severability. If one or more provisions of this Note is held to be illegal, invalid or unenforceable under applicable law, such provision shall be excluded from this Note and the balance of the Note shall be interpreted as if such provision were so excluded and shall be enforceable in accordance with its terms.

5.9 Remedies. The Company and the Holder hereby waive notice, presentment, protest and notice of dishonor. 5.10 Loss, Theft or Destruction of Note. Upon receipt by the Company of evidence reasonably satisfactory to it of the loss, theft or destruction of this Note and of indemnity or security reasonably satisfactory to it, the Company will make and deliver a new Note which shall carry the same rights to interest (unpaid and to accrue) carried by this Note, stating that such Note is issued in

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replacement of this Note, making reference to the original date of issuance of this Note (and any successors hereto) and dated as of such cancellation.

5.11 Subordination. This Note shall not be subordinate in right of repayment to any indebtedness incurred by the Company and provided to the Company by any institutional lender (including, without limitation, any bank, venture capital fund, private equity fund or hedge fund) without written consent of the Company and Noteholders representing a majority of the aggregate principal amount of the Notes then outstanding. Upon approval, Noteholders agree to execute any separate written subordination agreement provided by any such institutional lender that evidences the same.

IN WITNESS WHEREOF, the Company has caused this Note to be signed in its corporate name by its duly authorized officer and dated the day and year first written above

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