CONVERTIBLE NOTES: COMPREHENSIVE GUIDELINES AND COMPLIANCE

Chaitanya Vaidya, Legal Advisor (Corporate and Real Estates practice areas)

1. Background:

In the context of The Companies (Acceptance of Deposits) Rules, 2014, specifically explanation II of Rule 2(xvii), a convertible note is defined as an instrument that initially represents the receipt of money as a debt. This debt is repayable at the option of the holder or can be converted into a specific number of equity shares of the start-up company upon the occurrence of specified events and in accordance with the terms and conditions outlined in the instrument.

Convertible notes are financial instruments that offer an option for conversion into equity at a future date. This means the holder of a convertible note can choose to exchange it for a predetermined number of equity shares of the company. These notes are particularly popular among early-stage companies as they provide a way to raise capital without the immediate need to determine the company's valuation, which can be a complex task during the initial phases of development.

2. Pre-requisites for Issuing Convertible Notes:

For a company to issue convertible notes, it must be officially recognized as a “start-up” by the Department for Promotion of Industry and Internal Trade (DPIIT), as per explanation II of Rule 2(xvii) of The Companies (Acceptance of Deposits) Rules, 2014.

According to the DPIIT's amended notification dated January 16, 2019, an entity qualifies as a "start-up" if it meets the following criteria:

- The entity must be incorporated as a private limited company, a registered partnership firm, or a limited liability partnership in India.

- The entity should not have been in existence for more than 10 (Ten) years from the date of its incorporation or registration, and its annual turnover for any of the preceding financial years since its incorporation should not exceed INR 100 crore (Indian Rupees Hundred Crores).

- The entity's business model should focus on developing or improving a product, process, or service, and it should possess a scalable business model with high potential for wealth and employment creation.
- The entity should not have been formed by splitting up or reconstructing an already existing business.

Additionally, the company must raise a minimum of INR 2,500,000 (Indian Rupees Twenty-Five Lakh) in a single tranche from a single investor for the convertible notes to be exempt under the deposit rules as per Rule 2(xvii) of The Companies (Acceptance of Deposits) Rules, 2014.

Convertible notes must be redeemed or converted into equity shares within a maximum period of 10 (Ten) years, as stipulated by Rule 2(xvii) of The Companies (Acceptance of Deposits) Rules, 2014.

3. Procedure for Issue of Convertible Notes:

While The Companies Act, 2013 does not explicitly outline the procedure for issuing convertible notes, Section 62(3) allows a company to raise a loan with an option to convert it into equity. The process for issuing convertible notes includes the following steps:

- **Board Approval:** Convene a board meeting and pass the necessary resolutions, including approval of the issuance of convertible notes, approval for convening a general meeting specifying the day, date, time, and venue, and identification of the intended recipients of the convertible notes, as per Section 173 of the Companies Act, 2013, and Secretarial Standards - 1.
- **Shareholders' Approval:** Hold a shareholders' meeting and obtain a special resolution approval for the issuance of convertible notes, as required by Section 100 of the Companies Act, 2013, and Secretarial Standards - 2.

- **Filing Requirement:** File Form MGT-14 with the Registrar of Companies (ROC) within 30 days of obtaining special resolution approval, in accordance with Sections 94(1) and 117(1) of the Companies Act, 2013.

- **Agreement**: Prepare and execute a convertible note agreement or purchase agreement that clearly outlines the terms agreed upon between the parties.

- **Separate Bank Account and Valuation Report Not Required:**

Private placement procedures do not apply to the issuance of convertible notes, as these are considered loan instruments until conversion occurs.

Compliance will require only a board resolution and a special resolution at a shareholders' meeting, in accordance with Section 62(3) of the Companies Act. Consequently, the compliance requirements related to private placement, such as the offer letter (PAS-4) and record of private placement (PAS-5), are not required for the issuance of convertible notes.

Since convertible notes function as loan instruments until conversion, the company is not obliged to obtain a valuation report at the time of issuance. Moreover, private placement provisions are not applicable during this phase.

The company is also not required to open a separate bank account for the issuance of convertible notes. The Companies Act, 2013, does not necessitate funds to be transferred to a distinct bank account for convertible notes, as they are perceived as loan instruments until the conversion option is exercised. Therefore, there is no requirement for funds to be routed through a separate account before transferring them to the operating account.

Upon conversion, the company must file Form PAS-3, as per Rule 12 of the Companies (Prospectus and Allotment of Securities) Rules, 2014. The terms specified in Section 5 of this article will also apply during this stage.

Case Law: Wurknet Private Limited, Registrar of Companies Order, Maharashtra, Mumbai order dated 17 November, 2023 –

i. Wurknet Private Limited violated the Companies Act, 2013, due to a misinterpretation of Section 62(3) when proposing to raise funds through convertible notes in December

2019.

ii. *The company mistakenly followed procedures under Section 62(1)(c) regarding preferential allotment instead of Section 62(3) for the issuance of convertible notes.*

iii. *The discrepancy was identified during internal due diligence, leading to a suo-moto compounding application.*

iv. *The presenting officer contended that the Companies Act, 2013, permits convertible notes under Section 62(3).The presiding officer clarified that convertible notes should be governed by Section 62(3) and not Section 62(1)(c), which pertains to preferential allotment.*

4. Procedure for Conversion of Convertible Note:

Upon reaching the 10 (Ten)-year mark or upon the occurrence of specified events as outlined in the convertible notes agreement, the company may convert the notes into equity shares at the predetermined conversion price. This conversion must adhere to the allotment provisions detailed in Rule 14 of the Companies (Prospectus and Allotment of Securities) Rules, 2014.

- **Valuation Report :** A valuation report is not required at the time of issuing convertible notes. However, it is mandatory to obtain a valuation report at the time of conversion of convertible notes, as per Rule 12 of The Companies (Prospectus and Allotment of Securities) Rules, 2014.

- **Board Resolution for Allotment:** Convene a board meeting and pass the necessary resolutions for the allotment of convertible notes through private placement and authorize the filing of the return of allotment with the ROC, as per Section 173 of the Companies Act, 2013, and Secretarial Standards - 2.

- **Filing of Return of Allotment:** File the return of allotment in Form PAS-3 along with the relevant fees within 15 days of the date of allotment, as per Rule 14(6) of the Companies (Prospectus and Allotment of Securities) Rules, 2014.

- **Share Certificate Issuance:** Issue share certificates to the allottees, as per Rule 5(2) of the Companies (Share Capital & Debentures) Rules, 2014.

- **Register of Members (MGT-1):** Update the register of shareholders in Form MGT-1 to ensure accurate record-keeping of shareholders, as per Section 88(1)(a) of the Companies Act, 2013, and Rule 3(1) of the Companies (Management and Administration) Rules, 2014.

5. Non-Applicability of deposit rules:

According to Clause (xvii) of Rule 2 of the Companies (Acceptance of Deposits) Rules, 2014, an amount of INR 25,00,000 (Twenty-Five Lakhs) or more received by a start-up company through a convertible note in a single tranche from a person will not be considered a deposit.

6. Stamp Duty on Issuance of Convertible Notes:

As per 5(c)(ii) under Schedule I of the Maharashtra Stamp Act, the stamp duty on convertible notes is set at one rupee for every INR 10,000 (Indian Rupees Ten Thousand) of the security's value at the time of purchase or sale.

7. Issue of Convertible Notes to Foreign Entities:

A "convertible note" is an instrument issued by a startup company acknowledging the receipt of money initially as debt, which can be repaid at the holder's option or converted into a specific number of equity shares within a period not exceeding 5 (Five) years from the date of issuance.

This conversion occurs upon the occurrence of specified events and in accordance with the terms and conditions outlined in the instrument, as defined in Rule 2(e) of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019.

A person residing outside India can purchase convertible notes issued by an Indian startup company for an amount of INR 25,00,000 (Indian Rupees Twenty-Five Lakh) or more in a single tranche, as stated in Rule 18(1) of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019.

Issuance of these convertible notes requires approval through a board resolution during a board meeting and a special resolution at a shareholders’ meeting, as per Section 62(3) of the Companies Act, 2013.

When issuing convertible notes to a foreign resident, the startup company must receive the consideration amount via inward remittance through banking channels or by debiting the NRE/FCNR(B)/Escrow account maintained by the individual, in compliance with the Foreign Exchange Management (Deposit) Regulations, 2016, as per Regulation 3.2 of the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019.