

The Convertible Note Mechanism and the Risk of Share Dilution: Legal Protection for Minority Shareholders

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Abstract: *The convertible note instrument is increasingly being used by startup companies to raise early-stage funding due to its flexibility and efficiency, particularly in deferring company valuation until a subsequent funding round. However, despite its convenience, this scheme entails legal risks, especially for minority shareholders. The debt-to-equity conversion process may lead to shareholding dilution and weaken the bargaining position of minority shareholders within the company's decision-making structure. This journal examines how the conversion mechanism in a convertible note can lead to share dilution risks and explores the available legal protections for minority shareholders against such risks. This research adopts a normative juridical method with a statutory and literature-based approach, analyzing both legal texts and contractual practices. The findings indicate that although Law No. 40 of 2007 concerning Limited Liability Companies recognizes the right of first refusal (pre-emptive right), Article 43 paragraph (3) exempts this right in the context of the conversion of convertible securities into shares. As a result, minority shareholders often lack adequate protection and are vulnerable to ownership dilution. The study concludes that there is an urgent need to reconstruct corporate legal norms in response to the growing practice of debt-based convertible financing. The author recommends that policymakers consider limiting the exceptions to the pre-emptive right and encourage contractual compensation schemes for minority shareholders as a more equitable form of protection within modern corporate structures.*

Keywords: *Anti-Dilution; Convertible Note; Share Dilution; Minority Shareholders; Legal Protection*

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INTRODUCTION

In the early stages of startup development, external funding is a crucial

aspect to ensure business continuity and growth. Startups are generally characterized by low production costs, high risk levels, and

the attractive potential of their business opportunities.¹ Therefore, early-stage financing plays a crucial role in ensuring the continuity and growth of a business during its initial operational phase.²

One of the financing instruments that is increasingly popular within the startup ecosystem, both globally and in Indonesia, is the Convertible Note. This instrument takes the form of debt that can be converted into shares at a certain point in the future, typically when the company secures subsequent funding (next equity financing).³ This mechanism offers advantages in terms of flexibility for investors as well as efficiency in the fundraising process, as it does not require a company valuation at the initial stage of the transaction.⁴

For startups, the use of Convertible Notes provides several advantages; First, its strategic use allows the deferral of company valuation to a more appropriate time, namely when business performance and prospects become clearer. This enables a more accurate and favorable valuation for the founders.⁵ Second, the conversion of debt into new shares under a Convertible Note is generally executed in the future, typically upon subsequent funding rounds, so that during the period before conversion, control of the company remains with the original owners. Although advantageous, the use of

Convertible Notes carries legal risks that must be carefully considered, particularly regarding the potential occurrence of share ownership dilution. According to the Indonesian Dictionary, dilution is defined as the reduction in the value of securities due to the granting of option rights or because the number issued exceeds the appropriate amount.⁶

In the context of Convertible Notes, dilution occurs when debt is converted into new shares, thereby increasing the total number of outstanding shares in the company. Consequently, the ownership percentage of existing shareholders, including minority shareholders, decreases. The impact of this dilution is not limited to share ownership but can also affect voting rights and weaken their bargaining position within the corporate decision-making structure.

In Indonesia, protection for minority shareholders is generally regulated under Law Number 40 of 2007 concerning Limited Liability Companies ("Limited Liability Companies Law"), meaning there is no specific regulation that explicitly governs legal protection for minority shareholders. The Limited Liability Companies Law only regulates certain rights, one of which is the pre-emptive right, which obligates the company to offer new shares first to existing

¹ Muhamad Bakhar et al., *Perkembangan Startup di Indonesia dalam Berbagai Bidang* (Jambi: Sonpedia Publishing Indonesia, 2023).

² Ashamayee Mishra dan Samran Jena, "Awareness of Investment Promotion for the Start-ups Eco-system: A Study on Odisha," *International Journal For Multidisciplinary Research* 5, no. 2 (April 18, 2023): 1–10, <https://www.ijfmr.com/research-paper.php?id=2420>.

³ Peak Capital, "What Is a Convertible Note in Venture Capital?," *Peak*, last modified 2025, diakses Mei 22, 2025, <https://peak.capital/what-is-a-convertible-note-in-venture-capital/#:~:text=Convertible notes are a type,at a pre-determined price.>

⁴ Kahfiya Hasbi, "101 Convertible Note dalam Pembiayaan Startup," *Linkedin*, last modified 2019, diakses Mei 22, 2025, <https://id.linkedin.com/pulse/101-convertible-note-dalam-pembiayaan-startup-kahfiya-hasbi>.

⁵ KPMG Bahrain, *Interpreting Convertible Notes: Exploring alternative fund raising investments in Bahrain for Closed Joint Stock Companies* (Sanabis: KPMG, 2023).

⁶ Pusat Pembinaan dan Pengembangan Bahasa, *Kamus Besar Bahasa Indonesia*, 3 ed. (Jakarta: Balai Pustaka, 2007).

shareholders proportionally to their ownership, whether the new shares have the same or different classification compared to previously issued shares. Although the preemptive right is recognized in Article 43 paragraph (1) of the Limited Liability Companies Law as a mechanism to maintain proportionality of share ownership, this right is not absolute. Articles 43 paragraphs (3) and (4) provide exceptions through resolutions of the General Meeting of Shareholders or under certain conditions, thereby allowing this right to be set aside in practice. For minority shareholders, these provisions can serve as a form of protection; however, their implementation remains limited and is not explicitly designed to address potential abuses of power by majority shareholders, especially in the context of dilution resulting from the conversion of instruments such as convertible notes.⁷

Although the principle of pre-emptive rights is established in the Limited Liability Companies Law, this mechanism fundamentally applies only in the context of issuing new shares as part of conventional capital increases. In practice, the conversion of debt into shares through a Convertible Note does not automatically confer such rights, as it is contractual in nature rather than a legal obligation. Consequently, these rights are often granted solely to investors acquiring shares through the conversion mechanism, while other shareholders particularly those in minority positions do not receive equivalent protection. This situation renders minority shareholders vulnerable, diminishing their opportunity to maintain their ownership proportion and

increasingly marginalizing them from the ownership structure and corporate decision-making.

Given these circumstances, it can be concluded that the legal protection for minority shareholders remains inadequate. This is due to existing regulations not explicitly addressing or anticipating conversion-based funding models such as Convertible Notes, thereby creating a normative gap that potentially disadvantages parties structurally positioned as weaker within the corporation.

This paper aims to analyze the legal consequences of share dilution resulting from the execution of Convertible Note conversions, as well as to evaluate the forms of legal protection available to minority shareholders. Furthermore, this study also considers the urgency of regulating anti-dilution clauses as a risk mitigation measure in contractual practices between investors and the company.

Based on the foregoing, the research problem addressed in this paper is as follows:

1. How can the conversion scheme in a Convertible Note give rise to the risk of share dilution for minority shareholders?
2. What forms of legal protection are available to minority shareholders in addressing the risk of dilution?

METHOD

This research constitutes a legal study. A normative juridical approach, aimed at providing a systematic explanation of the applicable legal provisions.⁸ This approach also encompasses the statutory approach, which examines written legal norms serving

⁷ Cynthia Catharina Junita dan Arman Nefi, "Konversi Utang Menjadi Saham Sebagai Kompensasi Tagihan yang Mengakibatkan Dilusi Saham (Studi Kasus: Putusan Mahkamah Agung Republik Indonesia Nomor

118 PK/Pdt/2017)," *Indonesia Notary* 3, no. 1 (2021): 242–266.

⁸ Peter Mahmud Marzuki, *Penelitian Hukum: Edisi Revisi*, 19 ed. (Jakarta: Prenada Media Group, 2019).

as the basis for analyzing the legal issues under discussion.⁹ The data utilized in this study consist of secondary data, obtained through a literature review of books, scholarly journals, prior research findings, and various relevant legal issues.¹⁰ All data were analyzed using qualitative analysis methods to achieve a comprehensive understanding of the legal issues under discussion.

ANYLISIS AND DISCUSSION

The Risk of Share Dilution in Convertible Note Conversion Schemes Against Minority Shareholders

A convertible note is a funding instrument in the form of a debt agreement that may be converted into shares under certain conditions, typically upon the occurrence of specific events such as reaching a predetermined funding target, loan maturity, or the sale of the company. Such specific events are commonly referred to as trigger events.

At the initial stage, the investor extends a loan to the company, and the loan amount is not immediately converted into shares but remains recorded as debt until the occurrence of certain triggering events. Common provisions found in convertible notes include, among others: Valuation cap: The maximum company valuation used to calculate the conversion price in a convertible note scheme. Discount rate: A price reduction (discount) granted to investors when their debt is converted into shares. This scheme is widely used by startups to expedite the fundraising process without conducting a comprehensive valuation at the early stage. The use of

convertible notes inevitably entails benefits for investors and potential losses for existing shareholders, particularly minority shareholders. For investors holding convertible notes, provisions such as discounts enable them to acquire shares at a lower price compared to new investors.

Conversely, for existing shareholders who do not participate in the conversion scheme, including minority shareholders, this may result in losses in the form of ownership dilution. In practice, provisions such as the valuation cap and discount play a decisive role in determining the conversion price of shares for convertible note investors. For example, if a new investor enters at a company valuation of IDR 100 billion, but the convertible note investor holds a valuation cap of IDR 50 billion, the latter will receive shares as if the company's valuation were only IDR 50 billion. In other words, they acquire shares at half the price paid by the new investor. Consequently, the number of shares issued to the convertible note investor will be significantly greater, directly reducing the ownership percentage of other shareholders, especially those not involved in the new funding. In this context, minority shareholders risk losing a portion of their ownership stake without adequate protective mechanisms.

Minority shareholders occupy a vulnerable position due to their lack of control in the convertible note agreement process and their frequent exclusion from initial funding decisions involving this instrument. Their influence in determining company policies is severely limited, except in cases where they also serve as directors

⁹ Ibid.

¹⁰ Juan Matheus dan Ariawan Gunadi, "Pembentukan Lembaga Pengawas Perlindungan Data Pribadi Di Era

Ekonomi Digital: Kajian Perbandingan Dengan KPPU," *JUSTISI* 10, no. 1 (2024): 20–35.

within the company.¹¹ Moreover, the votes of minority shareholders in the General Meeting of Shareholders often lack the strength to influence the company's strategic decisions and merely serve as a symbolic component of the decision-making process.¹² In the context of convertible note conversions, such non-involvement results in minority shareholders lacking sufficient bargaining power to reject or mitigate the dilutive effects that may arise from the conversion of debt into new shares.

This situation is exacerbated by the fact that, under Indonesian positive law, there is no specific provision obligating companies to provide protection or compensation to minority shareholders in the context of conversions based on convertible notes. Although shareholders generally possess pre-emptive rights, in practice these rights may be set aside. This is stipulated in Article 43 paragraph (3) of the Limited Liability Companies Law, which exempts the obligation to offer shares to existing shareholders when the new shares are allocated to holders of bonds or other securities convertible into shares, subject to approval by the General Meeting of Shareholders.¹³ These exceptions create loopholes whereby the rights of minority shareholders may be overlooked, particularly in the context of debt-to-equity conversion through convertible notes, which do not necessarily require the approval of all shareholders, including minority shareholders.

Although the issuance of new shares through the conversion of convertible notes may be considered procedurally valid under

Article 43 paragraph (3) of the Limited Liability Companies Law due to the approval of the General Meeting of Shareholders and a valid agreement, it cannot be overlooked that such practices raise fundamental questions regarding substantive fairness for the affected parties. In line with Gustav Radbruch's legal theory, justice is an essential element of the legal system. When there is a tension between legal certainty and justice, the law should prioritize justice.¹⁴

In cases of dilution resulting from convertible notes, the conversion procedure may indeed be lawfully executed based on the contract and approval of the General Meeting of Shareholders. However, substantively, this scheme can disadvantage minority shareholders who lack sufficient voting power to influence such decisions. Consequently, this legally permissible loophole warrants critical scrutiny as it has the potential to cause systemic injustice within the corporate structure.

Thus, the conversion scheme inherent in convertible notes presents a tangible risk of dilution to minority shareholders, both in terms of ownership percentage and decision-making power within the company. Provisions commonly found in convertible note agreements such as valuation caps, discounts, and minimum qualified financing—typically negotiated bilaterally between investors and the company, further strengthen the position of investors while weakening that of minority shareholders who are not directly involved in the process. The absence of explicit legal protections addressing the impact of such conversions

¹¹ Lina Salma, Mutiara Sinta Agustin, dan Chintia Sari, "Kedudukan dan Perlindungan Hukum Pemegang Saham Minoritas dalam Perusahaan Terbuka," *Journal of Multidisciplinary Inquiry in Science, Technology and Educational Research* 2, no. 1 (2024): 99–106.

¹² Ibid.

¹³ M. Yahya Harahap, *Hukum Perseroan Terbatas* (Jakarta: Sinar Grafika, 2009).

¹⁴ Dwi Atmoko, *Teori-Teori Hukum* (Malang: Literasi Nusantara Abadi, 2022).

within the framework of Indonesian positive law exacerbates the risk of loss borne by minority shareholders. Therefore, further analysis is necessary to assess the extent to which the current legal framework can adequately safeguard minority shareholders against such dilution risks.

Legal Protection for Minority Shareholders Against the Risk of Dilution

Normatively, Indonesian company law recognizes the existence of minority shareholders and provides several protective mechanisms, including rights to information, the right to sue corporate organs, and pre-emptive rights as stipulated in Article 43 of the Limited Liability Companies Law. However, in the context of convertible notes, the effectiveness of these protections is limited because Article 43 paragraph (3) excludes the application of pre-emptive rights when shares are allocated to holders of securities convertible into shares. Although formal approval from the General Meeting of Shareholders is still required, in practice minority shareholders often lack sufficient voting power to influence the decision-making outcome, thereby allowing the conversion scheme to proceed without their meaningful involvement or protection. Legal protection is a crucial matter, as it is intended to safeguard those who are in a vulnerable position, whether economically or legally.¹⁵

Legal protection may be classified into two forms:¹⁶ First, preventive legal protection, which is aimed at preventing the occurrence of disputes. This form of protection is reflected in statutory provisions

that provide guidelines, limitations, and rules that must be observed by the parties in exercising their rights and fulfilling their obligations.¹⁷ To avoid potential violations. Second, repressive legal protection, which refers to legal efforts undertaken to resolve disputes or violations that have occurred, with the aim of restoring the rights of the aggrieved party. Both forms of protection are essential to ensure that the rights of minority shareholders remain safeguarded, particularly in instances of changes to the ownership structure that may be detrimental through the conversion of financial instruments such as convertible notes.

However, in practice, the legal protection afforded to minority shareholders remains suboptimal, both in preventive and repressive terms. Convertible note agreements are generally contractual in nature and are not explicitly regulated under existing laws and regulations, resulting in the absence of specific provisions that may serve as a reference to ensure protection against the effects of conversion. Furthermore, the provision of Article 43 paragraph (3) of the Limited Liability Companies Law, which excludes the application of pre-emptive rights in the issuance of new shares for debt conversion, further weakens the position of minority shareholders.

Although formal approval by the General Meeting of Shareholders is a legal requirement for conversion, it must be emphasized that minority shareholders often lack sufficient voting power to influence the outcome of such decisions. As a result, the

¹⁵ Salim HS dan Erlies Septiana Nurbani, *Penerapan Teori Hukum pada Penelitian Tesis dan Disertasi* (Depok: Rajawali Pers, 2022).

¹⁶ Ibid.

¹⁷ Jonathan Elkana Soritua Aruan, "PERLINDUNGAN DATA PRIBADI DITINJAU DARI TEORI

PERLINDUNGAN HUKUM DAN TEORI PERLINDUNGAN HAK ATAS PRIVASI," *Jurnal Globalisasi Hukum* 1, no. 1 (Mei 1, 2024): 1–22, <https://e-journal.trisakti.ac.id/index.php/globalisasihukum/article/view/19499>.

conversion of debt into equity may still proceed despite the potential harm to minority shareholders, particularly through ownership dilution that cannot be effectively prevented or fairly compensated.

Secondly, in the event that dilution is unavoidable or pre-emptive rights are not applied, compensation may be provided to the affected shareholders. Such compensation need not necessarily take the form of direct monetary payment, but may instead be structured as limited bonus shares, preferential information rights, or options to participate in subsequent financing rounds. Although such arrangements are not expressly regulated under the Indonesian Limited Liability Companies Law, they may be lawfully implemented through provisions in the articles of association or shareholders' agreement, thereby constituting valid contractual safeguards. In this context, clarity and specificity within such agreements are essential to minimize the risk of future breaches or disputes. By applying this mechanism, a company may retain flexibility in capital raising while ensuring that the rights of minority shareholders are not wholly disregarded, thus preserving a balance between corporate efficiency and structural equity.

Second, in situations where dilution is unavoidable or pre-emptive rights are not applied, compensation may be granted to affected shareholders. Such compensation need not take the form of direct financial payment, but may instead be provided through limited bonus shares, priority access to information, or the option to participate in subsequent funding rounds. Although not explicitly regulated under the Limited

Liability Companies Law, these forms of compensation can be implemented through provisions in the articles of association or shareholders' agreements, serving as legitimate contractual protections.¹⁸ Given that clarity and precision in agreements are essential to minimizing potential breaches or disputes in the future, the implementation of such mechanisms allows the company to retain funding flexibility while ensuring that the rights of minority shareholders are not entirely disregarded. This, in turn, helps to maintain a balance between corporate efficiency and structural fairness.

Thus, although Indonesian company law has provided a foundational framework for the protection of minority shareholders, in practice these provisions have yet to adequately respond to the evolution of modern funding instruments such as convertible notes. The exception clause under Article 43 paragraph (3) of the Limited Liability Companies Law creates room for dilution to occur without the involvement of minority shareholders, which ultimately risks generating structural injustice within the company. Therefore, more progressive normative measures are necessary to accommodate the protection of minority shareholders' rights, whether through restrictions on exceptions to pre-emptive rights or through the implementation of fair and proportional compensation schemes. By applying a balanced legal protection principle that reconciles efficiency with equity, corporate sustainability can be maintained without sacrificing the rights of those in structurally weaker positions.

¹⁸ Gunardi Lie, "A Negative Pledge as an Alternative Solution to Achieve the Pari Passu Pro-Rata Parte Principle," *International Journal of Sustainable Development and Planning* 18, no. 1 (Januari 31,

2023): 265–274, <https://iieta.org/journals/ijstdp/paper/10.18280/ijstdp.180128>.

CONCLUSION

The Convertible Note, as an early-stage funding instrument for startups, offers convenience and efficiency in fundraising; however, it also poses potential dilution risks for minority shareholders. The debt-to-equity conversion scheme carried out without involving existing shareholders, along with valuation cap and discount provisions that favor early investors, results in a significant increase in the number of shares, ultimately leading to a decrease in the ownership proportion of existing shareholders. Within the corporate structure, this can reduce the voting rights and bargaining power of minority shareholders, rendering them vulnerable to decisions they did not agree to or were not previously informed of.

The legal protection available within the Indonesian legal system, particularly through the mechanism of pre-emptive rights as stipulated in Article 43 paragraph (1) of the Limited Liability Companies Law, remains insufficient to fully safeguard against such risks. The exception clause provided in Article 43 paragraph (3) of the Limited Liability Companies Law instead creates a loophole that may be exploited to carry out conversions without involving other shareholders, including minority shareholders. Therefore, normative efforts are needed to strengthen the position of minority shareholders, among others by reinstating pre-emptive rights in cases where a conversion results in dilution exceeding a certain threshold (e.g., 10%), as well as introducing alternative contractual compensation mechanisms for affected parties. This approach is expected to strike a balance between corporate flexibility in obtaining funding and fairness for all shareholders, particularly those who are

structurally in a weaker position. Accordingly, the author recommends that policymakers and business actors design regulations and funding agreements that pay greater attention to the position of minority shareholders, in order to ensure fairness within the company's ownership structure.

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