Convertible Notes a Boon for Early Stage Start Ups

S. Ravishankar
Practicing Company Secretary
ASR & CO – Company Secretaries
Email ID: ravishankar@asrandco.com

Indian start-ups have attracted billions in private equity and venture capital funds from across the world, but early-stage start-ups and those that haven't yet started raking in revenue struggle to raise funds. Banks do not back companies without collateral and since the business model is unproven, other investors too hesitate.

In the above circumstances, when an early stage start up needs funds what do they usually do? Options include going to friends and family, crowdfunding, one's savings, or, if one is lucky, finding an angel investor.

"Choosing from the options can be tricky. It depends on the company's financial needs. Although bank loans are an option, start-ups, especially in the technology space, avoid them due to the high interest rate and need for collateral. The natural progression for a start-up is to bootstrap, and then look for a professional angel investor and negotiating with investors is all about playing hardball.

Therefore, the early-stage start-ups were left with no option but to issue common stocks (equity shares with voting rights) to the investors for quick turnaround of investments and move on with their ideas & projects.

The issuance of shares of common stock creates three potential problems. First, the founder's risk substantial dilution because it is often difficult for the founders and the investors to agree on a valuation for the start-up and, accordingly, to agree on the percentage ownership the investor will receive. For example, if a start-up is merely two guys and an idea, how much equity should an investor receive for a 10 crore or 1 crore investment? 10%? 25%? Or 50%, the start-up founders will be reduced to a minority as they need funds and have to issue equity and the valuation are difficult, only in a few cases the valuation are high, with new valuation rules kicking in this becomes even more complex and difficult to justify a huge valuation.

Second, there may be tricky tax issues depending upon the timing of the investment, if two co-founders are issued shares of common stock for a nominal purchase price upon incorporation, and incoming investors pay substantially high prices on valuations for their shares of the same common stock at the same time or shortly thereafter, this may raise questions with the income tax authorities and if the excess premium paid by the investors become difficult to justify they may end up paying huge taxes . Third, the issuance of shares of common stock may cause potential problems with respect to stock option grants (ESOP) for future because the valuation of the common stocks is already fixed at a high rate due to investments and the underlying value of the common stock (i.e., the "strike" or "exercise" price) will have to be fixed keeping in mind the new valuation of the common stocks established due to the investments. The goal, of course, regarding option grants is to price the options as low as possible to attract better skills and to retain good employees A high strike price undermines that goal and the very purpose of issuing ESOPs.

Convertible Notes Solve These Problems

Convertible Note was first introduced by Reserve Bank of India (RBI) and considered as a very welcoming option provided to early-stage start-ups to raise funds by way of convertible notes which is prima facie a debt instrument with conversion terms.

Under FEMA and Rule 2(1)(c)(xvii) of Companies (Acceptance of Deposit) Rules, 2014, convertible note is been defined as follows:

" 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 as may be agreed depending on the valuations.

So, it is a form of short-term debt that converts into common stock (equity), typically in conjunction with a future financing round; in effect, the investor is giving money as loan to a start-up and instead of a return in the form of principal plus interest, the investor receives a percentage of equity in the company.

The primary advantage of issuing convertible notes is that it does not force the issuing company and investors to determine the value of the company upfront as the investment is in the form of convertible notes are considered debts with option to convert into equity at a later date. Early stage startups may not have much revenues or business models to base a valuation on, they may just have an Idea which needs funding to materialize into reality & thereafter a business. The valuation can then be determined during the Series A financing, when there are more data points of which to base a valuation on.

In India as per the latest legislation, convertible notes can only be issued when:

1. The investment amount is more than or equal to INR 25 lakh.
2. The start-up is DPIIT approved (Department for Promotion of Industry and internal trade)

To issue any instrument by a company in India, provisions under Companies Act, 2013 (the Act) shall apply. Under the Act, Convertible note was introduced as exempted deposit under Rule 2(1)(c)(xvii) of Companies (Acceptance of Deposit) Rules. Apart from above provision, there is no other provision in the Act which talks about issuance of convertible note.

Then there is a section 42 (private placement) under the Act where Company can issue share or securities, but if convertible note is issued under section 42, you may have to provide the details of Valuer who performed the valuation and basis for the price [Rule 14 of Companies (Prospectus and Allotment of Securities) Rules, 2014]

Also, exemption from valuation in convertible notes option is given only by RBI under FEMA regulation there is no mention of any such exemption under the Companies Act. Therefore, issuing under section 42 without valuation may be a violation of the provisions.

If you still go ahead and issue the convertible note U/s 42 ignoring the valuation provisions, you will be required to submit a form PAS-3 for allotment of such securities. But, in case of issuance of Convertible Notes, form PAS-3 cannot be filed as there is no specific column in the e form about convertible notes.

In view of the x`above, the best option would be that Convertible Notes are not issued u/s 42 of the Act but under 62 (3) as this makes more sense to raise money through convertible notes as convertible debt and not equity.

Company can issue Convertible Note under the provision of Section 62(3) of the Act by passing Special Resolution and accordingly form MGT-14 should be filed with ROC within a period of 30 days.

Also, the company if raising money from foreign investors by way of convertible note, it must ensure the compliances to be done under FEMA regulations, like filing of form FCGPR etc. on the FIRMS portal.

Convertible Notes as Debt Under IBC

Convertible notes are a hybrid form of venture equity and debt. The investor loans money to the company without arriving at a valuation figure. The promise is that the loan will be converted to common stock (shares) when the company raises its next round of funding from a series A Funding or a mature investor. If a follow-on round doesn't take place, then the money remains a debt for the company.

convertible debentures (CCDs) are a form of convertible notes, where the loan necessarily has to convert into equity after a certain period of time. These have been used regularly in Silicon Valley and Singapore and also in India by many early stages start up investors and financial institutions, but these have been gaining popularity in India only from 2016.

The National Company Law Appellate Tribunal ("NCLAT") has recently ruled that the Limitation Act, 1963 is not applicable to the Insolvency & Bankruptcy Code, 2016 ("IBC"). In effect, the NCLAT has held that debts which were otherwise not recoverable due to being time barred, can now be basis for initiating insolvency proceedings. This is a stark change from the earlier position and paves way for initiation of multiple insolvency proceedings on debts which could earlier not be recovered.

This judgement has also dealt with other interesting issues which are generally applicable to structures involving issuance of convertible and non-convertible debentures, now convertible notes may as well fall within this ambit.

In this case the financial creditor had subscribed to optionally convertible debentures ("OCDs") issued by the corporate debtor. OCDs carried a nil or 1% p.a. interest rate and matured in years 2011, 2012 and 2013.

The order of the NCLT was challenged by the corporate debtor, amongst others, on following grounds:

1. Given that the debentures matured in years 2011, 2012 and 2013, the petition for initiation of corporate insolvency resolution process filed in year 2017 is time barred.
2. The application of the financial creditor before NCLT was not complete as it did not contain document prescribed under Section 7(3)(a) of the IBC;
3. The financial creditor is actually an investor and not a 'Financial Creditor' as defined under the IBC.

Judgement:

On Time – Barred Debt:

The NCLAT held that that in the absence of any provision in IBC, the Limitation Act, 1963 would not be applicable to initiation of Corporate Insolvency Resolution Process. The NCLAT further observed:

“If there is a debt which includes interest and there is default of debt and having continuous course of action, the argument that the claim of money by Respondent is barred by Limitation cannot be accepted.”

This suggests that NCLAT treated the cause of action arising from non-payment of debt which includes interest as a continuing one. Thereby holding that limitation period could not have expired.

On Compliance with Section 7(3)(a) of the IBC:

Let us first understand what Section 7(3)(a) provides:

“(3) The financial creditor shall, along with the application furnish—(a) record of the default recorded with the information utility or such other record or evidence of default as may be specified;”

Corporate Debtor further contended that “The Insolvency & Bankruptcy Board of India (“Board”) has not specified any other record or evidence of default which may be furnished. Further, as there was no record of default recorded with the information utility, it was contended that the application filed was incomplete.”

The NCLAT rejected the argument, holding that a procedural requirement could not frustrate the substantive provision of law. Failure of the Board to frame regulations could not lead to inability of the adjudicating authority from dealing with application for initiation of insolvency resolution process.

The NCLAT also referred to the Rule 41 of the Insolvency & Bankruptcy (Application to Adjudicating Authority) Rules, 2016 whereby a financial creditor is required to make an application in accordance with prescribed form – 1, and Part V of the said form prescribes the particulars that need to be provided as part of the application.

The NCLAT ruled that in absence any regulation framed by the Board, the evidence of default, records and documents prescribed under Part V of the Form – 1 will be sufficient to determine default of debt under Section 7 of the IBC. Regulation 8 of Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 was also relied upon to substantiate the documents and records the financial creditor could rely upon to prove a claim.

On Meaning of Financial Creditor & financial debt:

A financial creditor is one to whom a financial debt is owed, on issue regarding meaning of financial debt. Financial debt is defined under Section 5(8) of IBC as:

“5 (8) "financial debt" means a debt along with interest, if any, which is disbursed against the consideration for the time value of money and includes any amount raised pursuant to any note purchase facility or the issue of bonds, notes, debentures, loan stock or any similar instrument;” (Emphasis supplied)

It was argued by the corporate debtor that considering that the interest rate on the OCDs was 0 or 1%, they were not issued against consideration for the time value of money. In fact, the subscriber to the OCDs was an investor in the company and not a financial creditor. However, the NCLAT held that section 5(8)(c) makes it clear that a debenture comes within the meaning of financial debt. Thus, in the present case, the amounts owed on maturity of debentures would be a financial debt.

The ruling of NCLAT holding that debenture comes within the meaning of financial debt, irrespective of the applicable interest rate has opened the doors and is useful for the industry.

Convertible debentures with nil or negligible interest rates were on various occasions used in financing structures for stat ups such that the holder of the instrument would benefit from being in a position of a creditor till such time that the OCDs were converted into equity.

This judgment now confirms that such structures would not imply that the subscriber to the OCDs would get the colour of an equity shareholder prior to its conversion (same would be the position of convertible notes), the current stand of NCLAT seems to have completely changed the position. This ruling effectively allows parties to initiate insolvency proceedings on basis of convertible instruments or debts which could not be recovered due to expiry of limitation period. This could open the flood gates for petitions under the IBC.

Ref :

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IBC case laws