

The convertible loan: a familiar tool with new rules

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A new law sets forth the model convertible loan agreement and the procedure for converting a lender’s claims into the borrower’s interests or shares. Federal Law No. 354-FZ on Amendments to Certain Legislative Acts of the Russian Federation dated July 2, 2021 (the “**Federal Law**”), amends the federal laws on Joint Stock Companies, on Limited Liability Companies, on the Securities Market, on the State Registration of Legal Entities and Individual Entrepreneurs, and also the Fundamentals of Russian Federation Legislation on Notaries. The Federal Law went into effect on July 13, 2021.

The convertible loan is a common funding tool. It allows the lender (the investor) that funded the borrower company to get an equity interest or shares

in the borrower company instead of repayment of the loan with interest.

Russian law did not previously regulate legal arrangements related to providing convertible loans. In structuring the conversion of a loan into an equity interest (or shares) the parties had to rely on legal models that existed in foreign jurisdictions. They also used the limited tools of Russian law. Now, however, they have new rules they can follow; rules detailing how a convertible loan agreement can be made and performed.

In the table below we briefly describe how a convertible loan works under the newly enacted legislative amendments:

BORROWER

A non-public JSC or LLC can act as borrower

The following cannot be borrowers:

- Lending institutions or non-bank financial institutions
- Companies of strategic significance for national defense and state security
- Companies created through privatization and 25 percent of whose voting shares are publicly or municipally held

LENDER

For an LLC: a company participant or a third party (if the company’s charter doesn’t prohibit increasing its charter capital by contributions of third parties)

For a JSC: any person/entity

ESSENTIAL TERMS OF THE AGREEMENT

- Subject matter
- Loan amount
- Loan maturity and/or circumstances in which the lender may request conversion (e.g., the parties to the agreement or third parties taking or not taking certain actions, the borrower passing certain resolutions or achieving certain financial performance)
- **For a JSC:** the offer price for additional shares to perform the convertible loan agreement or how to determine it
- **For an LLC:** the amount or procedure for determining the amount of increase in the nominal value of the company participant lender’s interest, or the nominal value of the interest being acquired, if the lender is not a company participant

FORM AND PROCEDURE FOR ENTERING INTO THE AGREEMENT

- If the borrower is a JSC, the agreement is made in simple written form.
- If the borrower is an LLC, the agreement is notarized.
- Information about the concluded agreement is entered in the Unified State Register of Legal Entities.
- The participants (or shareholders) of the borrower company pass a unanimous resolution pre-approving the agreement (and in an LLC the notary notarizes the resolution).
- The agreement may be invalidated on the suit of the company itself or its shareholders/participants if there is no general meeting approval.

Upon loan maturity and/or other circumstances contemplated by the agreement, the lender may request that the company do the following instead of repaying the loan and paying the interest:

- That additional shares be allotted to the lender (for a JSC)
- An increase of the nominal value and size of the lender's interest and decrease of other company participants' interests (if the lender is a participant in the LLC), or
- That the lender be admitted to the LLC and that the lender acquire an equity interest in the LLC (if the lender is a third party)

A conversion request may be sent within three months after the maturity date and/or the occurrence of other circumstances contemplated by the agreement (unless the agreement sets a shorter time).

The lender may request conversion in court if the borrower objects (which it is entitled to do within 14 business days of receiving the conversion request). If the lender's claims are granted, the court judgment will be grounds to transfer the interest (shares) to the lender.

WHAT TO DO WHEN THE LOAN MATURES

The new changes will make it much easier to structure relations based on a convertible loan model. Now the parties will not have to resort to multi-component legal structures containing elements of various contractual models. The convertible loan concept proposed by the Russian legislation could become a convenient tool for raising investment, especially in venture capital. At the same time, the regulatory enforcement has yet to develop its own approaches to certain issues that arise when relationships are structured using the convertible loan model.

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Please contact our lawyers with any questions related to convertible loans.

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