

Convertible Note Term Sheet Explainer

Background

Venture capital terminology can be complex. The following guide is provided as a supplement to the [Maine Venture Fund Convertible Note term sheet](#) to help explain what different terms mean and why they are important for both investors and companies. MVF terms are based on standard, [model documents](#) provided by the National Venture Capital Association (NVCA). For even more detailed explanations, consider reading [Venture Deals](#) by Brad Feld and Jason Mendelson.

Common Vocabulary

There are a handful of common concepts related to venture capital investment that are helpful to know even *before* reading a term sheet. These are defined below:

- **Equity:** Ownership in a company, usually allocated in *shares*, like slices of a pie.
- **Lead Investor:** The investor who negotiates the term sheet with the Company. Other investors in the funding round (often there are many investors in a single round) will be expected to invest on the same terms; a lead investor reduces or eliminates the Company's need to negotiate separately with each.
- **Definitive Documents:** Legally binding agreements that are signed to finalize a deal. The term sheet is a non-binding precursor to the Definitive Documents.
- **Governance:** The practices and structure of the Board of Directors of a Company. Boards are critical to the success of venture-backed companies.

Introduction to Convertible Notes

Convertible notes are a type of investment that act as a loan initially and then convert to equity at a later stage. Thus, some traditional equity terms are negotiated later, once that conversion happens, usually at the company's *next* fundraise (venture-backed companies usually raise many rounds of funding). Specifically, the important negotiation point of *valuation*, which sets a price for the company and allocates ownership across investors and company employees (i.e. a "priced round"), is avoided altogether with Convertible Notes. Companies may choose to raise Convertible Notes when they are close to a big milestone which will impact their valuation for the better (in which case the notes can bridge the company to that point in time) and/or the Company is so early stage that there is no good basis for valuation. Convertible Notes rounds are generally faster to raise and require lower legal fees relative to priced rounds, but are usually smaller in magnitude.

Review of Important Terms

Term	Explanation of Term	Perspectives
Amount	Defines the investment size	Max and min limits provide the company with enough capital to meet milestones, but not too much so as to overly dilute ownership when the notes convert to equity.
Closing	All investors will sign and wire funds on the same day once the minimum amount has been committed.	Either the company legal counsel or that of the lead investor will facilitate the closing. Additional investors may participate after the Initial Closing until either the Final Closing Date or the max amount has been met.
Valuation Cap	Sets an upper limit for the "conversion price" that investors will pay at the next fundraising	A valuation cap should be roughly equivalent to the company's expected valuation at the next fundraising, assuming all goes well. If a company valuation spikes unexpectedly after the investment, today's investors are protected against paying that high price.
Discount	Upon "conversion to equity", provides the investor a discount to the share price set at the next fundraising	Relative to investors in the next fundraising, investors are taking greater risk today. A discount can be increased or decreased to incentivize investors today depending on the company's trajectory and time duration until the next round.
Inclusion	Sets a process for Board oversight of inclusion practices	Companies benefit from being thoughtful about inclusivity best practices and should have buy-in from their Boards. Inclusive teams are generally more creative, innovative and successful.
Maturity Date	Principal and interest are due in full upon this date. Usually the investor has the option to convert to equity	Set the maturity date beyond the timeframe expected for the next fundraising (the goal should be to convert to equity, not pay back). If a company is not performing well, investors can ask for their money back with nominal interest.
Interest	Increases amount due according to how much time has passed	Interest compensates for default risk (like any loan). Conversion to equity includes interest and therefore, earlier conversion is better.
Conversion to Equity	Stipulates how and when the note will convert to equity	In addition to the next raise, conversion could also take place at the maturity date or in a sale of the company (whichever happens first). Investors have the option to redeem note if the company does not sell or raise additional funds, but goal is to convert into equity.
Governance	Defines the structure of the Board of Directors	A balanced board provides well reasoned decision-making; non-employee chair role and committees allow CEOs to focus more energy on the business.
Consent of Directors	These are rules of engagement for the board which outline the decisions that require board approval	Investors seek outsized decision-making authority relative to ownership % to compensate for the lack of control they have in running the business day to day. Shared decision-making for important, strategic objectives leads to better outcomes.
Information Rights	Establishes the reporting requirements for management updates to investors	Information rights provide both qualitative and quantitative metrics for company tracking and support. Regular reporting is just as important for internal decision-making as for investors.
General Terms	Defines more general terms (Disputes, Patents, Legal Fees, etc) more germane to any legal agreement	

Maine Venture Fund invests in *Maine businesses* that have the highest potential for *growth* and *impact*.

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