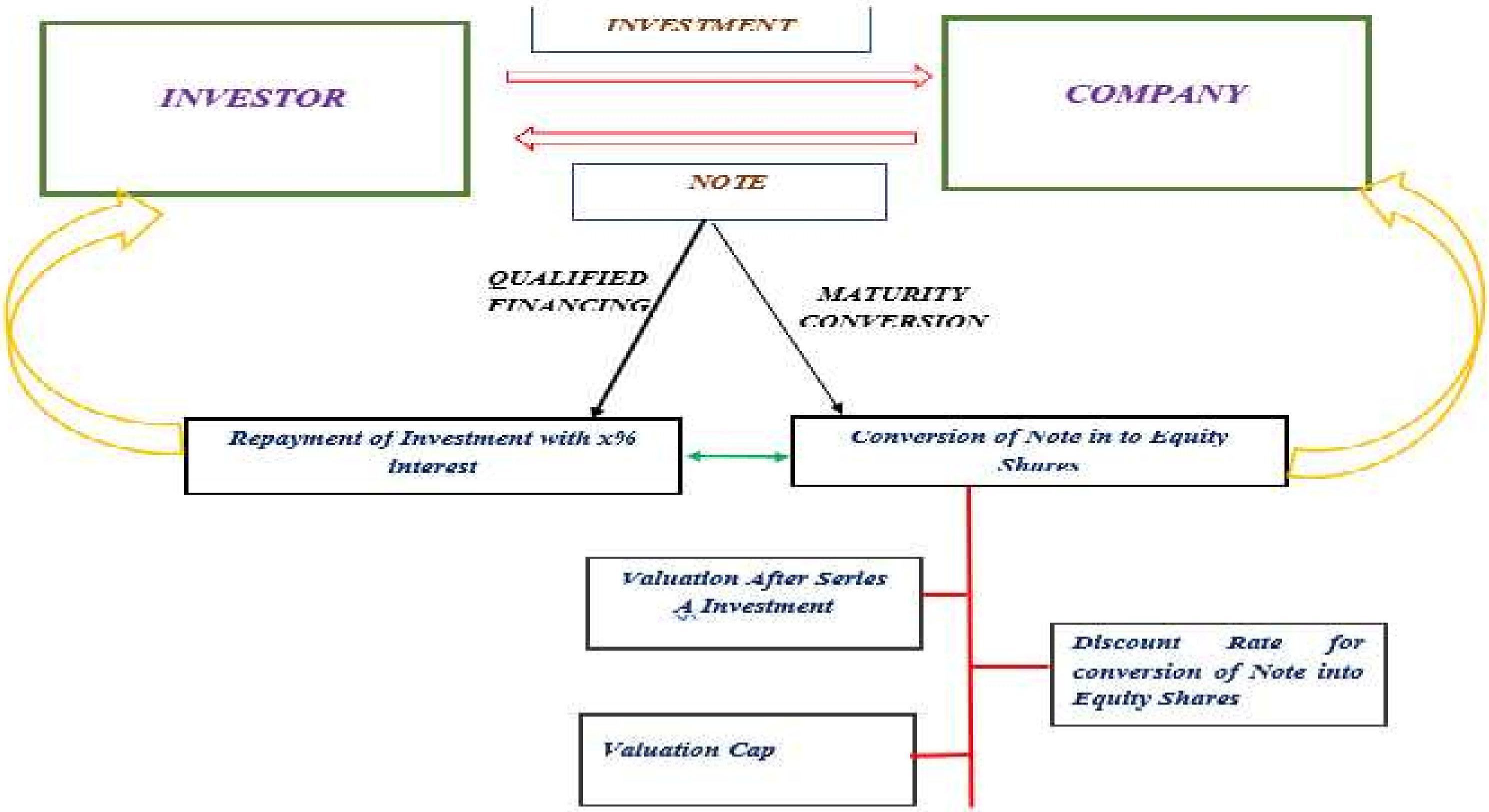
October 2020

CONVERTIBLE NOTE – EASE OF RAISING FUNDS BY STARTUPS

- *Today, we are in the golden age of startups, where people are ready to take risks for their dreams and passion. It takes more than just a great idea to run a successful business. Entrepreneurs and existing business owners need capital to pursue their dreams.*
- *New business ventures often have difficulty obtaining capital (whether for starting up, or for expanding operations). Today during economic downturns where standards for commercial investment are becoming water tight, a number of investors often seek non-traditional investment opportunities to enhance their portfolios. A convertible note ("**Note**") provides such an opportunity to serve the needs of both the startup business needing capital and the investor seeking an opportunity.*
- *As notified by Ministry of Corporate Affairs notification dated June 29, 2016 by amendment of definition of "Deposits" under Companies (Acceptance of Deposits) Rules, 2014, introduced the concept of Convertible Note as below:*
- *Convertible Note is 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.*
- *As per amended Companies (Acceptance of Deposits) Rules, 2014, an amount of Rs. 25,00,000/- or more received by a start-up company, by way of a convertible note (convertible into equity shares or repayable within a period not exceeding ten years from the date of issue) in a single tranche, from a person is not covered under the definition of Deposits.*

CONVERTIBLE NOTE

Equi Corp Associates
Advocates & Solicitors



www.equicorplegal.com

Convertible Note*'- A short-term debt that converts into equity or to be repaid in cash. In the context of a seed financing, the debt typically automatically converts into preference or equity shares upon the event of a Qualified Financing or Maturity Conversion. In other words, investors loan money to a startup as its first round of funding; and then rather than get their money back with interest, the investors receive preference or equity shares based on the terms of the Note.*

Qualified Financing: *Most (if not all) Notes contain an automatic conversion clause that dictates the automatic conversion of the convertible debt upon a "Qualified Financing." The Qualified Financing is typically defined as an equity financing by the startup, for the purpose of raising capital, in which the aggregate of pre-determined amount is purchased by investors. Thus, the Qualified Financing event is the trigger by which the convertible debt will automatically convert to equity. The conversion is considered "automatic" because it does not require the vote of either the startup or the investor.*

As a sweetener to the investor, Notes have a conversion discount feature by which the Note holder will exchange the debt/investment for Qualified Shares at a price per share equal to 80% (this amount can very per deal) of the price per share paid by the Qualified Financing investors, so the Note holder gets more shares for their investment.

One of the key advantages of Notes is that the valuation issue is kicked down the road until the Qualified Financing – when there are a lot more data points and thus it's much easier to value the startup (i.e., price the round). Again, a Note is a loan (debt, not equity). A valuation of the startup is thus unnecessary; and, if there is no valuation, there are no problems of dilution, taxes and option pricing. With startups and small companies, investors may not be financially savvy enough to properly value a company. By using Notes, investors can forgo valuation until a later date when more sophisticated investors value the company and inject additional equity. Therefore, a Note allows companies to access potential equity financing with the lower upfront costs and efforts of debt.

With the RBI Notification dated Nov.07, 2017, FDI is also permissible by means of Convertible Note.

Recently a lot of startups have been using more Notes in angel rounds as they make deals close faster. By making it easier for startups to give different prices to different investors, they help them break the sort of deadlock that happens when investors all wait to see who else is going to invest.

Note allows more flexibility in price as valuation caps for startups aren't actual valuations, and Notes are cheap and easy to do. So, startups can do high-resolution fundraising: if required, they can have a separate Note with a different cap for each investor.

Notes have a maturity date upon which the company have to repay the investment with agreed rate of interest or at the discretion of the investor to convert the Note into equity shares of the company. Company can be forced into bankruptcy if it hasn't closed a financing round and does not have money to repay the investment and the accrued interest. Convertible equity eliminates that threat. This is true in theory but extremely rare in practice. Unless the startup has been hoarding cash or investing it in hard assets in some unusual way, calling the Notes won't yield any proceeds to the investor. Sometimes aggressive investors will ask to control the board of directors or other things upon a payment default.

Notes accrue interest from the date(s) they are issued. This adds cost and administrative complexity, especially with multiple closings on different dates.

Yet startups have cranked out thousands of Notes for startups over the past several years, without any signs of the apocalypse (yet). Convertible equity strikes largely as a solution in search of a problem. The primary reason is that investors have every incentive to work with the startup to extent or renegotiate the terms of the notes, because that represents their best shot at seeing any return on their investment.

Notes have a maturity date upon which the company can be forced into bankruptcy if it hasn't closed a financing round. Convertible equity eliminates that threat. This is true in theory but extremely rare in practice. Unless the startup has been hoarding cash or investing it in hard assets in some unusual way, calling the Notes won't yield any proceeds to the investor. Sometimes aggressive investors will ask to control the board of directors or other things upon a payment default.

Connect with Us:

EquiCorp Associates, Advocates & Solicitors

Ground Floor, B-30, Sector-6, Noida-201301, Delhi-NCR, India

+918448824659/ 01204797509

W: www.equicorplegal.com
Email: admin@equicorplegal.com

Expertise:

- *Corporate & Commercial*
- *PE, Funds & M&A*
- *Finance & Technology*
- *Employment & Labour Laws*
- *Environment & Natural Resources*
- *Litigation & Arbitration*
- *Restructuring, Insolvency & Bankruptcy*
- *Regulatory Compliance & Audit*
- *Startup*
- *Tax & Consulting*

Notes accrue interest from the date(s) they are issued. This adds cost and administrative complexity, especially with multiple closings on different dates.

Yet startups have cranked out thousands of Notes for startups over the past several years, without any signs of the apocalypse (yet). Convertible equity strikes largely as a solution in search of a problem. The primary reason is that investors have every incentive to work with the startup to extent or renegotiate the terms of the notes, because that represents their best shot at seeing any return on their investment.

*To know further details, clarifications or any advice on business & legal risks, please connect with us at admin@equicorplegal.com / **+91 8448824659***