

Convertible Notes India – Process, taxation and requirements

CONVERTIBLE NOTES

CONDITIONS

- Startup should be registered under startup India scheme
- Minimum Rs 25 lakh to be invested in single tranche
- Can be issued to Indians as well as foreigners

What are convertible notes? Is it similar to iSafe notes as in USA?

Convertible note means an instrument issued by a start-up company acknowledging receipt of money (minimum Rs 25 lakhs from 1 investor) initially as debt, repayable at the option of the holder, or which is convertible into such number of equity shares of that company, within a period not exceeding five years from the date of issue of the convertible note, upon occurrence of specified events as per other terms and conditions agreed and indicated in the instrument.

Who can issue convertible note?

Convertible note means an instrument issued by a start-up company. Convertible notes are the instruments through which the registered startups can raise money from the investors without the requirement of the valuation report. It is the most easy and convenient way to raise the money. Convertible Notes (CN) can only be issued by Private Limited Companies registered under Startup India scheme. Convertible notes in India is similar to iSAFE in the USA.

Is Your Company A Startup?

Your company must meet the following criteria to be considered eligible for DPIIT startup recognition.



Company Age

Period of existence and operations should not be exceeding 10 years from the Date of Incorporation



Company Type

Incorporated as a Private Limited Company, a Registered Partnership Firm or a Limited Liability Partnership



Annual Turnover

Should have an annual turnover not exceeding Rs. 100 crore for any of the financial years since its Incorporation



Original Entity

Entity should not have been formed by splitting up or reconstructing an already existing business



Innovative & Scalable

Should work towards development or improvement of a product, process or service and/or have scalable business model with high potential for creation of wealth & employment

Steps / Procedure and documents required to issue Convertible notes in India:

1. Decide the amount to be raised and the terms of conversion of convertible notes
2. Prepare a convertible note agreement. This is the most important document and should have all the terms and conditions to avoid future dispute.
3. Pass a board resolution to approve the convertible note agreement.
4. Pass the EOGM to approve the issue of notes.
5. Get the amount in the bank account. It should be more than Rs 25 lakhs.
6. Issue convertible note to the investor.

Convertible Notes- Pros

- The primary advantage of issuing convertible notes is that it **share valuation is not required**. Thus it makes it very easy for startups to raise funds without having to worry about valuation.
- The investors do not have any control or voting power when they subscribe to convertible notes.
- Generally a Private Limited Company is not allowed to take loan from any other person other than its directors. So by way of convertible notes a startup can take a loan from any investor for period of 5 years. At the end of the 5 years the CN will be repaid and not converted.
- The interest can be paid to the holder of CN.
- The process can be completed in 5 days.

Convertible Notes – Cons

- If future financing rounds are not completed, the investors may opt not to convert the notes into equity and the CN will remain as debt and thus require redemption, potentially pushing still fragile companies into bankruptcy.
- Further, a Convertible Note has to be repaid or converted into equity shares of a start-up company within 5 years from the date of issuance of the Convertible Note. Since the maturity period is less, the risk involved becomes greater.

- The threshold to invest minimum INR 25 Lakhs for one tranche also becomes a hurdle for start ups struggling to seek from angel investors.
- You still have to decide the Floor Valuation and Valuation cap for convertible notes which may become a hinderance.

Is valuation report required to issue Convertible Notes?

No the valuation report is not required to issue the convertible notes. It is required only when the notes are converted into equity shares at the later date.

What is the valuation at which the convertible notes can be converted in to the equity shares?

The notes can be converted into equity share at the valuation on the date of conversion or based on the predefined formula for calculating the value of the company.

Whom can CN be issued to?

Convertible notes can be issued only to:

- Foreign investors
- NRI
- Resident Indians
- Indian companies and Indian investors

Can CN be issued to Indian residents?

Yes CN's issued to Indian residents.

What are the conditions to issue Convertible Notes?

- Can be issued only to foreign investors, NRI and resident Indians
- Minimum amount to be invested in one tranche by one investor is Rs 25 lakhs
- The maximum tenure of CN should be 5 years. That means it should be converted into equity or should be repaid within 5 years of issue
- The company that wants to issue CN should be registered under Startup India scheme.

What is procedure to issue CN?

The process to issue CN is as follows:

- Approval of board to approve the issue of convertible notes
- Approval of shareholder in EOGM to issue convertible notes
- Filing of MGT 14 with relevant terms and conditions of the convertible notes
- Preparation of the convertible notes agreement which should have all the important terms
- File Form CN with RBI once you receive the funds (this is applicable only if funds are received in foreign currency)

What is better Convertible notes or Compulsorily Convertible debentures?

For startups CCD is better as it has to be mandatorily converted into equity shares.
For investors CN is better as it is option to convert it into equity.

What is difference between CCD and CN?

- CN are optionally convertible whereas CCD are mandatorily convertible.
- Process is simple to issue CN whereas process to issue CCD is a bit complicated.

What are the laws that govern Convertible Notes?

In India, convertible notes are regulated by the Reserve Bank of India vide notification number FEMA 20(R)/2017-RB and the Companies Act, 2013.

What are the reporting requirements after the Convertible Notes is issued?

Under RBI only if the investors are foreign nationals (FEMA 20(R)/2017-RB):

1. Creation of Business User account and Entity Master account on FIRMS portal
2. Filing form CN within 30 days from the date of receipt of payment in bank account.
3. A certificate from CA, CS and the FIRC and KYC from bank is required.
4. Convertible notes agreement is also required when filing form CN

The Company issuing convertible notes to a person resident outside India shall report such inflows to the Authorised Dealer Bank in **Form CN** within 30 (Thirty) days of such issue.

Under Companies Act, 2013:

1.
 1. Unlike issuance of shares by private placement or preferential allotment, the procedure for issuance of a convertible note is comparatively easier.
 2. As it is a debt instrument, the issuing Company is required to seek approval of its members by way of a **special resolution** at the General Meeting. This must be notified to the Registrar of Companies by filing of eForm MGT-14 within 30 (Thirty) days of the General Meeting.

Convertible Notes Agreement Clauses:

Download Convertible Note Sample Agreement

Below is sample convertible note agreement will all the clauses

This Convertible Note Agreement is made at Bangalore, on this _____ of _____, 2021 (“**Execution Date**”), by and between:

1. I, Mr. _____, having PAN as _____, currently residing at _____ (hereinafter referred to as “**Investor**”, which expression shall, unless repugnant to the context to meaning thereof, mean and include his successors and permitted assigns);
2. _____ **PRIVATE LIMITED**, a company incorporated under the Companies Act, 2013 and having its registered office _____ (hereinafter referred to as “**Company**”, which expression shall, unless repugnant to the context or meaning thereof, mean and include its successors and permitted assigns);
3. **Mr** _____ -, son of _____, resident of _____, (hereinafter referred to as “**Founder 1**”, which expression shall, unless repugnant to the context or meaning thereof, mean and include his successors and permitted assigns); and
4. **Mr** _____ - son of _____, resident of _____ (hereinafter referred to as “**Founder 2**”, which expression shall, unless repugnant to the context or meaning thereof, mean and include his successors and permitted assigns).

Each of Founder 1 and Founder 2 shall hereinafter be referred to individually as a “**Founder**” and collectively as “**Founders**”

Each of the Investor, the Founders and the Company shall hereinafter be referred to individually as a “**Party**” and collectively as “**Parties**”.

WHEREAS:

1. The Company is a start-up company recognized by the by the Ministry of Commerce and Industry, Government of India, having recognition number as _____-.
1. The Company is engaged, inter alia, in the business of _____ (“**Business**”).
1. The Investor is desirous of investing in the Company on the terms and conditions stipulated in this _____.
1. Accordingly, the Parties are desirous of executing this Agreement to set out the agreement and relationship between the Parties and their rights and obligations in relation to the investment by the Investor in the Company and other matters in connection _____.

NOW THEREFORE, in consideration of the foregoing and other good and valuable consideration, the receipt and adequacy of which are hereby expressly acknowledged, the Parties, intending to be legally bound, hereby agree as follows:

1. DEFINITIONS

In this Agreement, the defined and capitalized terms, to the extent not inconsistent with the context thereof, shall have the following meanings assigned to them herein below.

- “**Act**” shall mean the Companies Act, 2013 and shall include all amendments, modifications and re-enactments of the foregoing.
- “**Agreement**” shall mean this convertible note agreement entered into between the Parties hereto and includes any written modifications to the same including all annexures / schedules attached
- “**Applicable Laws**” shall mean and include all applicable statutes, enactments, acts of legislature or parliament, laws, ordinances, rules, by-laws, regulations, notifications, guidelines, policies, directions, directives, orders and administrative interpretations of any governmental authority, tribunal, board, court or stock exchanges on which the Equity Shares or other securities of the Company may be

“**Business Day**” shall mean any day, other than a Sunday or a public holiday, on which scheduled commercial banks in Bangalore, Karnataka, India are open for normal banking business.

“**Confidential Information**” means any and all information disclosed by a Party (“Disclosing Party”) to the other Party (“Receiving Party”), whether orally or in writing, whether designated as confidential or not, that reasonably should be understood to be confidential given the nature of the information and the circumstances of disclosure. Confidential Information shall include (i) the terms and conditions of this Agreement (ii) all information relating to the transaction exchanged between the Parties in any manner whatsoever and (iii) business and marketing plans, technology and technical information, product plans and designs, and business processes relating to the business of the Disclosing Party.

“**Closing**” shall mean issuance of the Note to the Investor in accordance with Clause 3.2 of the

“**Closing Date**” shall mean the date on which Closing as contemplated in Clause 3.2 shall take place, which shall be a date not later than

“**Designated Bank Account**” shall mean a bank account maintained by the Company into which the Investor shall remit the Note Amount in accordance with the terms of this Agreement, the details of which are as follows:

Account Number:

Bank:

Branch Code:

Address:

Beneficiary Name:

IFSC Code:

“Equity Shares” shall mean the fully paid-up equity shares of face value of INR 10/- (Indian Rupees Ten only) each of the Company issued from time to time, together with all rights, obligations, title and interest in and to such

“Liquidity Event” means, in relation to the Company, one or more of the following events:

A merger, acquisition, change of Control, consolidation or a transaction or series of transactions resulting in a corporate restructuring; (b) Any voluntary or involuntary dissolution, liquidation, or winding-up of the affairs of the Company; (c) sale, lease, license or other transfer of all or substantially all the Company’s assets or similar

“Note” shall mean the instrument evidencing receipt of amounts paid by the Investor to the Company initially as debt, which is repayable at the option of the Investor, or which is convertible into Equity Shares in the manner detailed in **Schedule I** hereto and having the terms and conditions as set forth in Schedule I

“Note Amount” shall mean an amount of Rs. _____ (Rupees _____ Only) to be paid by the Investor in a single tranche on or before the Closing Date to the Company as a consideration for the

“Security” or **“Securities”** shall mean all securities of the Company, whether in the form of Equity Shares, preference shares or any other instrument which may be converted into Equity Shares at a later

“Transfer” shall mean transfer, sell, assign, pledge, hypothecate, create a security interest in or lien on, place in trust (voting or otherwise), transfer by operation of law or in any other way subject to any encumbrance or dispose of, whether or not

“Qualified Investment Transaction” means a transaction by the Company wherein the Company raises from a single investor or multiple Investor a cumulative investment of minimum INR 75,000,000/- (Indian Rupees Seven Crore Fifty Lakhs Only) in the Company, either in one tranche or in multiple tranches (but at same valuation), which does not involve the conversion of the Investor Notes.

2. ISSUANCE AND SUBSCRIPTION OF THE NOTE

- The Investor agrees to subscribe to, and the Company agrees to issue to the Investor, the Note against the payment of the Note Amount by the Investor. On or before the Closing Date, the Note Amount shall be remitted by the Investor to the Designated Bank Account. The remittance of the Note Amount by the Investor in the manner set out in this Agreement shall constitute full payment of the Note Amount by the Investor in lieu of issuance of the Note to the Investor by the
- The Parties agree that, notwithstanding anything contained in this Agreement, in the event that the Closing does not occur in the manner and time envisaged in this Agreement within 10 days after remittance of the entire Note Amount by the Investor, then, the Company shall forthwith refund the entire Note Amount to the

The Parties agree and understand that the Note Amount received under the provisions of this Agreement is not a deposit, whether for the purpose of Sections 73 or 76 of the Act or under the Companies (Acceptance of Deposits) Rules, 2014. The Parties further agree that none of the Parties shall claim that the Note Amount relating to the Note issued by the Company is in the nature of a deposit and shall not resort to any provision under the Act or Companies (Acceptance of Deposits) Rules,

3. CLOSING

The Closing shall take place at the registered office of the Company on the Closing Date or at such other place as the Parties may mutually

On or before the Closing Date, the Investor shall pay to the Company the Note Amount, by way of remittance to the Designated Bank Account. The Company shall, upon the receipt of such amount, issue the Note to the

The Company shall be responsible for the payment of any stamp duties related to the issuance of the Note, as per the Applicable

The Company shall undertake all required compliances under the Act in connection with the issuance of the Note to the

4. RIGHTS OF THE INVESTOR

The Note shall have such rights as set forth in **Schedule I** (Terms and Conditions of the Note). The conversion of the Note shall be in accordance with the terms set out in **Schedule I** (Terms and Conditions of the Note).

For so long as the Note is not converted in Equity Share, the Investor's consent shall be required for any action or decision relating to the following matters:

any voluntary winding-up, liquidation, bankruptcy or dissolution of the Company;

sale of all or substantially all the Company's assets or closure of an existing business;

grant of any loan by the Company to the Founders; and

4.3

Liquidation Preference

In the event of a Liquidity Event occurring post to conversion of the Note, the proceeds from the Liquidity Event (less any amounts required by Applicable Law to be paid or set aside for the payment of creditors of the Company, if applicable) shall be paid to the Investor, in preference to the Founders, such that Investor shall be entitled to such amount which is higher of: (i) total amount invested by the Investor in the Company, or (ii) *pro rata* entitlement of the Investor (the “**Preference Amount**”). In such a case, the other investors of the Company shall have preference over the

The Parties agree that for the purpose of liquidation preference right granted to the Investor, all the holders of Note in the Company shall be treated at par and no Note holder shall have any priority over the

4.4

Information Rights

- The Company shall supply to the Investor the final annual audited financial statements for the relevant financial year end, together with notes thereto in accordance with applicable accounting standards and any reports by auditors or directors in respect of such standalone statements for the Company in accordance with applicable
- The Investor agrees to provide all the information and documents as may be required by the Company for the purpose of various compliances under the applicable

5.

TRANSFER RESTRICTIONS

The Investor shall not be entitled to Transfer or assign the Note held by him to any Person without prior written consent of the

In the event the Founders desire to transfer all the Securities held by him in the Company to a third party, then the Founders shall have the right to require Investor to transfer the Note or the Equity Shares issued pursuant to conversion thereof, held by the Investor to the third party on the same terms and conditions agreed between Founders and the third party (“**Drag Right**”). For the avoidance of any doubt, the Parties agree that upon exercise of the Drag Right, the Founders shall have a right to negotiate transfer of hundred percent (100%) of the Securities of the Company. The Founders may exercise the Drag Right by issuing a written notice (“**Drag Notice**”) to

Any attempt to Transfer any Securities which is not in compliance with this Agreement shall be null and void and neither the Company nor any transfer agent shall give any effect in the Company’s register and transfer books to such attempted

6.

REPRESENTATIONS AND WARRANTIES

Each Party represents to the other Party that:

it has power to execute, deliver and perform its obligations under this Agreement and all necessary corporate, shareholder and other action has been taken to authorize such execution, delivery and performance;

this Agreement constitutes its legally, valid and binding obligation, enforceable in accordance with its terms;

the execution, delivery and performance of its obligations under this Agreement does not and will not:

contravene any Applicable Laws, or order of any Government Authority or any judgment or decree of any court having jurisdiction over it; or

conflict with or result in any breach or default under any agreement instrument, regulation, license or authorization binding upon it or any of its

- The Investor represents to the other Parties that the entire Note Amount invested by the Investor in the Company has been earned by the Investor from legitimate sources and duly accounted for and the investment by the Investor into the Company does not involve any money laundering
- The Founders undertake and warrant that all opportunities for new projects and businesses relating to the Business that are developed or sourced by, or offered to, the Founders shall be referred exclusively to the

7. CONFIDENTIALITY

- Each Party shall keep all Confidential Information including information relating to the other Parties and information relating this Agreement confidential. Except as provided in this clause 7, each Party agrees to hold in confidence and not use, disclose or reveal to any Confidential Information disclosed to it by the other Party. None of the Party shall issue any public release or public announcement or otherwise make any disclosure concerning this Agreement, and/or the transaction, without the prior approval of the other
- Nothing contained herein shall affect the right of a Party to disclose any Confidential Information to its investors/ prospective investors, employees, directors or professional advisers including to their affiliates or investors strictly on a need to know basis, subject to obligations of confidentiality substantially similar to those as applicable to the disclosing Party hereunder, and/or to any of the regulatory authorities or other person as required under Applicable Law.

8. MISCELLANEOUS

Notices

Each notice, demand or other communication given or made under this Agreement shall be in writing and delivered or sent to the relevant Party at the address mentioned in this Agreement (or such other address as the addressee has by five (5) Business Days' prior written notice specified). Any notice, demand or other communication so addressed to the relevant Party shall be deemed to have been delivered (a) if delivered in person or by messenger, when proof of delivery is obtained by the delivering Party, (b) if sent by post within the same country, on the fifth (5th) Business Day following posting, and (c) if given or made by email, upon dispatch / delivery.

Amendment

This Agreement shall not be amended, modified or supplemented except by a written instrument executed by each of the Party hereto.

Each Party acknowledges and undertakes to the other that if on account of any legal requirement including change in Law, this Agreement becomes unenforceable or causes any adverse tax implications on the Company, all Parties shall take best efforts to agree to such modifications to the Agreement so as to as to make this Agreement operative and enforceable in accordance with the intention of the Parties and spirit of this Agreement or minimize any adverse tax impact on the Company.

Counterparts

This Agreement may be executed in one (1) or more counterparts including counterparts transmitted by facsimile, each of which shall be deemed to be an original, but all of which signed and taken together, shall constitute one document.

No Assignment

Subject to the provisions of this Agreement, this Agreement shall not be assigned by a Party without the prior written approval of all the Parties.

9. DISPUTE RESOLUTION

- This Agreement shall be governed in accordance with the laws of
- If a dispute in relation to this Agreement is not resolved through discussions within thirty (30) Business Days, then such dispute shall be referred at the request in writing of any Party to the dispute to binding arbitration by sole arbitrator in accordance with the Arbitration and Conciliation Act, 1996. The sole arbitrator shall be mutually decided by the disputing Parties. All arbitration proceedings shall be conducted in the English language and the place and seat of arbitration shall be Bangalore.

Summary:

Convertible notes are the most simple and flexible option for a startup to raise funds from angel investors. It is one way for Private Limited to take unsecured loan from person

other than directors. It is also a bit risky as investor has the right to decide if he want to convert the notes in equity or wants it repaid.

FAQ's

What are convertible notes in India?

Is interest payable on Convertible notes?

Is valuation report required for convertible notes?

Can convertible notes be issued to Domestic investors?