

Ribbis and Convertible Notes

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Question: In the previous sessions, we have discussed investment issues in halacha and in particular with regard to the prohibition of *ribbis* (forbidden interest). Another common question that arises relates to what is known as a convertible note. What exactly is a convertible note, and what *ribbis* concerns must be taken into account when dealing with this type of investment?

Answer: A convertible note is essentially a debt given to a company (often a start-up) to which one gives money. It is often uncertain (especially with tech companies) what the value of a share in the company is at that point, as that is often determined in the future. Therefore, in a convertible note, the investment is made as a note (or debt), often with a little bit of interest added as well per annum (i.e., per year).

When the valuation of the shares in the company becomes better known, either as determined on a certain preset trigger date, or depending upon whether another round of investors join, the owner of the company agrees to let the investor join as a partner in the company at a **discount**. At that time, the investor has the option of deciding whether to allow the money to remain as a loan or to convert it into equity as an investment.

We should also mention that other agreements (not the subject of this session) also exist where the money given to a company does not take the form of a note or a debt, but is rather called a S.A.F.E agreement, meaning that the investor is promised the ability to purchase future equity in the company (these may have *ribbis derabanan* concerns).

The halachic question with convertible notes is: would a convertible note that has a condition that one receives a discount later in entering the company, constitute any form of *ribbis*? (Even if one waives any right to receive interest from the deal?)

In answering this question, it is important to understand (as has been mentioned in earlier sessions on *ribbis*) that any benefit whatsoever received from a loan is automatically considered *ribbis* halachically. Our case as well, where there is a discount received because of having given a loan is forbidden by the Gemara. The Gemara states that one who lends another money may not ask the borrower to later sell him a house at a cheaper price since this is considered a side benefit for giving the loan. This is known as *tzad echad b'ribbis*, where there are two possibilities of what will occur, one of which poses a problem of *ribbis* (in this case, if the borrower ultimately sells the lender the house at a discounted price) and one that does not (if the borrower does not).

Although it is clear that a case of *tzad echad b'ribbis* is *assur*, it is also important to determine whether the prohibition is *de'oraisa* or *derabanan*. This question is subject to a *machlokes Acharonim*, but it seems that the halacha according to many opinions is that if the interest is given only on the side of the sale, then it would constitute *ribbis derabanan*, while if the interest is given on the side of the loan, then it would constitute *ribbis*

de'oraisa.

Our case of a convertible note many times is such a case of *tzad echad b'ribbis* since the investor may choose on the trigger date whether to convert the loan into equity (which is similar to making it a sale, without any *ribbis de'oraisa* problem) or maintain it as a loan (which would render any profit *ribbis de'oraisa*).

Another relevant factor is that perhaps this case should be viewed as *ribbis derabanan* because the investor can only ask for the money in the note back from one specific company.

Based on the considerations mentioned, it is logical to classify a convertible note practically as constituting *ribbis derabanan* if one chooses to convert it to equity on the trigger date. It is potentially possible to arrange a *heter iska* for this situation in accordance with the conditions discussed in previous sessions.

In one case that was received at the Bais Havaad, the transaction had already taken place, but in that case, the company was owned by non-religious Jews. As we mentioned in one of the earlier sessions, in a case of *ribbis derabanan*, there is room to be lenient to rely on the opinions that hold that it is permitted to lend with interest to non-religious Jews since it is possible they are considered *mumarim* (as opposed to a *tinok shenishba*, one who transgresses simply because he does not know any better), those who intentionally transgress the Torah on a regular basis, to which the prohibition of lending with *ribbis* do not apply according to some.