

Debt & Debt-Linked Instruments

Debt and Debt-Linked Instruments in Startup Finance Legal Characterisation, Structural Mechanics, Regulatory Treatment and Strategic Implications in the Indian Context

Capital structuring decisions determine risk allocation, control distribution, repayment obligations and exit economics. Early-stage and growth-stage startups in India increasingly utilise hybrid instruments that combine elements of debt and equity. A clear understanding of these instruments is essential for founders, incubation managers and policymakers.

The discussion below examines plain debt, convertible debt, compulsorily convertible debentures, optionally convertible debentures, compulsorily convertible preference shares, non-convertible debentures and related instruments within the framework of Indian corporate, tax and foreign exchange regulation.

1. Plain Debt

Legal Nature

Debt is a contractual borrowing arrangement under which the company undertakes a legally enforceable obligation to repay principal together with interest within a defined period.

Debt arrangements are governed by:

- The Indian Contract Act, 1872
- The Companies Act, 2013
- Reserve Bank of India regulations in case of regulated lenders

Debt does not confer ownership. The lender is a creditor and not a shareholder.

Structural Features

A typical debt instrument contains:

- Principal amount
- Interest rate, fixed or floating
- Repayment schedule
- Security or charge, if any
- Event of default clauses

Practical Illustration

Assume a startup borrows ₹2 crore from a bank at 12 percent annual interest for three years.

Annual interest obligation equals ₹24 lakh.

Even if the company incurs losses, the repayment obligation remains enforceable.

Failure to repay may trigger:

- Legal recovery proceedings
- Invocation of personal guarantees
- Insolvency proceedings under the Insolvency and Bankruptcy Code

Strategic Implications

Debt does not dilute ownership. However, it creates fixed financial commitments.

For pre-revenue startups, debt introduces cash flow strain and may accelerate financial distress.

For revenue-generating startups with predictable cash inflows, debt may be a prudent instrument for working capital expansion.

2. Convertible Debt

Convertible debt begins as a loan but contains a contractual provision that permits or mandates conversion into equity under specified circumstances.

The instrument postpones valuation negotiation while providing interim capital.

In India, convertible debt commonly takes the form of Convertible Notes or Convertible Debentures.

3. Convertible Notes in the Indian Startup Ecosystem

Regulatory Framework

Convertible Notes are permitted for DPIIT-recognised startups under notifications issued pursuant to the Companies Act and FEMA regulations.

Key regulatory characteristics include:

- Minimum investment of ₹25 lakh in a single tranche
- Maturity period up to five years
- Conversion into equity upon occurrence of specified events

Structural Mechanics

An investor advances capital as debt.

Upon a subsequent priced equity round, the note converts into equity, typically at:

- A discount to the next round valuation, or
- A pre-agreed valuation cap

Illustration

A startup raises ₹50 lakh through a Convertible Note with a 20 percent discount clause.

One year later, the company raises a Series A round at ₹100 per share.

The Convertible Note investor converts at ₹80 per share.

If ₹50 lakh is converted at ₹80 per share, the investor receives 62,500 shares.

The discount effectively compensates the investor for early-stage risk.

Founder Risk Consideration

If the next round valuation is lower than anticipated, the conversion may cause greater dilution than founders originally estimated.

Furthermore, if no qualifying round occurs within maturity, the investor may demand repayment.

4. Compulsorily Convertible Debentures

Legal Nature

Debentures represent debt instruments under Section 71 of the Companies Act, 2013.

Compulsorily Convertible Debentures are structured so that conversion into equity is mandatory after a defined period or upon specified events.

For foreign investment purposes, compulsorily convertible instruments are treated as equity under FEMA regulations administered by the Reserve Bank of India.

Structural Characteristics

CCDs typically specify:

- Face value
- Coupon rate or zero-coupon structure

- Conversion ratio or formula
- Conversion timeline

Illustration

A startup issues CCDs worth ₹5 crore with a fixed conversion price of ₹200 per share after three years.

Upon conversion, the debenture holder receives 2,50,000 shares.

If the company's valuation increases substantially by the time of conversion, the fixed conversion price may result in significant investor upside and correspondingly greater founder dilution.

Strategic Analysis

CCDs provide investors with interim debt status while ensuring eventual equity participation.

They are frequently used when valuation discussions are structured but investors seek interim contractual protections.

5. Optionally Convertible Debentures

Legal Nature

Optionally Convertible Debentures grant the investor discretion to either:

- Convert into equity, or
- Demand repayment of principal with interest

Under FEMA, optionally convertible instruments are treated as debt rather than equity.

This classification has significant regulatory implications in cross-border investments.

Illustration

A startup issues ₹3 crore in OCDs carrying 10 percent annual interest with an option to convert at ₹150 per share.

If business performance weakens and valuation declines, the investor may choose repayment rather than conversion.

The company must then repay ₹3 crore plus accrued interest.

Founder Risk

OCDs impose dual exposure:

- Dilution risk if converted
- Repayment risk if not converted

This creates financial uncertainty in downturn scenarios.

6. Compulsorily Convertible Preference Shares

Compulsorily Convertible Preference Shares are among the most widely used instruments in venture capital transactions in India.

Legal Framework

Preference shares are governed by Sections 43 and 55 of the Companies Act, 2013.

CCPS must mandatorily convert into equity within a specified period.

Under FEMA, CCPS are treated as equity instruments.

Structural Features

CCPS generally include:

- Liquidation preference rights
- Dividend preference
- Anti-dilution protection
- Conversion ratio formula
- Voting rights on reserved matters

Illustration

A venture capital fund invests ₹10 crore in CCPS with:

- One times non-participating liquidation preference
- Mandatory conversion after five years

If the company exits at ₹15 crore, the investor receives ₹10 crore first.

The remaining ₹5 crore is distributed proportionately.

If the company exits at ₹100 crore, the investor converts and participates proportionately.

Strategic Importance

CCPS balance investor protection with equity upside.

They allow structured control rights without immediate ordinary equity issuance.

7. Non-Convertible Debentures

Non-Convertible Debentures are pure debt instruments with no conversion feature.

They are typically used in venture debt arrangements or structured lending.

Interest obligations remain enforceable irrespective of company performance.

NCDs are uncommon in early-stage startups without revenue visibility.

8. Liquidation Hierarchy

In insolvency or liquidation, repayment priority typically follows:

1. Secured creditors
2. Unsecured creditors
3. Debenture holders
4. Preference shareholders
5. Equity shareholders

Debt-linked instruments therefore materially affect exit distribution economics.

A founder holding majority equity may still receive minimal proceeds if senior instruments absorb exit value.

9. Regulatory Compliance Considerations

Issuance of debt-linked instruments requires:

- Board and shareholder approvals
- Filing of return of allotment with Registrar of Companies
- Compliance with valuation norms
- FEMA reporting for foreign investors
- Creation of debenture trust deed where required

Improper structuring may result in regulatory penalties, tax exposure or FEMA violations.

10. Comparative Structural Matrix

Instrument	Repayment Obligation	Conversion	Regulatory Classification	Founder Risk Profile
Plain Debt	Mandatory	None	Debt	Cash flow strain
Convertible Note	Conditional	Yes	Hybrid	Future dilution uncertainty
CCD	No repayment	Mandatory	Equity under FEMA	Fixed conversion risk
OCD	Conditional	Optional	Debt under FEMA	Repayment and dilution dual risk
CCPS	No repayment	Mandatory	Equity	Liquidation preference impact
NCD	Mandatory	None	Debt	High repayment obligation

11. Institutional Perspective for Incubation Centres

Incubation ecosystems must ensure that founders:

- Understand liquidation waterfalls
- Model dilution under multiple scenarios
- Evaluate interest accrual impact
- Examine protective covenants
- Avoid adopting foreign templates without Indian regulatory alignment

Debt-linked instruments are structural tools of capital engineering.

They determine risk sequencing.

An informed founder evaluates not only capital received but rights granted and obligations assumed.