Legal Syndication Primer

Nigeria

Created by

TLP ADVISORY

African Angel Academy

IN PARTNERSHIP WITH

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African Angel Academy

Contents

Introduction
- About This Legal Primer and Its Creators

Part 1: Syndication Legal Structures
- The syndicate agreement
- Regulation of angel syndicates in nigeria
- Basic angel syndication structures in Nigeria

Part 2: Angel Transaction Legal Structures
- Equity financing
- Simple Agreement for Future Equity (SAFE)
- Convertible Notes
- Additional Resources

Introduction

About the African Angel Academy

The African Angel Academy (AAA) is an online programme and knowledge community, which was established in 2020 by Viridian and ViKtoria Ventures, supported by the African Business Angel Network (ABAN), to grow the number of active angel investors on the continent. Drawing on the expertise of early-stage investors from across Africa, the Academy offers virtual learning and networking courses for those looking to start or grow their angel investing portfolio. As of 2022, AAA's alumni network comprises close to 400 (and counting) individuals representing more than 18 angel investing groups in 11 countries.

The AAA course is available for anyone to purchase and start learning at their own pace or to learn as part of cohort programmes AAA runs with partners throughout the year. In the cohort format, the online course is offered to selected participants along with live masterclasses, Q&As, networking and mentorship opportunities, and showcases spotlighting promising local startups.

To find out more about AAA's programme and course offerings, visit africanangelacademy.com/programmes.

The African Angel Academy is endorsed by the African Business Angel Network (ABAN).

About Viridian

Viridian is an impact agency that designs and delivers programmes for early-stage entrepreneurs, investors and entrepreneur support organisations across Africa's entrepreneurial ecosystem. Our programmes act as a catalyst for these key economic actors, ultimately growing shared prosperity across Sub-Saharan Africa.

www.viridian.africa

About ViKtoria Ventures

ViKtoria Ventures is a consulting and fund management firm with a focus on entrepreneurial finance in East Africa.

www.viktoria.co.ke

About the International Tech Hub Network

These guides were developed with support from the UK–South Africa Tech Hub, UK–Kenya Tech Hub, and UK–Nigeria Tech Hub. These hubs are part of the International Tech Hub network delivered by DCMS (Department for Digital, Culture, Media, and Sport), under a UK government initiative designed to promote inclusive growth of digital ecosystems in partner countries. Over the past two years, the Tech Hubs have partnered with the African Angel Academy to train, network, and mentor emerging angel investors and groups, connecting them to promising local startups and supporting them through an alumni network.

About the authors

This document was authored by The Longe Practice Legal Practitioners doing business as TLP Advisory through the contributions of:

Funkola Odeleye – Partner, TLP Advisory
Olusola Olubi – Senior Associate, TLP Advisory
Ayodeji Olufolahan – Senior Associate, TLP Advisory

TLP Advisory was founded by Odunoluwa Longe and Funkola Odeleye in 2014 as the first practice in Nigeria solely focused on startup law. TLP Advisory has since evolved into a niche global venture law practice that provides advisory and consultation to venture founders and their funders across Sub-Saharan Africa, Europe, and North America.

In 2021, TLP Advisory merged with Ollis Law, led by Oby Ezenduka, thereby strengthening its intellectual property and media practices to help more creators and innovators derive more value from their work. At TLP Advisory, we help entrepreneurs to start, grow, and scale their ventures.

About the Nigeria Syndication Legal Primer

This short guide was developed as a resource for a new supplementary AAA module, the AAA Active Angel Series Syndication Module. This module builds on the AAA foundational online course and aims to equip programme alumni with the knowledge and confidence to participate in syndicated deals, and to promote collaboration within the angel investing ecosystem. The guide outlines common syndication and angel deal structures available to angels in Nigeria as of January 2023. For further detail on each structure and the suitability of using a specific structure for your deal or syndicate, please feel free to reach out to TLP Advisory on: info@tlpadvisory.com.

As a partner of the African Angel Angel Academy, TLP has also made preferential rates available for alumni of the AAA programme.

This guide comprises the following sections:

Part 1: Syndication structures

Part one of this guide provides an overview of the various syndication structures available to you in Nigeria. It explores the advantages and disadvantages of each structure, and any tax or legal implications or compliance requirements when using the structure in question.

According to research conducted by Briter and ABAN in 2021, there were more than 58 active angel syndicates on the African continent, and this number is expected to be higher in the new report which was released in November 2022 in partnership with the African Angel Academy.

AAA strongly encourages programme participants to either join or form a syndicate, depending on their experience level. Not only does syndication have significant benefits for the participating angels but it can have a significant impact on startup success. For angels, syndication is a great way to learn more about the investment process from more experienced leads, access greater deal flows, access larger deals (by pooling capital) and, of course, decrease their risk by building a diversified portfolio with access to a diversified pool of expertise.

For a syndicate to be successful in the long run, it is important to ensure it is set up and governed in the most efficient and transparent manner, and this section lays out the common considerations with regard to this.

Part 2: Angel transaction structures

The second section of the guide looks at the available structures for angel investment deals in Nigeria. It also outlines the advantages and disadvantages of each structure, and any tax or legal implications or compliance requirements.

The 2021 *Analysing Africa's Angel Investment Landscape* survey also discovered that 58% of investors were using multiple or mixed structures when making deals, although the use of SAFEs and convertible notes is growing in popularity.

The selection of transaction structure(s) will impact an investment's management and returns, and it is worth considering the implications.

Please note that the content of this guide cannot be considered to be legal advice, and neither AAA nor The Longe Practice Legal Practitioners trading as TLP Advisory are responsible for any consequences arising from the selection of any of the structures outlined in this guide.

These course notes serve as an introduction to the legal structures that angel investors in Nigeria can employ when making an investment and structuring a syndicate.

These notes have been developed by TLP Advisory for the African Angel Academy as part of the African Angel Academy's Syndication Module. The content developed for this module was funded by the UK Government's International Tech Hub Network via its UK–Nigeria Tech Hub.

Part 1

Syndication legal structures

An investment syndicate, sometimes called an angel syndicate, is an arrangement where angel investors pool funds together for the main purpose of investing in a company or several companies. The investors as a group are referred to as a syndicate and individually as syndicate members.

In an angel syndicate, the syndicate members will typically appoint one or two members as syndicate leads. The syndicate lead's role is to actively manage and administer the syndicate's activities, including scouting for investment opportunities, interfacing with investee companies, and representing the syndicate as board members or in shareholder meetings in investee companies.

The syndicate agreement

An angel syndicate is governed by a syndicate agreement, which is signed by all syndicate members. Its terms provide for the administration of the syndicate, appoint syndicate leads where applicable, provide criteria for the type of companies to be invested in, and may include a power of attorney appointing the syndicate leads as attorneys authorising them to carry out certain activities on behalf of the syndicate in investee companies. The power of attorney will empower the syndicate leads (on behalf of syndicate members), to vote at meetings, sign agreements, and receive dividends and distributions on behalf of the syndicate.

The syndicate agreement may also include a declaration of trust that designates certain syndicate members as trustees to hold legal title of investments and act in such capacity.

Regulation of angel syndicates in nigeria

There are no specific regulations that govern angel syndicates in Nigeria. Angel syndicates are governed by the general laws on investment, corporate affairs, and taxation, such as:

- **Investments and Securities Act (ISA)** – The Investments and Securities Act (ISA), 2007, is the principal law that regulates the Nigerian capital market and is administered by the Securities and Exchange Commission (SEC) as its apex regulatory body.
- **Consolidated Rules and Regulations of the Securities and Exchange Commission, 2013** – In addition to the ISA, these rules regulate and govern the activities of the various stakeholders in the Nigerian capital market.
- **The Companies and Allied Matters Act (CAMA)** – The Companies and Allied Matters Act (CAMA), 2020, is the principal law that regulates the establishment and management of companies in Nigeria. It is enacted to provide for the incorporation of companies, limited liability partnerships, and partnerships. Section 1 of the Act establishes the Corporate Affairs Commission (CAC), which is the apex regulatory body for companies in Nigeria. The CAC is charged with the regulation and supervision of the formation, incorporation, registration, management, and winding up of companies in Nigeria.
- **Companies Income Tax Act (CITA)** – The Companies Income Tax Act (CITA), Cap C21, LFN, 2004, is the principal law that governs the taxation of companies in Nigeria. Companies' income tax (CIT) is a tax imposed on a company's profit from all its sources, and is also imposed on foreign companies operating a business in Nigeria.
- **Personal Income Tax Act** – The Personal Income Tax Act, 2011 (as amended) governs tax charged on the income of individuals, families, bodies of individuals, and trustees. Section 1 of the Act provides that the tax is an obligation paid to the State Inland Revenue Service where the individual resides.

Basic angel syndication structures in Nigeria

An angel syndicate can either be formally set up and registered or not, i.e. they can be incorporated or unincorporated.

Incorporated syndicate structures

Where the syndicate chooses to be incorporated, a special purpose vehicle (SPV) will then be registered. The two common structures for incorporated syndicates in Nigeria are a private company limited by shares and a limited liability partnership.

Private company limited by shares

Issue	Notes
Overview of structure	With this structure, the company is registered with the Corporate Affairs Commission (CAC) and the syndicate members are the company's shareholders. The syndicate lead(s) can be appointed as company directors. Syndicate members contribute funds to the company by way of share capital.
Advantages	• As this structure is registered with the CAC, it can be used when the syndicate members intend to invest in the entities or funds which require a registered legal entity. • The liability of investors in a private company limited by shares is limited to their capital contribution, and they are not liable for the company's debts in the event of its winding up. • Foreign investors can be registered as members of the company.
Disadvantages	• One of the main disadvantages of a private limited company is that it restricts the transferability of shares by its articles, and the number of shareholders cannot exceed 50. • A private limited company is not tax efficient as the company's earnings are subject to taxation on two levels.
Liability of investors	In a private company limited by shares, the investors (shareholders) in these entities would have limited liability for the company's debts.
Legal considerations	This structure is required to comply with the Companies and Allied Matters Act, 2020, which regulates the entity and the relationship between its members. If the shareholders are non-Nigerian, the company will be required to have a minimum share capital threshold of N10,000,000 and register with the Nigerian Investment Promotion Council (NIPC) as all foreign-owned companies in Nigeria are required to comply with this statutory requirement. A private company limited by shares is also prohibited from making public investment offerings and, where it plays other roles (like financial advisory roles) aside from an investment holding role, it will be required to meet the share capital threshold set by CAC and also to register with Securities and Exchange Commission. Legal and financial due diligence should be conducted on investee companies prior to the syndicate making an investment.
Tax treatment	Where an angel syndicate's SPV is structured as a private company limited by shares, the company's earnings are subject to taxation on two levels. The company is initially subject to companies' income tax (CIT) because the distributions/dividends are deemed to be revenue earned by the company. Upon receiving any distributions, the syndicate members are also subject to personal income tax.
Ongoing compliance requirements	• Filing of annual returns at the CAC • Holding of annual general meetings • Filing of companies' income tax with the FIRS
Cost of setting up	• Company incorporation: $500–$800 • Investment document: $600–$1000

Limited liability partnership (LLP)

Issue	Notes
Overview of structure	This partnership structure is regarded as a separate legal entity from its partners, and each partner's liabilities are limited to the amount they put into the business. In Nigeria, an LLP is expected to have at least two "designated partners", who will be responsible for ensuring the LLP's compliance with the requirements of the Companies and Allied Matters Act. One of the designated partners must be resident in Nigeria. In using this structure for angel syndicates, the syndicate members contribute capital during the formation of the LLP and become partners in the LLP. The syndicate leads can be appointed as the LLP's designated partners.
Advantages	The liability of investors in a limited liability partnership is limited to their capital contribution. There is no limit set by the law for the number of partners in an LLP, which provides the option to pool more investors than a private company limited by shares. This entity is often considered a tax pass-through entity as there is only one level of taxation. Foreign investors can be registered as partners of an LLP.
Disadvantages	There are no disadvantages with using this structure for an angel syndicate investment.
Liability of investors	In a private company limited by shares, the investors (shareholders) in these entities would have limited liability for the company's debts.
Legal considerations	A partnership agreement needs to be drafted and executed by the investors. All investments by the incorporated syndicate will be made and held in the name of the LLP. Legal and financial due diligence should be conducted on investee companies prior to the syndicate making an investment. Any dividends or distributions earned from investment activities are distributed by the LLP to its members.
Tax treatment	LLPs are seen as attractive investment vehicles due to their tax transparency as taxation only levied at one level. The LLP is not subject to CIT, and only the distributions received by the syndicate members are subject to personal income tax.
Ongoing compliance requirements	An LLP will be subject to the typical obligations of registered legal entities as provided by CAMA, such as filing annual returns, holding annual general meetings, and maintenance of proper financial and accounting records.
Cost of setting up	• LLP incorporation: $300–$400 • Partnership agreement: $500–$1000

Unincorporated syndicate

Where an angel syndicate is unincorporated, it can be set up as a syndicate trust or a partnership.

Issue	Notes
Overview of structure	In a syndicate trust arrangement, the syndicate agreement will include a declaration of trust. A trust is a fiduciary relationship in which the owner(s) of assets (the "settlor") transfers the title of such assets to a named individual(s) or entity (the "trustee(s)"), to hold in trust for the benefit of others (the "beneficiaries"), which may sometimes be or include the settlors. The trustee is the legal owner of the property while the beneficiaries have beneficial interests. When a trust is embedded in a syndicate, the declaration of trust will establish all syndicate members as both settlors and beneficiaries, and the syndicate leads as trustees. The trustees will have legal title to investments held by the syndicate members in investee companies and the syndicate will be identified as "The Trustee(s) of XYZ Syndicate Trust" in transaction documents, with its authorised signatories being the trustees. By being appointed trustees, the syndicate leads give the trust a legal personality. They are effectively the syndicate trust's alter ego, and have the responsibility of entering into legal contracts on behalf of the syndicate.
Advantages	• Easy and cheap to set up. • The trustees' powers are limited to the syndicate agreement. • No registration obligation with any regulatory authority. • No ongoing compliance obligation. • Foreign investors can be members of a syndicate formed in Nigeria.
Disadvantages	Where certain investments require a registered legal entity to be provided, this structure cannot be used. To enable proper administration of the syndicate, the syndicate may agree to have a certain number of members. (A limitation on the number of members may apply in this instance.)
Legal considerations	A syndicate agreement needs to be drafted to regulate the syndicate members' activities and their investments in other companies. Legal and financial due diligence should be conducted on investee companies prior to the syndicate making an investment. The trustees may charge a carry interest for the management of the syndicate trust. The investment agreements for each investment being done by the partnership should be reviewed by a lawyer prior to execution by the trustees on behalf of the syndicate members. All agreements should be duly executed, and proper records of the agreements and each syndicate member's investment should be kept.
Tax treatment	Taxes payable on earnings are limited to personal income tax for individual partners and companies' income tax for corporate partners.
Ongoing compliance requirements	This structure is not subject to corporate administrative regulations and requirements.
Cost of setting up	• Drafting of syndicate agreement: $500–$1,000 • Each member may be required to pay administrative fees or membership fees to enable the syndicate to pay for legal costs and other transaction expenses.

Partnership

Issue	Notes
Overview of structure	A partnership is an unlimited collaboration of partners governed by a partnership agreement. The partnership agreement will govern the syndication members' administration and participation obligations. Designated member(s) of the syndicate may be given a power of attorney to act and hold investments on behalf of other members. Where there are no such designated members, each partner will hold an interest in their respective personal capacity.
Advantages	• Easy and cheap to set up • No registration obligation with any regulatory authority • No ongoing compliance obligation • Foreign investors can be partners of a partnership formed in Nigeria.
Disadvantages	Each partner is liable for the other partners' actions in connection with the partnership. Where certain investments require a registered legal entity to be provided, this structure cannot be used.
Legal considerations	A partnership agreement needs to be drafted to regulate the partners' activities and their investments in other companies. Legal and financial due diligence should be conducted on investee companies prior to the partnership making an investment. The investment agreements for each investment made by the partnership should be reviewed by a lawyer prior to its execution by the partnership's designated members or each partner. All agreements should be duly executed, and proper records of the agreements and each partner's investment should be kept.
Tax treatment	Taxes payable on earnings are limited to personal income tax for individual partners and companies' income tax for corporate partners.
Ongoing compliance requirements	This structure is not subject to corporate administrative regulations and requirements.
Cost of setting up	• Drafting of partnership agreement: $500–$1,000 • Each partner may be required to pay administrative fees or membership fees to enable the partnership to pay for legal costs and other transaction expenses.

Summary of the angel syndication structures in Nigeria

	Private company limited by shares	Limited liability partnership	Syndicate trust	Partnership
Nature of participants' role	Shareholders (and often also directors)	Members	Beneficiaries	Co-ownership
Nature of participants' economic interest	Shares	Membership interests in the LLP	Beneficiaries	Co-ownership
Legal title to assets/ investments is held by	The company	The LLP	The trustee(s)	Joint owners
Direct tax payable at the level of the syndicate structure	Yes (corporation tax)	No (but there is a filing obligation)	Depends on form of trust arrangement	No
Accounts required to be filed at Corporate Affairs Commission	Yes	Yes	No	No
Participants' interest, a matter of public record?	Yes Members' information is required to be filed at the company's registry, although members could participate through nominees for privacy.	Yes Members' information is required to be filed at the company's registry, although members could participate through nominees for privacy.	No	Yes Partners' names all appear as the owners of the relevant assets.
Participants required to file tax returns in Nigeria	Yes	Yes	Yes	Yes
Flexibility for new members to join	Requires statutory filings for new members to join.	Requires statutory filings for new members to join.	Does not require statutory filings for new members to join.	Does not require statutory filings for new members to join.

Part 2

Angel Transaction Legal Structures

THE PRIMARY PURPOSE for which angel investors and syndicates invest in early-stage companies is to own a part of a company. Therefore, their investment deals are usually structured as equity financing or hybrid financing such as a convertible note or a simple agreement for future equity (SAFE).

This section provides an overview of the various deal structures that angel investors and syndicates can use to invest in startups and other companies.

Equity financing

Equity financing refers to the process of a company raising capital through the sale of its shares. The ownership of a company is measured by how many shares it has and how those shares are distributed.

By issuing shares in a company to an investor, the investee gives the investor a stake in the ownership of the company. The people who receive shares in a company are referred to as shareholders, and a company may issue ordinary shares or preference shares to an investor.

These are some advantages of equity financing:

- As investors are typically focused on the long term without expecting an immediate return on their investments, the investee company is usually not under any pressure to repay the investment amount, unlike with debt financing.
- Equity financing provides working capital that can be used to grow a business since large sums of capital can be injected by investors as opposed to debt financing from banks.
- This financing option provides a company with access to business contacts and management expertise as some investors who invest during an equity financing round may wish to contribute to a company's growth and be involved in the company's operations as directors and advisors.
- As shareholders, investors receive part of a company's profits when dividends are distributed by the company.

A disadvantage of equity financing is that existing shareholders' shares are subject to dilution each time the company raises new rounds of equity financing.

Legal documents used for equity financing

The following investment documents are used for raising equity financing from angel investors.

Term sheet

A term sheet is an agreement that outlines the material terms and conditions of a potential financial investment to be made by an investor.

The term sheet serves as a negotiation document and is usually subsequently developed into more detailed legal documents. Term sheets are generally non-binding, but parties can agree for a term sheet to be binding.

Term sheets usually detail the following:

- The economics of the financing: how much is being raised, the valuation of the company, the number of shares to be issued for the funds raised, and the type of shares to be issued
- Corporate governance: control, board seats if applicable, frequency of board meetings, voting rights of an investor, and whether any decisions require investor approval
- Liquidation: what happens in a liquidity event, such as if the company is acquired, merges with another, or is wound up – i.e., how the assets of the company are distributed in a liquidity event
- Investor rights: information rights, pro rata rights, anti-dilution rights, etc.
- Exit options available to the investor

Shareholders' agreement

- This is a legal agreement between the company and its shareholders, describing the shareholders' rights and obligations.
- A shareholders' agreement usually details the following (amongst others):
- A company's share capital
- Transfer of shares: how a shareholder may transfer shares and restrictions on who they can transfer them to
- Issuance of new shares: when and how the company can issue shares to additional investors
- Board matters: appointment of directors, removal of directors, quorum of directors for a board meeting, and frequency of board meetings
- Shareholder matters: frequency of general meetings and matters requiring the shareholders' approval
- Founder restrictions: clauses that prevent or restrict founders from competing with the company or poaching the company's employees or customers if they leave the company
- Intellectual property: clauses that confirm that the company owns its intellectual property
- Voting: voting procedure and methods and matters shareholders can vote on
- Dividend: the company's dividend policy
- Investor rights: additional rights that may be given to an investor such as pro rata rights (the investor's right to participate in future rounds and retain its equity stake), tag-along rights (the investor's right to also sell its shares to a third party buying shares from other shareholders, usually the founders), drag-along rights (the right to ensure that other shareholders sell some or all of their equity along with the investor in certain circumstances), conversion rights (if an investor is issued preferred shares, the right to convert these to ordinary shares).

Share subscription agreement (SSA) or share purchase agreement (SPA)

A share subscription agreement is an agreement between an investor and a company which outlines the terms on which an investor agrees to buy shares from a private company.

When an investor is purchasing a company's shares from an existing shareholder, a share purchase agreement is usually used.

Share certificate

This is a written document issued by a company, which serves as proof of the investor's ownership of the number of shares indicated.

Capitalisation (cap) table

This is a spreadsheet or table that shows capitalisation or ownership stakes in a company. It lists the company's shareholders and the number and type of shares held by each of the shareholders. The table uses these details to show ownership stakes on a fully diluted basis, thereby enabling the company's overall capital structure to be ascertained at a glance. It is a useful tool before and after an equity investment.

In addition to having the necessary documents in place for the equity financing transaction, a Nigerian company has an additional obligation to file the issuance of shares to investors at the CAC so the company's records reflect its new shareholders and shareholding structure.

Simple Agreement for Future Equity (SAFE)

A SAFE is an agreement between an investor and a company that provides rights to the investor to own equity in the company in the future.

The SAFE was created by the Silicon Valley startup accelerator Y-Combinator in 2013 for the purpose of having a standard set of terms and conditions that investors and startups can agree upon without prolonged negotiations. This allows investors to engage a company at an early stage of development, and for the company to receive funding from investors quickly.

Although the SAFE is similar to a convertible note, it is not debt but rather equity that will be issued at a future date – upon the occurrence of certain future events.

The future event could be one or a combination of:

- a future equity financing round;
- the sale of the company; or
- an IPO or a dissolution of the company.

In the SAFE, the investor and the company decide on key terms like investment amount and valuation cap. Upon mutually signing the SAFE, the investor can fund the company with the investment amount.

A SAFE usually has an unconverted status until the occurrence of one of the specific events described within. In the meantime, an unconverted SAFE will be referenced on the company's capitalisation table like any other convertible security.

Upon conversion to equity, the SAFE terminates as its aim is to turn SAFE holders into shareholders. The standard SAFE does not bear an interest rate as it is not a loan. It does not have a maturity date like a convertible note, which means the investors must wait for the occurrence of any of the future events before they can have access to any equity.

There are three versions of SAFEs, and any of them can be used by angel investors or syndicates.

- **SAFE – Valuation Cap, no Discount:** During a future financing round, SAFE holders will convert at a valuation no higher than the valuation cap, but there will be no discount applied on the price of shares as shares will be bought at the same price future investors are buying at.
- **SAFE – Discount, no Valuation Cap:** During a future financing, SAFE holders will convert at whatever valuation is agreed upon by future investors, but a discount will be applied to the share price, which means the SAFE holders will buy shares at a lower price than future investors.
- **SAFE – MFN, no Valuation Cap, no Discount:** No valuation cap or discount will be applied on the share price, but the SAFE will have a Most Favoured Nation clause. This clause means that, if the startup issues equity during a future financing round with more favourable terms than those agreed to with the SAFE holder, the SAFE holder can convert at these more favourable terms.

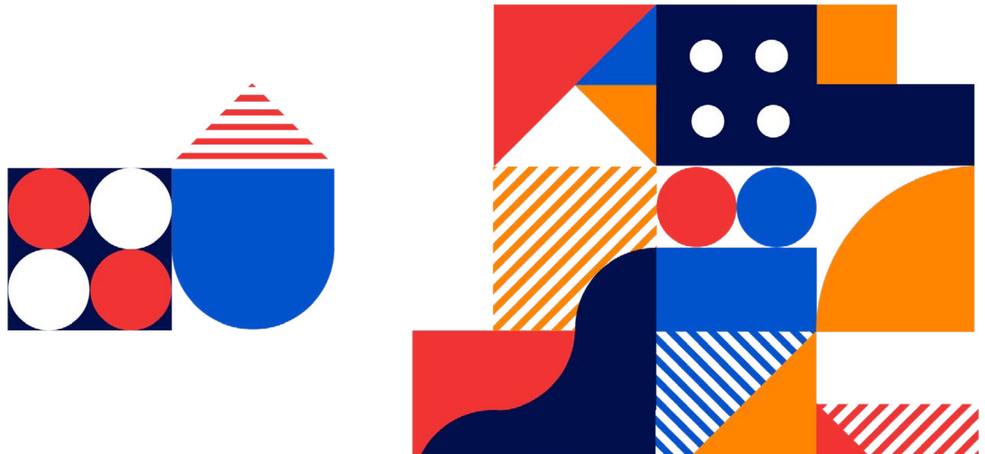
Before using any of the SAFEs provided by Y Combinator, a lawyer licensed in the country where the investee company was formed should be consulted so that the SAFEs are modified in accordance with the laws of that particular country.

Advantages of the SAFE

- It provides efficiency and expediency as only one document generally constitutes the substantive agreement.
- With fewer variables to understand and negotiate, investment terms can potentially be agreed upon faster.
- The SAFE does not require interest to be paid on the principal invested amount.
- In the event that the investee company is acquired or merges with another company, the SAFE holder is protected as the SAFE can be converted to shares or the investment can be returned to the SAFE holder.

Disadvantages of using a SAFE

- As a SAFE does not have a maturity date, there is a possibility that it never converts to equity if any of the future events do not occur.
- In the event of a company's insolvency, a SAFE holder may have no legal claim to the startup's assets because a SAFE holder is neither a creditor nor an equity holder.
- A SAFE may be transferred to affiliates of the investor only; i.e. it cannot be sold to third parties that are not owned by or do not share the same ownership as the investor.



Convertible Notes

A convertible note, sometimes called convertible promissory note, is a hybrid form of investment combining some of the features of an equity investment with that of a debt investment.It is a short-term debt instrument that converts to equity upon the occurrence of predetermined conversion events, such as a company's next equity financing, maturity date, or initial public offering.

A convertible note allows a startup to raise investment without the startup having to determine its valuation. It is called a note because the company issues a promissory note (which the investor buys) stating that it will repay the investor at a future date. Upon the occurrence of a conversion event or at the loan's maturity, the investor can be repaid with a pre-agreed amount of shares instead of cash.

Features of a convertible note

- **Principal** – This is the actual amount invested by an investor, usually referred to as a noteholder.
- **Interest** – Convertible notes typically carry an interest rate, the standard rate of which differs from jurisdiction to jurisdiction, but is typically less than the inter-bank lending rate. Some investors opt for no interest.
- **Term** – The term of a convertible note is the duration for which the debt exists before it must be repaid (in cash or by converting to equity). As it is short-term, a convertible note's usual term ranges from 12 to 36 months.
- **Maturity** – Maturity is the date when the term expires, at which time repayment is due either in cash or by the noteholder converting the note to equity.
- Security – Convertible notes are generally unsecured financing, meaning the loan is neither backed up by any assets nor collateralised (i.e. no assets will be confiscated if the loan is not paid). Noteholders rank equally with any other unsecured debtors.

The basis of convertible note issuance is usually for the conversion of the amount invested by an investor into equity. Depending on an investor's requirements, a convertible note financing can be structured in one the following ways:

- **Only interest rate** – If only an interest rate is applied to the investment amount, a convertible note functions as a regular business loan and, upon the occurrence of a conversion event, the loan is either repaid in cash or is converted to equity at the company's valuation at the time of conversion.
- **Only discount rate** – In this case, investors are offered a discount on the share price at the company's next equity financing.
- **Interest and valuation cap** – With this structure, a note is converted at a valuation cap instead of the actual value. In addition to this, interest will accrue on the principal amount based on the interest rate.
- **Discount and valuation cap** – Applying a valuation cap in addition to a discount rate results in an increased discount per share for the investor.
- **Interest, discount, and valuation cap** – This is the most expensive option for company founders. This structure will involve applying an interest rate, discount rate, and valuation cap when determining the equity to be issued to an investor.

Advantages of convertible notes

- As shares are to be issued upon the occurrence of a conversion event, the valuation conversation/ process is delayed until a company can accurately determine its actual valuation.
- A convertible note transaction is simple and quick to set up.
- As a convertible note is usually referred to as an unpriced round, the founders of a company are not likely to cede control of the company (usually board seats) to investors during this investment round.

Disadvantages of convertible notes

- Investors face a risk of the failure of the repayment of their investment amount if the company is unable to raise subsequent equity financing to repay the loans, or where the company goes bankrupt.
- The unsecured nature of convertible notes may make it difficult for investors to recover their investment amount by the sale of the company's assets, in the event of the company being unable to repay the loan.

Legal documents used for a convertible note financing

The documents usually used during a convertible note financing are a term sheet, a note purchase agreement, and a convertible promissory note.

Term sheet

The term sheet is a non-binding document that outlines the terms of the loan to allow both the investor and founders to negotiate and agree on terms and conditions. It will state terms such as the principal amount to be invested, the term and maturity of the loan, interest rates, coupon discounts and valuation caps if any, and conversion trigger events and mechanisms. After the term sheet is agreed on and signed, substantive binding agreements are then exchanged and signed.

Note purchase agreement

The substantive agreement for a convertible note financing is the note purchase agreement, which usually has a convertible promissory note as an appendix.

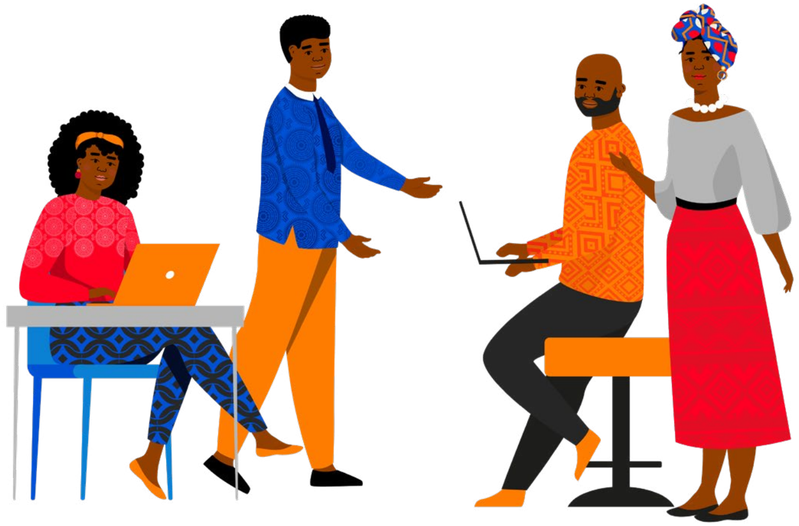
A note purchase agreement is a simple contract that documents the purchase and sale of the convertible promissory notes by a company to an investor. It typically includes an expanded version of the terms in the term sheet and contains additional clauses like representation and warranties by parties, conditions precedent, and conditions subsequent, if any.

Convertible promissory note

A convertible promissory note is a debt instrument issued by a company to signify a promise to repay the debt or convert the debt to equity. It is usually numbered for easy identification and states the basic terms like the principal amount, prepayment terms, maturity, and security.

Additional Resources

- ABAN African Investment Survey 2022
- Understanding SAFEs and Priced Equity Rounds: Fundraising + Investors, Legal, Safes | Y Combinator
- How to Invest in Startups with Angel Syndicates
- Syndication: Overview, Examples Reasons for Syndication
- Angel Networks in Emerging Markets
- How Venture Capitalists and Angel Investors Can Benefit from Investing in African Startups
- From Supa Strikas to Startups, Tomi Davies' Approach to Angel Investing



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