LEGALITE ADVISORS

A NOTE ON CONVERTIBLE NOTES

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A. Introduction.

The start-up industry has always pushed the boundaries in all facets of its functioning and predominantly when it comes to raising funds. Over the period of time, we have seen a lot of developments on the regulatory front to provide more avenues to the start-ups so as to raise funds seamlessly and without more hassles. With the start-up industry attracting more funding progressively, there has been a need to introduce instruments which give flexibility to the founders to raise funds without diluting the voting capital in the present day to manage the operations of the company with a reasonable runway.

Moreover, more often than not, we have early stage founders seeking advice on raising funds when they are unable to reach a conclusion on the valuation of their start-up. Bearing in mind the challenges around establishing the valuation of an early-stage start-up, the Reserve Bank of India came up with the notification dated January 10, 2017 which allowed start-ups to issue Convertible Notes to potential foreign investors. Having said that, the definition of Convertible Notes was first introduced by the Ministry of Corporate Affairs *vide* notification dated June 29, 2016 ("**Deposit Notification**") by amending the Companies (Acceptance of Deposits) Rules, 2014, which read as under and which was treated as an exempt deposit:

*"**Convertible Note**" means an instrument evidencing receipt of money initially as a debt, which is repayable at the option of the holder, or which is convertible into such number of equity shares of the start-up company upon occurrence of specified events and as per the other terms and conditions agreed to and indicated in the instrument.*

The Foreign Exchange Management (Non-debt Instruments) Rules, 2019 ("**FEMA Rules**") defines Convertible Note aligned with the aforesaid definition, albeit with a minor inconsistency in terms of its operation, that the FEMA Rules allow the companies to issue the Convertible Notes with a maturity date of 5 (five) years while the Companies Act, 2013 ("**Companies Act**") allows 10 (ten) years as the maturity date. It would be prudent to amend the FEMA rules to make it consistent with the Companies Act.

B. So what precisely is Convertible Notes.

- Convertible Note is a hybrid instrument that uniquely combines features of debt and equity. However, in respect of the debt aspect, the issuer is not obligated to pay interest but provide a right to the investor to buy equity at a future investment round mostly at a discounted price within a specified period.

- The Convertible Notes can be issued only by start-up companies i.e. who are recognised so by Department for Promotion of Industry and Internal Trade (DPIIT)[1] to foreign investors, NRI and resident Indians and in case of the non-residents, either on repatriation or non-repatriation basis, i.e. electing whether to take the monies back outside India or not.

[1] An entity shall be considered as a **Start-up**:
(i) Upto a period of 10 years from the date of incorporation/ registration, if it is incorporated as a private limited company (as defined in the Companies Act, 2013) or registered as a partnership firm (registered under section 59 of the Partnership Act, 1932) or a limited liability partnership (under the Limited Liability Partnership Act, 2008) in India.
(ii) Turnover of the entity for any of the financial years since incorporation/ registration has not exceeded INR 100 crores.
(iii) Entity is working towards innovation, development or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation. Provided that an entity formed by splitting up or reconstruction of an existing business shall not be considered a 'Start-up'.

- The Convertible Notes can be issued only for an amount of INR 25 lacs or more in a single tranche. The Deposit Notification, specifically excludes only that amount which is more than or equal to INR 25 lacs with regards to Convertible Notes, hence any amount received against Convertible Notes which is less than INR 25 lacs shall be considered as a 'Deposit' and the start-up company shall have to comply with all the provisions relating to deposits as stated in the said deposit rules.

- The maximum tenure of Convertible Notes should be 10 years (5 years in case of non-residents). It has to be converted into equity or should be repaid within 10 years (5 years in case of non-residents).

C. Terms of Convertible Notes used as parameter to ascertain future value.

- **Discount rate**. Represents the valuation discount the holder of Convertible Notes receives relative to investors in the subsequent financing round, which compensates the holder of Convertible Notes for the additional risk they bear by investing and back the companies at the nascent stage of operations.

- **Interest rate.** Is a parameter used to increase the issued number of shares during the conversion as interest is accrued to principal invested, as opposed to being paid back in cash.

- **Maturity date**. Used to determine the date for repayment of both the principal and interest.

- **Valuation cap.** A valuation cap is used in a Convertible Note to give the noteholders a 'ceiling value' at which their investment will convert and, in turn, that gives them a 'floor' in regard to their ownership. With a valuation cap, they know that their money will convert from loan to equity at or below a price per share price established by the valuation cap. It gives the holder a**n** equity-like upside if the start-up takes off out of the gate.

D. Steps plan to issue Convertible Notes in India.

Being categorised predominantly as a convertible debt instrument, Indian start-up company can issue the Convertible Notes under section 62(3) of the Companies Act read with the FEMA Rules in case of non-residents and as per the agreed terms and conditions with the contracting party which shall be encapsulated in the Convertible Notes Agreement.

- Pass a board resolution in the Board Meeting to approve the Convertible Notes Agreement and issuance of Convertible Notes thereof;
- Pass a special resolution in the Extra-Ordinary General Meeting of the member of the start-up company to approve the issuance of Convertible Notes;
- File e-Form MGT14 within 30 days of passing the shareholders resolution;
- Issue a Convertible Notes to the investor;
- The issue of Convertible Notes to persons resident outside India shall be as per Chapter VIII (General Provisions), Rules 18 of the FEMA Rules and particularly a person resident outside India may acquire or transfer by way of sale, convertible notes, from or to, a person resident in or outside India, provided the transfer takes place in accordance with the entry routes and pricing guidelines as prescribed for capital instruments;
- It is worthy to note that the Companies Act does not specify clearly if the Convertible Notes can be transferred but the FEMA Rules do and in case the terms and conditions of the issuance of the Convertible Notes;
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  (a) The Indian start-up company issuing Convertible Notes to a person resident outside India or

(b) a person resident in India, who may be a transferor or transferee of Convertible Notes issued by an Indian start-up company shall transfer to or from a person resident outside India, as the case may be,

shall report such inflows/transfer in Form CN on RBI FIRMS portal within 30 days of such issue/transfer and file SMF (FC-GPR) upon conversion of the Convertible Notes into equity shares of the start-up company.

E. Advantages of Convertible Notes.

The concept of issuance of Convertible Notes is largely a winner without much disadvantage either for the investor or the start-up company issuing it and few of the advantages are mentioned herein

- **Pre-valuation investment** - The start-up company is not obligated to go through the rigours of valuation exercise and can agree with the investors the amounts required subject to the minimum thresholds.

- **Fixed income for noteholders and discount benefit** - In case there is a healthy interest rate agreed for the issuance of the Convertible Notes, it can assure a fixed income for the investors. The investors are also assured a discount percentage to the price of the next qualified funding round, subject to a valuation floor which is a reward for backing the start-up company early.

- **No dilution in voting control** - Unlike common shareholders, investors of the Convertible Notes do not have voting rights and hence the founders can raise funds without losing voting control and manage the operations of the start-up company seamlessly.

- **Access to foreign funds in a hassle free manner** - Since the FEMA Rules recognize the concept of Convertible Notes, the companies can go for issuance thereof and raise foreign funding without following a complicated procedure of issuance of equity instruments.

- **Easy exit and conversion** - The terms of exit and conversion are well defined with the same being linked to maturity or specific events and this avoids any dispute in future.

- **Tax law advantages** - At the time of issuance of the Convertible Notes, there is no tax implication, it being initially 'debt'. The conversion price of such Convertible Notes shall be at a fair market value. Automatically, there will be no tax liability. In case if the conversion price of Convertible Notes is above the fair market value, then the difference between the conversion price and fair market value may be taxable in the hands of the company under section 56 (2) (viib) of the Income Tax Act, 1961. Fortunately, this is also tax exempt in case the company is recognized start-up and has also availed the tax exemption approval till first 10 years, from the Income Tax department at the time of the conversion.

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