Research paper

Mechanics of a convertible note

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CONVERTIBLE NOTE - DEMYSTIFIED

We are often confronted with confounded investors and equally confounded entrepreneurs who have no idea that doing a convertible structure is possible in India - only it isn't called a "convertible note" and looks different. We at Evaluer have collaborated with 91 Springboard; a fantastic incubator founded to simplifying start-up acceleration that helps build a company from scratch.

BASIC IDEA

A substantial amount of fundraising in start-ups around the world is undertaken through what is commonly referred to, as a “convertible structure”. This structure is reflected in documentation with varied nomenclature depending on the jurisdiction. For instance in the United States, a convertible note typically refers to any instrument that denotes debt funding that provides an option to the investor to convert the debt amount to equity in lieu of repayment. The convertible structure in the Indian context requires some variation in the form and substance given the legal and regulatory context applicable to fundraising transactions in India, but can be structured in a manner that satisfies most objectives of doing a convertible round.

CONVERTIBLE STRUCTURE - EXPLAINED

Simply put, a convertible structure is a set of contractual terms that allow the company and the investor to put in abeyance the task of determining a valuation for the company. There are significant advantages for the investor and the company in doing so, these include:

(a) The company is not prejudiced by a set valuation as it enters into discussions with an institutional investor or any large investor who will invest at a pre-determined valuation;

(b) While the investor is not assured a specified portion of equity at the time of investment, the principles of 'conversion' into equity are clearly pre-determined in a manner that allows the investor the benefit of a return upon the closure of a significant round of investment;

(c) Given that the investment does not entail any equity shares in the company, it is not necessary for the company and the investor to negotiate and agree on a complicated set of rights and principles that become relevant only at the time of issuance of equity shares. For instance, no discussions are required in relation to a broad set of governance rights and economic protections, such as the rights of the investor to have board representation or to participate in an exit;

(d) Since the instrument or character of the investment by the investor is in the nature of debt until conversion, the investor is assured of preference upon liquidation until the time of conversion into equity. That is to say, if the company is liquidated in any manner - debt/debenture holders get paid in preference to other stakeholders in the company, such as preferred and equity shareholders. This balances the risk of not agreeing on the protections in paragraph (c) above;

(e) To provide clarity on the method and timing of conversion, the investor and the company agree on a specified threshold of future investment that requires the investor to convert into equity, say the occurrence of an investment of up-to x at a minimum valuation of y (i.e., a significant round of investment). If these conditions are not satisfied, the investor continues to be entitled to not convert into equity shares for a specified period of time, i.e., until the maturity date. To provide the investor with the benefit of having invested earlier than the 'significant round' referred to above, a discount on the valuation is stipulated (which may increase over time as specified in an agreement) which is calculated with reference to the valuation offered to the investors investing in the significant round of investment;

(f) An instrument providing for a convertible structure can be entered into severally and successively, i.e., it is not necessary to close a convertible round simultaneously with all investors as is the case in equity investments (for legal, contractual and logistical reasons). This provides the company a fair degree of flexibility in approaching investors and closing investment rounds, and presents a lesser logistical challenge than to bring a number of individual investors on the same page at the same time. It is advisable for the company to provide investors a clear time frame during which successive rounds may be entered into with other investors so as to assure current investors that the terms are available for a definite period of time on the same terms as them.

WHEN SIGNIFICANT ROUNDS DO NOT OCCUR

While 'convertible notes' as understood commonly in most jurisdictions involve a 'redemption option', i.e., the investor has a right to demand repayment after a specified period of time if no 'significant round of investment' has occurred and the investor has not chosen to convert into equity shares, the legal framework in India requires a different approach.

Under Indian company law, individual investors are not permitted to be issued 'optionally convertible debentures / debt' (except in certain exceptional circumstances). This means that investments by individuals in companies generally cannot involve an option for the investor to redeem or demand repayment of monies invested. It is for this reason that the convertible structure available for investments in Indian companies entail a 'compulsorily convertible debenture'.

A compulsorily convertible debenture is a debt instrument that is compulsorily convertible into equity shares of the company after a specified period of time, which is required to be not in excess of 5 (five) years. It is for this reason that a typical compulsorily convertible debenture agreement provides for a 'valuation threshold', i.e., the valuation at which the investment by the investor should convert into equity after the expiry of a specified period of time, if - (a) a significant round of investment has not occurred; and (b) if the investor has not otherwise converted debentures into equity. While establishing this valuation threshold dilutes the objective of not setting out any valuation at all, it permits the company to take advantage of a higher valuation in a significant round of investment by linking the current investment valuation to such investment round. At the same time, it provides the investor an assured return linked to the discount in addition to the assurance that if no significant round of investment is consummated. At this time the investor is required to convert at a valuation threshold that has been pre-agreed with the investor in the agreement and which is aimed to commercially correspond to the valuation which the investor may have been able to obtain if the investor had been issued equity shares at the time of the investment.

UPON CONVERSION

Upon conversion of the debentures issued to the investor during a significant round of investment, the debentures issued to the investor are converted into equity shares at a valuation that represents a discount to the valuation in the significant round of investment. For instance, if the agreement provides for a 20% discount to the valuation during the first year after the investment has occurred if a significant round of investment occurs, the investor will receive equity shares at a 20% discount to the price of the shares subscribed by the significant round investor as calculated on an “as converted basis”.

The significant round investor may at such time subscribe to preference shares or debentures and require the company and its existing investors to offer a superior set of rights and protections in comparison to all other shareholders. This is usually acceptable given the principle of “last in, first out” and the comparatively larger size of the investment being brought in the significant round.

To assure the investor of a minimum degree of protection upon conversion as an equity shareholder, the compulsorily convertible debenture subscription agreement provides for an indicative set of terms that are agreed to be entered into with the investors during the significant round of investment. While these are subject to negotiations and execution of a shareholders agreement at the time of the significant round, these terms are persuasive in nature and provide a baseline expectation for negotiations with an investor in the significant round of investment. These include basic rights and protections that are typically available to any minority financial investor and equity shareholder in a company, such as right of first refusal and tag along, basic corporate governance protection matters and vetoes, anti-dilution rights and liquidation preference. If the equity holding of the investors who are converting into equity is substantial post the significant investment round, investors may also negotiate the right to have board representation or the right to observe board proceedings.

CHALLENGES

A convertible structure is suitable for companies that are entering into successive rounds of investment as a part of their business model. In companies operating in sectors where it is difficult to assess the investment cycle and needs, it may be suitable for an investor to freeze her equity participation at a pre-determined level.

Given the novelty of the convertible structure in India, not many tax advisors and lawyers are clear on how to tackle the tax implications. Simply put, a conversion at a discount at the time of the significant round results in shares being issued at differential prices. This may result in a certain % of the discount/appreciation of price being taxable in the hands of an investor for the financial year during which the subsequent investment round has occurred. Given the logic and philosophy of start-up investments and the marginal implications, it is likely and not unheard of for investors to commercially price the tax implications into their investments.

Another issue is that issuance of debentures must necessarily be undertaken through the private placement route under the Companies Act, 2013 which provide for detailed procedure and elaborate requirements for issuance of debentures. Particularly, issuance of compulsorily convertible debentures require a valuation to be undertaken by a valuer (such as a chartered accountant with prescribed qualifications), which may be linked to the threshold valuation described above in addition to compliance with time bound filing and disclosure requirements.

It is however important for your legal counsel, chartered accountant and company secretary to understand the nuances of undertaking a convertible structure to aid an efficient fundraising process. This is calculated by assuming all shares of different classes have been converted into equity so the pricing of shares of all shareholders irrespective of class can be measured equivalently. A thumb rule in corporate finance that implies that the investor who has most recently invested in the company must be protected the most and offered the first exit in comparison to prior investors.