Start-up Financing – Convertible Notes

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Team CVs

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Mohamed Toorani is a Partner and Head of the Bahrain office of DLA Piper. As a Bahraini national, his bilingual skills, innate understanding of the culture, and invaluable international and legal experience on corporate and finance matters, bring high value to the team.

Mohamed, ranked by various award winning legal directories including Chambers & Partners, is experienced in the Corporate and Finance practice and came to DLA Piper after working in situ at Mashreqbank psc, Dubai for a number of years. Mohamed has over 14 years of legal experience and advises on a broad range of corporate and finance matters, including general corporate, corporate governance, company formation, share and asset transfers, financial technology (FinTech), funds (ranging from mutual funds to hedge funds or PIUs), liquidations, drafting and reviewing of conventional banking facility documentation, securitization, joint ventures, special purpose vehicles, trademarks, licenses, intellectual property, employment, real estate, insurance, investments under Bahrain, UAE, and UK law.

Mohamed is admitted at the Bahrain Cassation Courts (Supreme Courts) and a Private Notary (English) appointed by His Excellency Sheikh Khalid bin Ali Al Khalifa, Minister of Justice, Islamic Affairs in Bahrain.

Mohamed is also the first and only Bahraini national to head an international firm in Bahrain.

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Sohail Ali is a litigation and arbitration lawyer, with over 15 years' experience advising a wide range of corporate clients on high value, premium banking and commercial disputes.

Sohail has particular expertise in advising on complex, cross-border disputes. He also leads the firm's global Islamic Finance disputes practice.

Sohail has done a number of client secondments including at Goldman Sachs, Barclays Capital, Mars and Lloyds Banking Group and he understands the importance of providing clear, commercial and strategic advice to his clients.

Ranked as a rising star in the Legal 500 for 2022, Sohail has been described by clients as "sharp as a tack", "peerless for his generation" and a "stand out individual in the litigation/arbitration team" with "exceptional client handling skills".

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Shabaz is a Senior Associate in the UK Corporate Crime, Investigations and Financial Services Regulatory group, with experience of acting in financial services regulatory (advisory, transactional, and contentious), corporate crime, and investigations matters for both corporates and individuals in both domestic and international matters.

Prior to qualifying as a solicitor, Shabaz spent over 2 years in the regulatory compliance team at a well-known UK stock broking firm. Further, Shabaz spent time on secondment in the Government Affairs and Regulatory Strategy team at the London Stock Exchange. These experiences allow Shabaz to combine his knowledge of regulatory law with an understanding of how things work in practice.

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Lulwa Alzain is a qualified lawyer with several years of experience at the Bahrain office of DLA Piper, with primary focus on general corporate, regulatory, investigation, fraud, employment and intellectual property matters.

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Jenan is a Shari'a qualified corporate lawyer who sits in the Bahrain office of DLA Piper.

Jenan specialises in supporting clients across all major financial services sub-sectors. Her core area of practice is regulatory driven strategic projects, corporate reorganisations, transactions and restructurings, as well as cross-border and FinTech related assignments.

1. Introduction

1.1 This document serves as a guide for start-ups that are looking to issue convertible notes in the Kingdom of Bahrain.

1.2 **In simple terms, a convertible note is a loan from an investor to a company, which is returned by the company at the end of an agreed period of time in the form of equity under certain circumstances.**

1.3 The guide sets out:

a. An overview of start-up funding;

b. The associated benefits of utilising convertible loan notes for both start-ups and investors;

c. The key terms in relation to the same;

d. An overview of the legal and regulatory framework in the Kingdom of Bahrain relating to convertible loan notes; and

e. A brief discussion of alternatives to convertible notes.

2. Start-up funding – an overview

2.1 One of the key factors for early stage businesses is capital. Many start-ups use convertible notes in their early financing rounds.

2.2 We set out the different types of early-financing rounds below.

Pre-seed funding:

2.3 The earliest funding round to assist start-ups with their initial formation is known as "*pre-seed*" funding.

2.4 The amount raised during this stage can vary depending on the nature of the company, however customarily up to USD50,000 is raised during this phase.

2.5 The investors during this phase are commonly the founders themselves, plus close family, friends, and supporters.

Seed Round

2.6 Whilst pre-seed capital may enable businesses to get started, they may soon require more significant capital to finance product/service development and launch.

2.7 After the pre-seed round, the next round of funding is commonly referred to as the "*seed round*". Again, the amount raised in this phase can differ depending on the nature of the company, however ordinarily start-ups conduct raises of around USD50,000 up to USD2 million in the seed round.

2.8 Investors typically include founders, high-net worth individuals, venture capital companies, and start-up accelerators.

Series A, Series B, Series C etc

2.9 Businesses that can evidence the development of a viable product or service may seek further capital for development in subsequent rounds to promote business growth. Growth capital may be required for a number of reasons, such as expansion of facilities, purchase of machinery, hiring of personnel, and gaining access to new markets.

2.10 Each subsequent round of funding is identified by a letter of the alphabet – Series A, Series B, Series C, Series D and so on. The letter of the alphabet expresses the number of times a start-up has raised external funding.

2.11 The amount raised in these later stages ranges from around USD2 million to upwards of USD100 million, although this will depend on the company raising funds.

2.12 The investors are most commonly venture capital companies, private equity funds, hedge funds, and even sovereign wealth funds.

3. Benefits of convertible notes

3.1 As mentioned above, convertible notes are loans from investors to companies, which loans are returned by the company at the end of an agreed period of time in the form of equity under certain circumstances.

3.2 There are a number of benefits to using convertible notes which we set out below, and which make them favoured for a large number of start-ups and also private equity backed companies (particularly when supporting a management buy-out).

3.3 **Benefits of convertible notes for start-ups:**

a. **Relatively simpler, faster, inexpensive process:** convertible note agreements are typically short and straight forward when compared with documents in other types of funding transaction. For example, a preferred stock financing deal can be complex in nature, and negotiating such a deal may take more time and expend more resources. Opting for a convertible note issuance may result in a simpler, faster process that is usually completed within 1-2 weeks. This in turn means that the process is also less expensive since it may require less legal involvement;

b. **Flexibility:** The terms of the convertible note are flexible, and companies are free to negotiate the terms of these to their benefit. This includes the types of conversion event, and the rate at which any outstanding loan amount and interest will convert to equity;

c. **Control:** Start-up owners are able to have more operational flexibility with convertible notes as investors do not have voting rights, and therefore do not have control over business operations;

d. **Delaying valuation of the start-up**: Utilising convertible notes allows start-ups to postpone valuation of the company. This can be important because:

- Placing a value on a start-up before it takes off financially can be difficult. Delaying valuation can allow start-ups to value the company in a more accurate and appropriate manner at a later stage;
- It may allow start-ups to avoid overvaluation;
- It may allow start-ups to avoid having a complicated financing structure; and
- Start-up founders will not have to provide investors with a set percentage ownership until a later date when the notes convert. If the value of the company has grown significantly since issuance, this may result in a smaller percentage of the company having to be given to investors (depending on the conversion mechanics).

3.4 **Benefits of convertible notes for investors:**

a. **Investor rights:** Parties can agree on which rights are granted to investors. Such rights include, but are not limited to:

- **Access Rights:** Prior to the second round of financing, the investor would usually have regular access to information rights, which may include the right to view the start-up's annual, quarterly, and monthly financial statements, as well as annual operating budgets and financial forecasts;
- **Pre-emption rights:** Investors can negotiate pre-emption rights on the issuance of new convertible notes. If the company is doing well, this can allow existing note holders to share in additional upside by investing more in any future issuance;

b. **Knowledge on the Start-up status:** Investors will like build up a relationship with the founders and employees of the start-up and, therefore, may be familiar with their collective capabilities and strengths (particularly if access rights are negotiated). Accordingly, once the start-up develops an established user base and consistent revenue figures and is poised to receive additional funding to expand the business past the development stage, the investor will be in the most advantageous position when it comes to deciding whether to expand their shareholding equity in the start-up. This can be particularly useful when coupled with pre-emption rights;

c. **Recovery of Capital in the event of insolvency:** Where a start-up is faced with a liquidation or bankruptcy order, holders of convertible notes are entitled to recover their investment before common shareholders receive any of the proceeds. This is commonly referred to as having seniority over shareholders, who are usually the start-up's founders and employees.

4. Convertible note documents

Term Sheets

4.1 Prior to signing a convertible note, investors will commonly (but not necessarily) request start-ups to negotiate and draft a term sheet.

4.2 A term sheet is a non-binding document that sets out the conditions and terms for investment.

4.3 Terms sheets allow parties to agree on the key components of the convertible note. Once completed, the parties can draw up the convertible note which conforms to the details of the term sheet, among other terms and conditions, as set out below.

4.4 Start-up companies are encouraged to agree on these terms for transparency purposes as they eliminate most uncertainties and provide the parties with clarity and assurance.

Key Terms

4.5 **Principal Amount:** The financing amount which is being invested by the investor.

4.6 **Interest rate:** The parties to agree on whether an interest rate shall be applicable to the debt amount. According to international practice, the interest rate is usually set between 4 – 8%.

4.7 **Conversion event:** This sets out when the convertible notes will convert to equity. There are a number of different types of conversion event that might apply, including:

a. **Future equity financing:** which is when a start-up raises an agreed amount by an agreed date (for example, USD10,000 within two (2) years);

b. **Sale of the company:** the convertible debt bond typically obligates the start-up to repay the payment equal to the outstanding principal and accrued but unpaid interest if the company is sold prior to the maturity date;

c. **Maturity Date:** the date on which the loan and any interests becomes payable by the start-up to the investors, if it is not converted into shares or if an event of default occurs. This is typically 12 – 24 months from the convertible note's issuance date. Under the Laws of Bahrain, this cannot be more than five (5) years (see section 6 below). It is important to note that in the event that a start-up is unable to convert its debt by the maturity date, an amendment which either grants an extension or accepts the conversion of the note into shares may be agreed with the investors. Investors are unlikely to force a start-up into bankruptcy or liquidation. On the contrary, investors will likely want to assist the start-up in achieving a long-term success.

4.8 **Event of Default:** common events of default include failure of the start-up to pay interest and principal to the investor, failure to comply with conversion obligations, or not providing notice on fundamental changes to the investor.

4.9 **Price of the equity at the time of conversion:** This term sets out the price for the shares at which a loan and any accrued interest will convert. For example, if the outstanding loan amount and accrued interest is USD1,000 and the value of each share is USD10, without any valuation cap or discount (discussed below) the investor would receive 100 shares on conversion.

4.10 The price of the equity can be set at the market value. For example, there could be a valuation of the company at a set date, and the price of each share is the total value of the company divided by the number of shares.

4.11 However, start-ups may agree a valuation cap or a discount rate in order to give investors an incentive to invest in the convertible notes, with the idea that they will receive additional upside in future.

a. **Valuation Cap:** This sets a contractual cap or ceiling on the price that noteholders will pay for shares on conversion.

b. **Discount rate:** To compensate for investor's risk by investing in the company at such an early stage, parties may agree to a discount that is provided by the company to the investor upon conversion of the debt to preferred or common shares. Discount rates typically range between 10% – 30%.

c. **Example:** A convertible note holder has provisions in place that provides him with a discount rate of 20% or a valuation cap of USD50 million. The relevant company has 100m shares in issue.

Discount Rate: If the start-up is later valued at USD100 million, each share would be valued at USD1.00. If the convertible note holder was relying solely on the discount rate provision, their principal and interest would convert into shares at a 20% discount i.e. USD0.80 per share.

Valuation Cap: Alternatively, if there is a valuation cap, a convertible note holder can rely on this. In the above example, the valuation cap is set at USD50 million. This means that even though the company is valued at USD100 million, the value of the company is deemed to be USD50 million for the purposes of conversion. By dividing USD50 million by 100m shares in issue, we get an effective price of USD0.50 per share.

This means that convertible note holders will get twice as many shares when compared with a conversion price of USD1.00 per share on a company valuation of USD100 million.

4.12 **Investors Rights:** Parties may agree to provide investors with certain rights, such as the right to access information related to the company such as financial statements, pre-emptive (or pro rata) rights which would allow investors to subscribe for additional shares in the next equity financing or convertible note issuance, and attending general assembly meetings without the right to vote.

4.13 **Amendments:** Parties can agree the basis for amendments and waivers – such as with the consent of the start-up and the leading investor only, rather than agreement of all note holders.

4.14 **Terms of Termination:** Parties may specify the circumstances under which the start-up or the investor may terminate the agreement. Upon such termination the start-up shall return the debt amount and any agreed interest rate to the investor.

4.15 **Repayment Terms:** The parties may agree on repayment terms in the event that a Conversion Event does not occur. This may include, for example, cash repayment, or automatic conversion into equity.

4.16 **Option of Partial payment:** Start-ups may, prior to the end of the agreed maturity date, provide partial payment of the debt to the investor prior to the end of the agreed term, subject to providing the investor with a thirty (30) day written notice.

4.17 **Whether the debt is guaranteed:** The parties may agree to any type of guarantees, such as a bank guarantee, collateral or surety. This is unusual and debts are usually unsecured.

4.18 **Regulating utilisation of debt:** Terms governing how the debt may be spent by the company.

5. Process of issuing convertible notes

5.1 There are a number of stages to issuing convertible notes, including:

a. Obtaining interest from investors;

b. Conducting due diligence on investors;

c. Agreeing and finalising the key terms of the notes;

d. Approval from the extraordinary general assembly and pre-notification to the Companies Control Department in the Ministry of Industry and Commerce (the "**Department**");

e. Issuing the notes to investors and collecting sums due.

5.2 We discuss each stage in more detail below.

Obtaining interest from investors

5.3 Prior to proceeding with the formal convertible notes process, start-ups will usually have to reach out to potential investors to persuade them to provide debt to the company.

5.4 Start-ups usually prepare a pitch / slide deck which may include:

a. An overview of the start-up, including the relevant business activities, personnel and distinguishing factors/unique selling point;

b. Financial forecasts covering the period before and after receiving investment. This will enable investors to have visibility of how the start-up intends to use the investment, and how this impacts its vision for growth;

c. An identified relevant market that the start-up's products or services would be entering, the rationale behind it, the opportunities that the start-up may be able to take advantage of, and the impact on the market that the start-up forecasts its products/services will have;

d. Proposed terms with regards to the convertible note, and its utilisation (see section 4 above).

Due diligence on investors

5.5 Prior to allowing investors to invest in the start-up, the start-up will be required to conduct appropriate due diligence on that investor to satisfy any anti-money laundering requirements.

5.6 This will include identifying and verifying the beneficial owners of the investor, in addition to the source of funds.

5.7 This exercise may be more or less onerous depending upon whether the investor is an individual or a company and, if a company, how complex the group structure is.

5.8 Whilst it is impossible to be exhaustive when discussing due diligence requirements in general terms, information we would expect start-ups to obtain on investors include:

If individuals:

a. Full legal name and any other names used;

b. Full permanent address (i.e. the residential address; a post office box is insufficient);

c. Passport (with clear photograph);

d. Copy of a recent utility bill, bank statement or similar statement;

e. Current national identification or residency permit number (for residents of Bahrain or GCC states) or government issued national identification proof;

f. Telephone/fax number and email address (where applicable);

g. Occupation or public position held (where applicable);

h. Employer's name and address (if self-employed, the nature of the self-employment);

i. Signature specimen; and

j. Source of funds (typically obtained in the form of a signed declaration with respect to funds above BHD6,000).

If companies:

a. Commercial registration documents of investors (i.e. certificate of incorporation and/or certificate of commercial registration or trust deed);

b. Company bylaws (i.e. Articles of association and Memorandum of Association);

c. Corporate documents which evidence how the group is structured (such as shareholder registers, group structure charts, partnership agreements, etc);

d. Identification documents for directors, authorised signatories and beneficial owners of corporate investors;

e. Copy of the latest financial report and accounts, audited where possible;

f. List of persons authorised to do business on behalf of the company;

g. Company accounts for corporate investors; and

h. Bank statements for all investors to evidence cleared funds to make the investment.

5.9 The due diligence process would usually be undertaken alongside any negotiation of the terms of the convertible notes.

Negotiation of terms

5.10 Please see section 4 above. Before issuing the notes, a start-up will have to have agreed the terms with investors.

Approval of the extraordinary general assembly and notification to the Department

5.11 Please see section 6 below. A start-up will need approval of the extraordinary general assembly before it can issue convertible notes, and must make a pre-notification containing the required information to the Department.

Issuing the notes

5.12 Once terms have been agreed, start-ups will have to arrange signing and completion of the transaction.

5.13 On this day, the documents will be signed and funds will be released into the start-ups bank account.

5.14 From a practical perspective, the start-up should identify the account into which it is to receive funds.

5.15 Further, start-ups should notify the financial institution with which the account is held to avoid any complications from large amounts of unexplained money being deposited into the account.

6. Legal and regulatory requirements

6.1 Start-ups must ensure compliance with relevant laws and regulations, which vary from one jurisdiction to another. The following legal provisions govern the process for issuance of convertible notes in the Kingdom of Bahrain:

a. Article 239bis of the Commercial Companies Law promulgated by Decree No. 21 of 2001, as amended, in the Kingdom of Bahrain (the "**Law**"); and

b. Decision No. 118 of 2021 with respect to the conditions and regulations of issuing convertible notes by closed joint stock companies (the "**Decision**").

6.2 Together, the Law and the Decision set out the requirements in relation to convertible notes. We discuss these in further detail below.

Article 239bis of Decree No. 1 of 2001

6.3 Article 239bis of the Law allows closed joint stock companies to borrow money from investors in order to increase share capital by way of issuing convertible notes that convert to company shares, subject to the:

a. Approval of the extraordinary general assembly;

b. Provisions of the Company's memorandum of association; and

c. Compliance with the Central Bank of Bahrain and Financial Institutions Law promulgated by Law 64. of 2006, and its implementing regulations, in respect of companies licensed by the Central Bank of Bahrain (not relevant for the purposes of this publication, unless the start-up is so regulated).

Decision No. 118 of 2021

6.4 The Decision sets out more detailed requirements in relation to the issuance of convertible notes. In particular, the Decision stipulates that:

a. It applies to convertible notes issued by joint stock companies that are not licenced by the CBB;

b. The company shall write to the Department (the Companies Control Department in the Ministry of Industry and Commerce) notifying them of the intention to borrow through issuing convertible notes. The notice shall:

- Include the total value of the loan amount;
- Set out the main particulars of the convertible notes to be issued; and
- Be accompanied by an accounting report on the company's financial position, its activities, and the feasibility of borrowing by issuing convertible notes;

c. The convertible notes shall include a statement expressly stating whether interest is payable on the note and, if so, the interest rate;

d. The convertible notes shall be converted into shares within a period not exceeding 5 years from the date of issuance. Failing this, the company shall pay the value of the loan and accrued interest (if any) within thirty (30) days of a request from the holder;

e. The company shall keep a record called the "*Convertible Notes Register*" in which particulars of the convertible notes, ownership details, and any changes thereto, shall be entered. All shareholders of the company shall have access to the Convertible Notes Register;

f. If the company is liquidated or bankrupt before the notes are converted into shares, the rights of the convertible note holder to recover debt and interest takes priority over the rights of equity holders in the company.

6.5 Article 7 of the Decision also sets out matters that the company and the holder may agree, including:

a. The purposes for which the loan can be used and/or restrictions thereto;

b. Termination rights;

c. Rights of investors to attend the company's ordinary and extraordinary general meetings and obtain particulars and information related to the company;

d. Valuation caps and discount rates;

e. Repayment rights;

f. Whether borrowing is accompanied by a guarantee and/or warranty; and

g. Pre-emption rights in any subsequent issue of convertible notes.

6.6 These are discussed in detail in section 4 above.

7. Alternatives to convertible notes

7.1 Over the past decade, alternative solutions such as the "*simple agreement for future equity*" ("**SAFE**"), and the "*keep it simple security*" ("**KISS**") were developed to replace convertible notes as the financing instrument of choice when funding start-ups.

7.2 A KISS can be an equity KISS (whereby there is no maturity and no interest accrues) or a debt KISS (whereby there is a maturity, and interest does accrue).

7.3 The key purpose was to have clear templates and avoid extensive agreement negotiations with investors, thereby allowing start-ups to obtain financing in a shorter period of time at lower costs.

7.4 SAFE and KISS are similar, however:

a. SAFE will automatically convert into equity when the start-up raises money from investors in an equity funding round (i.e. issuance of shares to new investors); and

b. KISS will only convert when the company raises a set amount, most commonly at least USD1 million in an equity funding round.

Similarities with Convertible Notes

7.5 SAFE and KISS (both debt and equity) share certain features with convertible notes, such as:

a. Converting into equity if certain agreed conditions, such as conversion events, occur;

b. Set conversion mechanics; and

c. Investors having priority over equity holders in the event of insolvency.

7.6 A debt KISS also accrues interest (usually at 5%) and has a set maturity (usually 18 months).

SAFE and KISS vs Convertible Notes: Differences

7.7 Unlike convertible notes, SAFE and an equity KISS do not have a maturity date and do not accrue interest.

7.8 In essence, a SAFE and equity KISS are like convertibles notes that have had their debt-like features stripped away.

7.9 SAFE and equity KISS can be best conceptualized as contracts by which an investor commits capital to the business today in exchange for the right to receive stock in the company if certain contractual conditions are met in the future.

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