

**Regulation and Enforcement of Convertible Notes in Russia and the United States:
a Comparative Analysis**

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LLM Capstone Thesis
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ABSTRACT

With the adoption of Federal Law No. 354-FZ dated July 2, 2021, “Concerning Amendments to Certain Legislative Acts of the Russian Federation,” Russian legislators introduced several regulatory provisions to implement the concept of “convertible loan” into the Russian law to uphold the possibility to convert certain debts of Russian private corporations into equity.

U.S. law was not only the source of inspiration for the drafters of the new Russian law but for the purposes of this thesis, it also remains the benchmark based on which the drawbacks of the new Russian legislation could be remedied through the prism of peculiarities of Russian corporate law and market conditions. Similarly to the vast majority of newly developed legal concepts, new Russian law needs a thorough assessment of legal consistency with linked laws and efficiency of practical application in comparison with the regulation of convertible loans in the United States.

Such assessment would provide a great boost for the development of Russian capital financing instruments that accommodate the interests of both the investment recipient, who needs immediate access to development funds, and the investor, who has several options available for the settlement of its claims towards the borrower in case of default.

LIST OF ABBREVIATIONS

CC RF	Civil Code of the Russian Federation, as amended
IPO	Initial Public Offering
JSC Law	Federal Law No. 208-FZ as of December 26, 1995, “On Joint Stock Companies,” as amended
Law on Convertibles	Federal Law No. 354-FZ as of July 2, 2021, “Concerning Amendments to Certain Legislative Acts of the Russian Federation”
LLC Law	Federal Law No. 14-FZ as of February 8, 1998, “On Limited Liability Companies,” as amended
SAFE	Simple Agreement for Future Equity
SEC	U.S. Securities and Exchange Commission
Securities Act 1933	U.S. Securities Act of 1933, as amended
Securities Act 1934	U.S. Securities Act of 1934, as amended
UCC	Uniform Commercial Code, as amended
USRLE	Uniform State Register of Legal Entities

INTRODUCTION

As statistics show, 35% of transactions for investing in venture projects by Russia-domiciled investors were structured using the convertible loan model to invest in foreign companies, which corresponds to 70% of the total investment in such projects¹. After complex assessment of current tendencies in investments made with involvement of Russian parties, the legislators have passed the Law on Convertibles.

The main policy reason behind this law was the urge to refocus the attention of investors from foreign jurisdictions to Russian capital market by introducing new venture financing instruments adopted within prosperous capital markets that are well-known to investors². As a starting point of reference, the U.S. law provided a strong benchmark model supported by both legislative provisions and established case law on the matter of enforcement of convertible notes.

Nevertheless, the adoption of the Law on Convertibles clarified only the procedural aspects of executing convertible notes leaving behind the substantive part of the instrument. As a result, practitioners, including the author of this thesis, have faced severe red-tape implications of a new law that prevent it from being used effectively. Following that, the hypothesis of the present research is that through the prism of practical and doctrinal assessment, Law on Convertibles is drafted with a key system error in the qualification of the emerging relations.

Particularly, disadvantages and risks of the Russian model of convertible notes in general are similar to the already actively used instruments of repo transactions, pledging a

¹ Draft Federal Law No. 972589-7 as of June 15, 2020, “On Amendments to Certain Legislative Acts of the Russian Federation Concerning Convertible Loans,” as amended.

² Ibid.

participant's share upon receiving a loan by the company, as well as the classical disproportionate increase of the authorized capital. Consequently, the same economic objectives were also achievable with the help of available legal instruments way before the introduction of the Law on Convertibles. The main problem in all such cases is not the complete absence of a legal framework but rather the flaws of existing corporate governance regulation adopted in Russia and the overall bureaucratic system impairing the development of small and startup enterprises.

To support the hypothesis stated before, the author of the thesis has undertaken the following steps:

- (1) Analyzed the legal background and case law on the matter of enforcement of convertible securities in the US;
- (2) Analyzed the legal background related to regulation of convertible securities both prior and after enacting the Law on Convertibles; and
- (3) Compared the level of effectiveness of enforcement of convertible notes in both Russia and the U.S. given the peculiarities of corporate law issues pertaining to each of chosen jurisdictions.

Given that the adoption of the Law on Convertibles took place less than a year ago, and the average term for convertible notes is 2-4 years, the scope of analysis of the Russian model of convertible notes was limited strictly to the assessment of legal provisions, setting aside the possibility to revert to relevant case law.

This thesis consists of three chapters and seven sections dedicated to certain aspects of regulation and enforcement of convertible notes in Russia and the US. Chapter 1 deals with the basic outline of the concept of convertible securities and provides terminological background necessary to explore the corresponding features of convertible notes. Chapter 2 provides a more

in-depth analysis of certain peculiarities of the U.S. and Russian models of convertible notes, including its essential terms, conversion mechanism, and statutory limitations imposed on execution and enforcement of convertible notes. Chapter 3 highlights major flaws existing within the framework of the Russian model of convertible notes including complications connected with forced conversion, dilution of ownership and loss of control. Finally, Chapter 3 proposes certain amendments to current legislation necessary to pursue the goals that substantiated the adoption of the Law on Convertibles.

CHAPTER 1. GENERAL OUTLINE OF THE CONCEPT OF CONVERTIBLE FIXED INCOME SECURITIES WITHIN THE LEGAL FRAMEWORK OF CAPITAL INVESTMENTS

In the modern framework of capital investments, convertible securities may be construed as several different mechanisms, e. g. notes, bonds, debentures, and SAFEs. Notwithstanding that all these instruments share the same nature of having both debt-like and equity-like characteristics if convertible, their substance, and a set of rights attributable to parties differs in each type of convertible security.

The concept of convertible notes as a type of convertible security is always surrounded by an ongoing debate about whether it should be qualified as a debt instrument or an equity security, since such notes are by their nature a debt instruments that might convert into equity upon the occurrence of a future financing round. In particular, the U.S. nomenclature standard terms of an early-stage convertible note provide for the two main outcomes: the sum of investment is being repaid to investor upon occurrence of the maturity date, or the debt converts into a certain number of shares of company's preferred stock upon attracting additional investments at a certain valuation³.

As it stems from the practice developed by the U.S. courts, notes are generally considered as payment instruments which, however, can also be considered as investment vehicles in certain instances. In particular, the U.S. federal *Reves case* has introduced a four-step “*family resemblance*” test to decide whether an instrument falls within the scope of the term “securities” as defined in Securities Act 1934. Under the first step, it is necessary to define the motivation attributable to both seller and buyer before executing the note. Second, the court

³ Cambridge Business English Dictionary. 2011. Cambridge: Cambridge University Press; Gilson, Ronald J., and David M. Schizer. “Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock.” *Harvard Law Review* 116, no. 3 (2003): 874–916.

should assess the “plan of distribution” of the instrument to determine whether such instrument could be used for common trading. Third, it is vital to establish reasonable expectations of the investing public. As a final step, the court should determine whether the existence of another regulatory scheme might significantly reduce the riskiness of the instrument itself thereby shifting the instrument out of the scope of application of the Securities Acts.

While applying this test to the note involved in the *Reves case*, the court has concluded that the note should be deemed to be a security for the purposes of federal securities regulations in case the primary aim of such note is to raise capital and provide purchasers of the note with a profit in a form of interest. Such note should also be publicly offered to an unlimited range of third parties over an extended period⁴. As a result of the evaluation, the court has decided that the notes offered by the Farmers Cooperative of Arkansas and Oklahoma were investment instruments in the scope of the Securities Act 1934.

Therefore, not only the overall concept of convertible securities presupposes internal regulatory distinction based on the particular type of mechanism involved, but also specific mechanisms are to be treated differently based on their individual characteristics. In this regard, this chapter will draw a waterline between the characteristics of convertible bonds, debentures, and notes. It will also provide an assessment of major substantive and procedural differences regarding execution of such debt securities and examination of the terminology traits leading to a common confusion of convertible notes with other types of convertibles. Further, this chapter will determine the basic elements of a convertible note and provide definitions for the main terms widely used in relation to convertible notes.

⁴ *Reves v. Ernst & Young*, 507 U.S. 170, 113 S. Ct. 1163, 122 L. Ed. 2d 525 (1993).

1.1. Avoiding Terminology Caveat

To begin with, “fixed income security” is a denominator for debt instruments issued by a government, corporations, or other entities in order to financially support or expand their operations, that provides investors with a return in the form of fixed periodic payments and the eventual return of principal at maturity⁵. The range of fixed income securities used by entities also includes convertible ones, such as a convertible note, bond, or debenture.

U.S. governmental bodies usually stick to bonds within the framework of a sovereign debt to support government’s treasury. For example, U.S. Treasury issues long-term bonds bearing low level of investment risks providing its purchasers with comparatively small fixed interest payments⁶. These bonds are always subject to repayment to bond purchasers upon maturity date and do not provide for conversion options due to specificity of the parties involved. Small and medium-sized entities tend to use convertible securities, including convertible notes to attract investments in exchange for equity and to stimulate individual investors, accelerators, and venture funds to support the earliest stage of company’s development on the most beneficial terms for investors⁷. Larger vehicles mostly use non-convertible securities to raise capital in order to avoid unnecessary increase of the number of shareholders or opt out for more sophisticated instruments like warrants, convertible bonds, and debentures with prolonged maturity⁸.

Convertible notes as a type of fixed income securities are often confused with two other types of convertibles – convertible bonds and debentures. Nevertheless, despite the fact that

⁵ Fabozzi, Frank J., and Steven V. Mann. *The Handbook of Fixed Income Securities*. McGraw-Hill Education, 2012.

⁶ See https://www.treasurydirect.gov/indiv/products/prod_tbonds_glance.htm.

⁷ Schmidt, Klaus M. “Convertible securities and venture capital finance.” *The Journal of Finance* 58, no. 3 (2003): 1139-1166.

⁸ Mayers, David. “Why firms issue convertible bonds: the matching of financial and real investment options.” *Journal of financial economics* 47, no. 1 (1998): 83-102.

they share a common nature of providing a holder with a possibility to invest a principal sum into the company, retrieve certain income at the previously agreed rate, and option to convert the debt into the company's equity upon a certain date or commencement of certain events, these three instruments differ in their enforcement and rights attributable to each party.

For instance, a convertible bond is a type of debt security that provides an investor with a right or an obligation to exchange the bond for a predetermined number of shares in the issuing company at certain times of a bond's lifetime⁹. Simultaneously, the bondholder is usually granted an option to exchange the debt for equity at some point during the term of the bond, as well as the right to receive interest at a fixed or floating rate. Conversion is usually triggered by either the passage of a certain time leading to the bond's maturity date or noticeable changes in the trading price of the underlying security¹⁰. Unlike convertible notes, convertible bonds used within the U.S. investment framework usually state the pre-determined conversion price at the moment of execution of the bond agreement¹¹.

Another distinction of the U.S. bond from convertible note is the procedure of conversion of debt into equity. In particular, the bondholder should complete a conversion notice and submit it to the issuer along with a bond itself¹², while the conversion of notes mostly occurs automatically upon achievement of certain criteria listed in the note¹³. After receiving a conversion request from the bondholder, the issuer usually has an option to repay the bond rather than converting it into equity, while in case of convertible notes the issuer does not have

⁹ George S. Hills, *Convertible Securities - Legal Aspects and Draftsmanship*, 19 CALIF. L. REV. 1 (1930).

¹⁰ See Hirte, Heribert. "Convertible Bonds and Option Bonds: A Comparative Study." *European Business Organization Law Review* 1, no. 3 (2000): 507–37; Klein, William A. "The Convertible Bond: A Peculiar Package." *University of Pennsylvania Law Review* 123, no. 3 (1975): 547–73.

¹¹ Brennan, Michael J., and Eduardo S. Schwartz. "Analyzing convertible bonds." *Journal of Financial and Quantitative analysis* 15, no. 4 (1980): 907-929.

¹² "Corporation Finance. Preferred Stock Convertible into Bonds. Subordination of Claims of Bondholders to Unsecured Debts Accruing Prior to Conversion." *Columbia Law Review* 37, no. 1 (1937): 128–30.

¹³ Ammann, Manuel, Kristian Blickle, and Christian Ehmann. "Announcement effects of contingent convertible securities: Evidence from the global banking industry." *European financial management* 23, no. 1 (2017): 127-152.

an option to repay the debt once the conversion event has occurred, so the decision as to the fate of the note transfers to investor¹⁴.

At the same time, convertible debentures represent a type of long-term debt security that can be exchanged for another type of debt or common shares of the company within a particular period¹⁵. In case of debenture, its holder is entitled to a specified amount of interest for a specified length of time, while the issuing entity is obliged to repay the principal amount of the loan at maturity¹⁶.

What differentiates bonds and debentures is that bonds issued in the US, unlike debentures, can be secured by collateral¹⁷. Absence of a collateral behind the debenture drives the use of such mechanisms by larger ventures with high credit ranking which serves as additional reassurance to investors that the company will be able to repay the debt upon maturity¹⁸. At the same time, bonds, as secured instruments, are usually secured by one or several assets to be seized in case of the issuer company's default¹⁹.

While convertible bonds and debentures are largely used by governments and large corporations, convertible notes represent a type of debt security instrument mostly used by small and medium-sized enterprises. Convertible notes usually have a short-term maturity of 2-5 years and are primarily intended to raise capital from investors with the purpose of conversion of debt into equity instead of return of principal²⁰. What illustrates the primary

¹⁴ Schmidt, Klaus M. "Convertible Securities and Venture Capital Finance." *The Journal of Finance* 58, no. 3 (2003): 1139–66.

¹⁵ Chazen, Leonard, and Leonard Ross. "Conversion-Option Debentures." *The Yale Law Journal* 79, no. 4 (1970): 647–56.

¹⁶ Brigham, Eugene F. "An analysis of convertible debentures: Theory and some empirical evidence." *The Journal of Finance* 21, no. 1 (1966): 35-54.

¹⁷ Squillante, Alphonse M. "The Pledge as a Security Device-Part VII." *Com. LJ* 88 (1983): 326. See also Johnson, Robert W. "Subordinated debentures: debt that serves as equity." *The Journal of Finance* 10, no. 1 (1955): 1-16.

¹⁸ Flannery, Mark J. "No pain, no gain? Effecting market discipline via reverse convertible debentures." *Capital adequacy beyond Basel: Banking, securities, and insurance* (2005): 171-196.

¹⁹ Paakkola, Harri. "Determinants for convertible bond issuance: A study on US banks." (2017).

²⁰ Miller, Kenneth H. "Venture Capital: Techniques for Increasing Liquidity with a View Toward Rule 144." *The Business Lawyer* 29, no. 2 (1974): 461–75; Robicheaux, Sara Helms, Xudong Fu, and James Allen Ligon.

investment aim underlying both convertible and ordinary notes is the example of *Reves case*, where the notes were subject to repayment upon request of the note holder, which, according to defendant's testimony were subject to repayment within less than 9 months²¹.

Within the framework of convertible notes, as a part of a later financing round, when a conversion event occurs, convertible noteholders either get a repayment of the principal sum with the interest accrued until conversion event or receive equity at a price that is lower than the price paid by new investors. Such beneficial conditions for conversion are possible due to specific characteristics attributable to convertible notes, such as valuation cap and specific mechanism of determination of conversion price, as discussed in subsection 1.2 below.

Consequently, despite the fact that these three fixed income investment vehicles share quite a number of common features, they still cannot be equated and used interchangeably, since goals, process of enforcement, level of security in case of issuer's indebtedness, and range of parties involved differ drastically in each kind of debt security. Thus, while convertible notes are mostly used by small and medium-sized ventures, they are not always compatible with the investment goals of governments, municipalities, and larger ventures. As a result, the latter are most likely to opt out for convertible or ordinary bonds and debentures providing such entities with more control over the course and outcome of investment.

1.2. Basic Elements of Convertible Notes

To bring more clarity to the conversion mechanism and legal issues pertaining to it, it is necessary to establish the legal meaning of basic elements of convertible notes, which include

"Convertible Debt Use and Corporate Governance." Quarterly Journal of Business and Economics 46, no. 3 (2007): 65–94.

²¹ *Reves v. Ernst & Young*, 507 U.S. 170, 113 S. Ct. 1163, 122 L. Ed. 2d 525 (1993).

valuation cap, maturity date, qualified equity financing round, conversion event, conversion price, and interest rate.

Within the concept of convertible notes, “valuation cap” means the maximum price for the purposes of note conversion providing that the note is subject to conversion at a per-share price calculated as if the valuation of the company at the time of conversion was equal to the valuation cap, even though in fact the actual valuation can be several times higher than the valuation cap established in the note itself²². This element is a safeguarding measure, protecting investors from burdensome conversion prices in case of long-term investments for the situations where the actual valuation of the company extremely exceeds the one predicted at the time of entering into a note. Another benefit of the valuation cap is the possibility to prevent massive dilution of the first investors’ stake thereby making notes attractive for early-stage investors.

“Maturity date” means the date upon which the principal sum should be repaid to investor provided that the company has not yet attracted any investments in a qualified equity financing round²³.

A “qualified equity financing round” means a bona fide transaction or series of transactions aimed at raising company’s capital through which the company sells its stock to third-party investors²⁴. The definition of a qualified equity financing round may vary in different agreements and may provide for the minimal or maximal sum of company’s gross

²² Paul A. Jones, “The Convertible Debt Valuation Cap: The Trigger Financing Investor Perspective,” *RAIL: The Journal of Robotics, Artificial Intelligence & Law* 3, no. 1 (January-February 2020): 63-68.

²³ Mourell, Mark P., and Jonathan N. Willoughby. “Convertible notes.” *Australian Business Law Review* 21, no. 5 (1993): 338.

²⁴ Hala Khoury-Bisharat; Rinat Kitai-Sangero, “The Silence of Jesus and Its Significance for the Accused,” *Tulsa Law Review* 55, no. 3 (Spring 2020): 443-468

proceeds at the round to qualify such transaction as a “qualified equity financing round” and trigger the conversion event.

“Conversion event” generally means a conversion of the debt comprised of the principal sum and the accrued interest rate into the company’s shares. A conversion event is not always limited to the fact of commencement of a qualified investment round. It may include events of (1) commencement of public trading of company’s shares for notes exempted from registration with the SEC under Section 4(a)(2) Securities Act 1933, (2) liquidation of the company, (3) sale of all or substantially all assets of the investee, (4) merger, acquisition, or restructuring. In such cases the note will accelerate prematurely, and investor will be granted a right either to request an early payment of the principal sum and interest accrued or convert the debt into company’s equity²⁵.

“Conversion price” may be calculated differently in various scenarios. As a basic rule, it means the quotient resulting from dividing the valuation cap by the fully diluted capitalization of the company. Such capitalization is usually assessed immediately prior to the closing of the qualified equity financing round²⁶. Capitalization, for the purposes of convertible note structure, means the total number of shares issued and outstanding at the time of closing of the transaction. Capitalization also includes reserved and outstanding options issued under employee stock incentive plan, all outstanding unexercised warrants, and outstanding convertible securities sold by the company.

“Interest rate” is a certain percentage that accrues on the principal sum of investment and provides investor with profit in case of repayment of the note, fixed monthly or annual

²⁵ Hicks, J. William. “Recapitalizations under Section 3(a)(9) of the Securities Act of 1933.” *Virginia Law Review* 61, no. 5 (1975): 1057–1113.

²⁶ Jerome S. Katzin, “Financial and Legal Problems in the Use of Convertible Securities,” *Business Lawyer (ABA)* 24, no. 2 (January 1969): 359-374.

income. It may also provide investor with a possibility to increase the number of shares to be received upon conversion²⁷.

The aforementioned terms are essential for understanding of convertible notes. All these terms constitute the core of this instrument thereby making it impossible to properly exercise and enforce the rights and fulfill the obligations imposed by it as discussed in detail in the following chapters.

²⁷ Ibid.

CHAPTER 2. OVERVIEW OF THE BASIC LEGAL CHARACTERISTICS OF THE U.S. AND RUSSIAN MODELS OF CONVERTIBLE NOTES

1.3. Basic Legal Characteristics of the U.S. Model of Convertible Notes

The U.S. model of convertible notes was originally developed in order to finance mid- to late-stage companies during bridge financing²⁸ rounds. Nowadays, convertible notes are mostly being used in “seed”²⁹ financing³⁰.

A typical structure of the convertible note under U.S. law presupposes that the investee issues a convertible promissory note in exchange for a loan and, in some cases, allows the lender to purchase additional shares in the future³¹. In certain scenarios, the principal terms of the transaction provide the holder of the convertible note with certain controlling rights over the borrower, including the right to appoint its representative as a member of the investee’s board of directors with veto power over certain key decisions, such as, for example, reorganization or sale of the company, and informational rights, including the right to retrieve financial statements of the company³².

²⁸ Within the context of capital investments, “bridge round” means a short-term arrangement allowing entities to cover their short-term costs by attracting investments between major financing rounds through the means of either ordinary or convertible loans. See: Chaplinsky, S., Becker, J. M. “Convertible Notes: A Form of Early-Stage Financing.”

²⁹ “Seed round” means the first considerably small investment round allowing entities usually to help set up startup’s business and commence its operations. See: De Clercq, D., Fried, V. H., Lehtonen, O., and Sapienza, H. J. “An entrepreneur’s guide to the venture capital galaxy.” *Academy of Management Perspectives* 20, no. 3 (2006): 90-112.

³⁰ Barber, Brad M. “Exchangeable debt.” *Financial Management* (1993): 48-60.

³¹ Brown Jr, J. Robert, J. Robert Brown Jr, and Herbert B. Max. *Raising Capital: Private Placement Forms*. Wolters Kluwer, 1995.

³² See, for example, *Salamone v. Gorman*, 106 A.3d 354 (Del. 2014); *McIlquham v. Feste*, No. C.A. 19042, 2002 WL 244859 (Del. Ch. Feb. 13, 2002).

2.1.1. The Conversion Mechanism

There are two types of convertible note conversions: automatic and forced conversion. In the event of automatic conversion, all of the lender's claims against the borrower are converted into the borrower's shares without the lender's involvement following the conversion event. In such situation, the debt is converted into the shares of the same type holding the same corporate rights issued to other investors as a part of the qualified equity financing. As a general rule, these will be the shares of investee's preferred stock, at the conversion price taking into account all discounts and other conversion terms agreed upon by the parties.

The forced conversion may be effected after the maturity date in exceptionally rare cases where the terms of the convertible note provide for no basis for automatic conversion³³. Typically, the conversion of notes is carried out by the directors or shareholders of the issuing company upon their discretion or upon the request of the investor holding the underlying note. In particular, directors or shareholders are required to approve and enforce the terms of the convertible note by issuing an appropriate number of shares of the relevant class corresponding to the principal sum and interest accrued by the time of conversion³⁴.

2.1.2. Statutory Limitations

Although notes are listed as securities within the meaning of the U.S. Securities Act 1933, they are not always recognized as securities in case law. When determining whether an instrument is a security the decisive element is not the title of the agreement, but rather the nature and scope of rights and interests secured³⁵. In particular, the court takes into account

³³ 15 U.S.C. §77b(a)(1), § 2(1) of the U.S. Securities Act of 1933.

³⁴ See, for example, 8 Del. C. 1953, §15.

³⁵ Headman, A. O. "Is Our Promissory Note a Security?" Cohn Kinghor, November 22, 2012.

whether the holder intends to benefit from the efforts of others or become a business partner of the issuer. If these conditions are not satisfied, the notes are regarded as ordinary contracts not falling within the scope of the Securities Act 1933³⁶ and not as negotiable instruments covered by Article 3 of the UCC, unlike ordinary promissory notes³⁷.

One of the bases of such exemption is a private placement of convertible notes, i. e. the placement among a limited circle of qualified or unqualified investors, who undertake an obligation not to resell and not to distribute them to an unlimited range of third parties. A number of rules issued by the SEC directly specify conditions upon satisfaction of which the transaction is considered a private placement thereby exempting such transactions from the necessity of registration with SEC. Such conditions include restrictions on the amount of funds to be raised during any 12-month period, with a gap between such periods of at least six months (\$1 million with no limit on the type of investors, \$5 million provided that the number of “non-accredited” investors does not exceed 35 persons), and SEC notification³⁸. “Non-accredited” investors are any investors other than institutional investors and high-net-worth individuals, who, generally, do not reside within the territory of the U.S. and were not offered the note in the US³⁹.

Another prerequisite for exemption from registration is that the proceeds from the placement of such securities must be used to finance current operations or repay other short-term securities of the note-issuing company⁴⁰. The advantage of a private placement is that the absence of registration simplifies the paperwork associated with the transaction, speeding up

³⁶ Clinton, E. X. Jr. “What Is a Security Under The Federal Securities Laws?” The Business Law Blog By Edward X. Clinton, Jr., January 17, 2011.

³⁷ See *Highland Capital Management, LP v. Schneider*, 551 F. Supp. 2d 173 (S.D.N.Y. 2008).

³⁸ Rule 506(b) of the Securities Act of 1933.

³⁹ Ibid.

⁴⁰ Bartos, James M., and Jim Bartos. United States securities law: a practical guide. Vol. 2. Kluwer Law International BV, 2006.

the actual transfer of the principal sum, relieving the issuer of stringent disclosure requirements and reducing transaction costs.

The disadvantage of a private placement is that the notes and shares into which they are supposed to be converted are deemed to be “restricted securities” that cannot be traded on a stock exchange and transactions with them are permitted only in limited circumstances.

The list of such circumstances includes the most commonly used Rules 144 and 144A for qualified institutional buyers⁴¹ being used to determine the legality of a transaction in such securities. Rule 144 requires compliance with conditions regarding minimum holding period (at least 1 year from placement and full payment, in some cases, 6 months), public reporting by the issuer, maximum allowable transaction volume, broker involvement and SEC notification⁴². As a result of such limitations, the text of convertible notes issued in the U.S. without registration must contain special restrictive legends, indicating that the securities are restricted from public trading.

It also must be noted that each state has its own securities laws, which may differ from federal laws, so registration of the issuance of convertible notes may be required not only on the federal level, but also at the state level as a *lex loci actus*⁴³.

⁴¹ “Qualified institutional buyer” usually means “large sophisticated institutional investors that own and invest on discretionary basis at least \$100 million in securities and banks and other specified financial institutions with net worth of at least \$25 million”. See: 17 C.F.R. § 230.144A; *Lindeen v. Sec. & Exch. Comm’n*, 825 F.3d 646 (D.C. Cir. 2016).

⁴² Rule 144: Selling Restricted and Control Securities.

⁴³ Also known as the “blue sky” rules envisaged by Article 18 Securities Act 1933 and introduced into each state’s regulation on securities market.

1.4. Basic Legal Characteristics of the Russian Model of Convertible Notes

With the introduction of the Law on Convertibles legislators for the first time provided certain rules regarding regulation and enforcement of convertible loans⁴⁴. Despite the fact that the regulation of convertible loans was introduced into the Russian legislative system, the CC RF does not list convertible notes as part of “defined contracts” meaning that relations of the parties arising out of convertible notes are regulated in several legal acts. In particular, certain provisions regarding the regulation of convertible notes are introduced in the following acts:

- (1) Federal Law No. 208-FZ as of December 26, 1995, “On Joint Stock Companies” (“JSC Law”);
- (2) Federal Law No. 14-FZ as of February 8, 1998, “On Limited Liability Companies” (“LLC Law”);
- (3) Federal Law No. 129-FZ of August 8, 2001, “On State Registration of Legal Entities and Individual Entrepreneurs” (“SRLE Law”); and
- (4) Federal Law No. 381-FZ as of December 28, 2009, “On the Basis of State Regulation of Trade Activities in the Russian Federation” (“SRTA Law”).

While the CC RF generally outlines major features and attributable characteristics of particular types of Russian legal entities, the JSC and LLC Laws more specifically regulate the scope of rights and obligations of members and shareholders of the company, as well as procedural requirements for the amendment of corporate bylaws, increase of the authorized charter capital, and certain aspects of corporate governance. The SRTA Law imposes certain restrictions on the turnover of the stock of joint-stock companies, while the SRLE Law outlines

⁴⁴ For the purposes of this research the words “convertible note” and “convertible loan” with regards to Russian legislation should be deemed to be interchangeable and substitutable.

the procedural order for submission of the documents with the state register necessary to effectuate certain activities during the course of the corporate governance.

With the introduction of the Law on Convertibles these statutes together now cover not only roughly procedural aspects but also the definition of types of investment mechanisms, namely, convertible debt securities. In fact, none of the aforementioned laws has previously contained any specific provisions or established corporate procedures necessary for the introduction of certain forms of investment, including traditional loans and bonds.

Structurally, the Russian model of convertible notes strongly resembles the one adopted in the U.S. simultaneously combining certain aspects of SAFEs and convertible notes. It includes all basic elements of the US-adopted model of convertible notes, including the principal sum, interest rate, qualified equity financing round, and maturity date.

From the legal standpoint, the essence of a convertible loan can be summarized as a deferred conversion of debt into shares or stake of the company constituting a suspensive potestative condition, i.e., a condition depending on the will of one of the parties to the agreement. Such suspensive condition is partly attributable to the current peculiarities of the Russian economy, it allows to postpone the valuation of pre-seed and seed-stage companies that do not have enough assets for the proper evaluation that would have allowed them to enter into investment agreements on fair terms.

In the following subsections, this chapter will examine basic elements of the Russian model of convertible notes analogically to those discussed in section 2.1 above, including the conversion mechanism available for joint stock and limited liability companies, statutory limitations imposed on the implementation of convertible notes in corporate relationships.

2.2.1. Essential Terms of Convertible Notes

The Law on Convertibles establishes the essential conditions of a convertible loan agreement, the absence of which renders the agreement invalid. The list of essential terms includes the subject matter of the agreement, the term of the agreement, and specific circumstances triggering the potential enforcement of investor's right to convert the loan into the company's shares. In case of limited liability companies, the convertible note must state the percentage and value of additional contribution made by investor who is a member of the company, or the procedure of determination of the nominal value of investor's share in the authorized charter capital and the ownership percentage to be acquired upon conversion⁴⁵.

However, convertible notes created based on a Russian model may also include certain optional conditions, which are not statutorily required to be agreed upon but rather ordinarily used within the U.S. market. The list of such conditions includes interest rate, obligation of certain members to maintain their membership until the conversion event, obligation of the company to obtain preliminary consent of the investor to initiate restructuring, insolvency proceedings, or liquidation process.

2.2.2. The Conversion Mechanism

The Russian model of a convertible note envisages a specific conversion mechanism. In particular, such shares are not issued at the time of execution of the convertible note, they will become available to the investor only after its notice of increase in the charter capital following the conversion event. Such arrangements are partially regulated by the CC RF, allowing the pledge of the property that the pledger (investor) will acquire in the future upon

⁴⁵ Article 19.1(10) LLC Law.

satisfaction of the requirements listed in the convertible note⁴⁶. This element of the overall mechanism of conversion allows an investor to opt for either conversion of the debt into equity by demanding an increase in the issuer's charter capital or repayment of the principal sum together with an interest accrued by the time of repayment.

In private joint stock companies, the authorized charter capital is subject to increase by means of placing additional shares in the name of the investor⁴⁷. In limited liability companies the basis for making a decision to increase the authorized charter capital is either the investor's request as an existing member of the note-issuing company to make an additional charter contribution, or third-party investor's request on admitting it to the members of the company after making a subsequent contribution. It should be noted that LLC Law provides that to be subject to a loan agreement, company's shares must be owned by the entity itself, not by one of the members⁴⁸.

There is a general prohibition for the companies to acquire their own shares, and in case of existence of a so-called "treasury share," such share is subject to distribution among the company's shareholders within one year from the date of its issuance⁴⁹. It is hardly possible to convert the debt into equity automatically in one year from the effective date of a valid convertible note since the company does not have any reserved shares or participatory interest to be transferred to the investor.

However, the convertible note model adopted in the Russian Federation consists not only of elements of a loan agreement but also a corporate agreement settling certain rights and obligations of the company's shareholders or members. Therefore, the current model of a

⁴⁶ Article 336(2) CC RF.

⁴⁷ Article 34 JSC Law.

⁴⁸ Article 19 LLC Law.

⁴⁹ Articles 23, 24 LLC Law.

convertible note requires for such agreement to provide for the obligation of the company's existing members to convene a general meeting and approve the increase of the authorized capital by means of the debt conversion. However, the scope and a particular set of rights and obligations of the investor and existing company's members or shareholders is left to the discretion of the parties for the term of the convertible note.

The conversion scheme involves four major steps. First, both joint stock companies and limited liability companies are required to hold a meeting to unanimously agree on the implementation of the convertible note into the corporate structure. Second, after negotiating the terms of a convertible note, the parties must attend a notary public to certify and register the agreement with the USRLE. Third, upon the occurrence of a conversion event, the investor must apply for entering the company as a new member and existing members must approve the increase of a charter capital through the conversion of a note. Fourth, after such meeting, all parties to the agreement must revert to a notary public to register the charter capital increase and submit necessary documents to the USRLE to reflect the new distribution of shares⁵⁰.

The conversion mechanism in the Russian model of convertible notes involves a set of transactions, such as a loan, offsetting of claims, notarization of the convertible note, an increase of the authorized charter capital following the general meeting of shareholders, and execution of a corporate agreement. Each of these steps must be certified by the notary public in a separate appointment with the in-person presence of all members of the company or their representatives acting based on the notarized power of attorney⁵¹. The average costs of notarization of the overall transaction equates to roughly \$2,500, excluding the costs of

⁵⁰ Despite that the actual submission of the documents must be made via the in-person visit of the relevant local Federal Tax Service office, all changes are immediately reflected on the official website of the USRLE (available at: <https://egrul.nalog.ru/index.html>). One can retrieve all information regarding the corporate structure, certain personal data of members of the company, their shares and contribution pertaining to it, and contact details of the company.

⁵¹ Articles 1, 2, 4 Law on Convertibles.

notarization of the power of attorney for the members represented by third persons. Furthermore, considering that the convertible note is quite unknown to the Russian legal order, there are no tested out reliable templates and standard forms for convertible notes. This leads to the necessity of addition of the costs of legal assistance in drafting and clarification of the terms of a subsequent convertible note to both the company and its investors.

At the same time, from the U.S. perspective the number of steps is limited to three – approval of the note by a board of directors, execution of the convertible note, and providing the investor with a stock certificate or issuance of notice upon conversion of the debt into equity. Every step is made on the corporate level through internal resolutions and actions of corporate officers unless the transaction involves publicly traded companies.

As a result, the red-tape procedure pertaining to the formation and enforcement of convertible notes in Russia lowers its cost efficiency thereby decreasing its attractiveness to both the company and its investors.

2.2.3. Statutory Limitations

The Law on Convertibles has exposed convertible notes executed on the territory of the Russian Federation mostly to four main statutory limitations. These include limitations as to the legal status of the parties able to enter into a convertible note, conversion price limitations, procedural limitations as to the implementation of a valid convertible note as well as limitations as to the term of investor's right to enforce a convertible note.

With regards to the first limitation, since the Russian model of convertible note was intended to be used by startup enterprises, it permits only two types of legal entities to be considered as a borrower, which are private joint stock companies and limited liability companies. However, companies (1) with a status of a credit organization, non-credit financial

institution, (2) of strategic importance for national defense and state security, (3) created in the process of privatization and whose shares are in state or municipal ownership providing more than 25% of votes at the general meeting of shareholders to such state or municipal members, are exempted from this limitation thereby making such companies able to enter into a note agreement as a borrower even if such company is registered as a public joint stock company⁵².

As to the limitations on the lender's side, any persons are entitled to participate as an investor under a convertible note, including those already admitted to the note-issuing company as shareholders or members. Nevertheless, in order to attract investments from any third party, limited liability companies must directly permit an increase in a charter capital through investments from a third-party non-member by means of contribution and subsequent admission to the company as a new member.

Another limitation imposed on convertible notes in Russia is the requirement to obtain preliminary approval of a convertible note from the shareholders or members of the note-issuing company. While for limited liability companies such approval must be unanimous⁵³, the need for unilateral approval of a convertible note by the general meeting of shareholders in case of joint stock companies is debatable. For instance, the preliminary consent to enter into a convertible note agreement should be acquired on the general meeting of the company's shareholders through a resolution approving the increase of a charter capital by placing additional shares through a private subscription to shares by the investor⁵⁴. A three-quarter majority vote of shareholders owning voting shares and present at the general meeting of shareholders is sufficient to pass a resolution to place additional shares by private subscription⁵⁵. Technically shareholders who voted against or did not participate in voting on

⁵² Article 32.3(1) JSC Law.

⁵³ Article 4 Law on Convertibles.

⁵⁴ Article 2 Law on Convertibles.

⁵⁵ Article 39(3) JSC Law.

the placement of shares by private subscription must have the preemptive right to purchase such shares or unambiguously deny such purchase⁵⁶. However, the decision to increase the charter capital by placing additional shares by private subscription pursuant to the convertible loan agreement is taken unanimously, in reality the shareholders do not have a preemptive right to purchase additional shares placed by the loan conversion.

Such discrepancy exposes convertible notes entered into in violation of the requirement to obtain a unanimous preliminary consent of the general meeting to the risk of rendering such agreement void in trial proceedings. The same outcome follows in case the decision of the members of a limited liability company was taken without irrevocable consent of every single member of the company.

For limited liability companies, such approval must be obtained on two separate meetings of members. The first meeting should be dedicated to the approval of a convertible note⁵⁷. After that, the second meeting should be devoted to the increase of the charter capital of the company through the admission of the investor as a new member through additional contribution after the commencement of a conversion event⁵⁸.

The third limitation involves the amount of time granted to the investor to enforce his or her right to convert the debt into the company's equity. This right must be exercised by the lender no later than three months after the maturity date of the convertible note or commencement of the conversion event⁵⁹. This time limitation can be reduced by the parties; however, at the same time, the extension of this period at the discretion of the parties is not allowed. As a result, if the investor does not exercise its right to convert the debt into company's

⁵⁶ Article 40(1.1) JSC Law.

⁵⁷ Article 19.1(9) LLC Law.

⁵⁸ Article 19.1 (10) LLC Law.

⁵⁹ Article 19.1(6) LLC Law.

equity within three months, it will lose its right to acquire shares of the note-issuing company even if such acquisition was properly approved by company's members. Accordingly, an investor will only be entitled to the repayment of the principal together with the accrued interest.

The last limitation applies to the conversion price. Unlike the U.S. model of convertible notes, where the conversion price is calculated based on the valuation cap, discount (if any), and company's capitalization, the Russian model presupposes that in case of private joint stock companies the conversion per share price is being determined in accordance with company's charter following the rule that the per share price in no case should be lower than the par value per one share⁶⁰. In case of limited liability companies, the conversion price is hardly calculatable since the sum of charter capital increase is not equal to the sum of investment, so in fact the calculation of a conversion price is always correlated with a nominal value of a share⁶¹.

For example, if a lender invests 8,000,000 RUB through the convertible note, its share's nominal value which adds up to charter capital upon conversion will equate roughly to 27,000 RUB, which constitutes approximately 0.34% of the actual sum of investment⁶². Nevertheless, the procedure for determining the above amounts may depend on the circumstances not incurred at the time of entering into the convertible loan agreement thereby making the conversion price more flexible⁶³.

⁶⁰ Article 37(3) JSC Law.

⁶¹ Article 14(2) LLC Law.

⁶² For this calculation the author of this thesis has used the terms of the actual convertible note prepared by her during her work at a law firm. While the specific data underlying the correlation of the actual contribution and the nominal value of the share is protected by the attorney-client privilege, there are several services available in Russian language providing for the possibility to calculate the correlation between the actual and nominal value of the share. See, for example, http://www.c-a.ru/ocenka_doli_OOO_on-line.htm.

⁶³ Article 19.1 LLC Law.

To summarize, despite the fact that the general characteristics of statutory limitations imposed in Russia seem to resemble the U.S. model, the essence of the limitations introduced in the Russian legislation places additional burdens on each party to the convertible note agreement thereby making it less practical and attractive in capital investments.

CHAPTER 3. MAJOR RISKS AND BLANK SPACES IN THE NEW RUSSIAN LAW ON CONVERTIBLES

Under the regulation that had existed prior to introduction of the Law on Convertibles, investors had the choice of either suing investee to recover losses or to compel the members of a business company to make the necessary corporate decisions to increase capital in order to transfer shares to the investor. However, either outcome imposed the higher risks of the investee's default on the investor, especially in case the investment recipient succeeded in its business.

Consequently, as it stems from the statistics provided in the explanatory note to the Law on Convertibles, 35% of transactions for investing in venture projects by Russia-domiciled investors were structured using the convertible loan model to invest in foreign companies, which corresponds to 70% of the total investment in such projects⁶⁴. The rationale behind such shift towards foreign jurisdictions lies within the absence of protection for investors. Therefore, the creation of a transparent mechanism of investment in companies using the convertible notes was ought to stimulate the growth of private investment in startup enterprises.

The main policy reason behind this law was to refocus the attention of investors from foreign jurisdictions to Russian capital market by introducing new instruments of venture financing that are well-known to investors from prosperous capital markets. According to the expert surveys carried out by the Foundation for Internet Initiatives published as a part of the explanatory note, in case of successful solution of existing problems, up to 90% of transaction would be transferred to Russia⁶⁵.

⁶⁴ See fn. 1.

⁶⁵ Ibid.

Nevertheless, as it will be described in the following sections, through the prism of practical and doctrinal assessment, the Law on Convertibles was drafted with a key system error in the qualification of the emerging relations. As a result, disadvantages and risks of the Russian model of convertible notes in general are similar to the already actively used instruments of pledging a participant's share upon receiving a loan by the company, as well as the classical disproportionate increase of the authorized capital.

The main problem in all such cases is not the complete absence of a legal framework but rather the flaws of existing corporate governance structure adopted in Russia. In this regard, the following sections will show how these flaws still affect the possibility of enforcement of convertible notes in Russia even after the introduction of the Law on Convertibles.

3.1. Forced Conversion

As was discussed in a previous chapter, the Russian model of convertible notes does not provide for the automatic conversion of the principal sum into the shares. The absence of such mechanism imposes a considerable burden on each party and puts the interests of an investor under the threat.

Following the rule of law, the investor is entitled to request a capital increase following a conversion event by submitting such application to the notary public. At the same time the investment recipient has a right to submit its objections to conversion, either justified or unjustified, to the notary public within 14 days following such application⁶⁶. In case the investee exercises such right, the notary public is obliged to pause the process of conversion until the resolution of the dispute and deny the transfer of information regarding the capital restructuring to the tax and registration authorities⁶⁷. If investor does not agree with such

⁶⁶ Article 19.1(18) LLC Law.

⁶⁷ Article 103.13(5) of the Fundamentals of Legislation of the Russian Federation on Notarial System, approved by the Resolution of the Supreme Court of the Russian Federation N 4462-1 as of February 11, 1993.

objections the lender has a right to initiate court proceedings in order to force the investee to convert the debt into company's equity⁶⁸.

At a first glance, such option is intended to safeguard investor's interests in acquiring shares of the investment recipient. For the lender such action leads to an immediate termination of the convertible note by offsetting the counterclaim through the conversion of the principal sum into the equity once the decision was rendered by the court. The corresponding payment of the charter capital might be ordered to be made by setting off lender's monetary claims to the borrower under the convertible loan agreement.

Interestingly, from the standpoint of the classical Russian civil jurisprudence approach, the possibility to set-off the immature claims does not fully correspond to the classic model of counterclaim set-off. According to the general rule, the claim is subject to set-off only after the due date for such claims becomes effective unless otherwise is provided for by law⁶⁹. Nevertheless, the convertible note falls within the scope of this exemption, so the set-off of immature counterclaims is permissible even though the due of the underlying obligations have not yet matured. Prior to the adoption of the Law on Convertibles, Russian legislation has acknowledged only one exemption from the general rule of impossibility to set-off the immature claims. Such exemption covered the pledge of property, so the premature set-off of claims was permitted only in case of breach of the pledge agreement or loss, withdrawal, or destruction of the pledged item⁷⁰. Consequently, it is nearly impossible to predict the practical implications of setting off premature claims within the outline of convertible notes given the complete absence of similar mechanisms adopted with regards to corporate law peculiarities.

⁶⁸ Article 19.1(20) LLC Law.

⁶⁹ Article 410 CC RF.

⁷⁰ Art. 351 CC RF.

As per the company's members, such conversion will result in a considerable reduction of their corporate rights following the decrease of the ownership percentage. Accordingly, in case the investor enforces its right to convert the note, the share capital will be in accordance with the resolution of the general meeting of members of the investee and the terms of a convertible note. Following such non-proportional increase in the share capital, the distribution of corporate rights among the remaining participants will change considerably.

However, it is obvious that in case investee exercises its legal rights in order to postpone or cancel the conversion, the forced conversion might lead to the psychological disturbance of the relationships between the company's members thereby giving rise to in-corporate conflict. This conclusion is especially true considering that minority shareholders in both limited liability companies and private joint-stock companies still have the right to object to the decisions requiring a unanimous consent of all members, including those related to attracting new investments through the increase of the authorized charter capital. As a result, forced conversion of a convertible note might be destructive for the company economically because Russian corporate governance mechanisms do not provide for the effective ways of resolution of corporate conflicts.

3.2. Dilution of Ownership Percentage

In case of dilution of ownership percentage, it is clearly distinguishable that the current tendencies in development of the concept of convertible notes in Russia give rise to another ground of a corporate conflict. According to the functional matter of the convertible note, investor grants a loan to company to fund its operations; however, in fact the offsetting of the monetary claims of the investor during the conversion process will be provided not by the company but by its members.

In particular, if we assume that some hypothetical limited liability company has 4 initial members with equal ownership percentage equal to 25% per member. The company also has a third-party investor who has a contractually substantiated right to demand a conversion into 50% of company's shares or repayment of the principal sum equal to 5,000,000 RUB resulting from an earlier investment through the convertible note. Upon conversion of the debt into equity under the said convertible note, the investor will be the owner of 50% of the company's shares, while the shares of other four members will reduce by 50% each thereby making such members the owners of 12,5% of the company. As a consequence, the corporate rights of initial members as well as the weight of their votes during the process of resolution of ongoing corporate issues will drastically decrease.

In this regard, it is not yet clear as to how the Russian model of convertible note conforms with the economic rationale underlying the origin of convertible securities developed in the U.S. and adopted in Russia. The explanatory note to the draft law stipulates the purpose of introduction of convertible notes into the Russian legislation system as follows:

“Stimulation of the growth of investment in small and medium-sized enterprises, especially in high-tech projects, which require significant support at the earliest stages of development, by creating a legal mechanism to balance the interests of the investor and recipient.”⁷¹

However, what we see in fact is a key system error in the qualification of the emerging relations. Considering that in case of conversion on the terms similar to the ones described in the hypothetical above the controlling participants will lose their status due to severe dilution of shares, such dilution might negatively affect the corporate governance since the guiding role in decision-making process will be transferred to the investor. While it might be helpful in

⁷¹ See fn. 1.

extremely rare cases where investors have a deep knowledge related to the course of investee's business operations and might guide the company towards the growth, in case of investments in larger ventures the situation can change dramatically.

For instance, in most medium-sized and large limited liability companies the members involved are not only natural persons but also legal entities whose executive body has a fiduciary duty combined with a duty to report all decisions taken by the subsidiary to its members. Eventually, the loss of control over a subsidiary resulting from a conversion of debt into equity through a valid convertible note will most likely be qualified as an unjustified business decision thereby making such executive officers subject to liability incurred through such decisions⁷². Such situation potentially leads to the development of a corporate conflict not only in the investee's company but also in its parent or member entity.

Nevertheless, the potential negative effects of conversion are substantially minimized in case of conversion of the debt into the shares of the private joint-stock company since such conversion is usually conditioned by the obligation of the investee to provide investor with the shares of non-voting preferred stock. Such distribution ensures that the control over the company's decisions will remain with the limited range of holders of shares of common stock thereby preventing massive corporate conflicts. However, at the same time, the issuance of new shares for the purposes of raising capital through attracting additional investments involves voting by holders of shares of both common and preferred stock⁷³, therefore, leaving the issue of obstruction of corporate decisions related to new investments unresolved.

⁷² Decision of the Arbitration Court of Khanty-Mansiysk Autonomous District – Yugra on case No. A75-2374/2008 as of August 16, 2008; Rubeko G.L. Legal status of governing bodies of joint-stock companies. Statut, 2007.

⁷³

As it can be clearly drawn from the analysis above, convertible notes are relatively beneficial for both parties only in case of their implementation into the corporate structure of private joint-stock companies. Such implementation into the corporate structure of limited liability companies will most likely lead to the series of corporate conflicts preventing the company from concentrating on the development towards its business goals. Instead, businesses will have to concentrate on resolving an eternal number of conflicts inside the company caused by existing flaws of the system of the Russian corporate law.

3.3. The Cure

One of the possible solutions to the problems discussed above is to create a specific legal exemption from red-tape regulation at least for startups operating in the field of top-notch technological products and services. From the first glance introduction of such exemption seems impossible due to the overall slowness and rigidity of the Russian legislative mechanism. Nevertheless, recent amendments to the legislation regulating the status of Skolkovo Innovation Centre (“Skolkovo”)⁷⁴ show that in certain circumstances statutory limitations could be shifted or minimized for the sake of growth and development of innovative and progressive initiatives.

For example, in order to minimize red-tape restrictions preventing researchers and highly technological startups from development, Russian legislators created a body called “managing company,” towards which they shifted several powers of governmental and municipal authorities. As a result, the management company is vested with a power to issue normative acts failure to perform which may invoke imposition of certain sanctions⁷⁵.

⁷⁴ Skolkovo is a Russian analogue of the U.S. Silicon Valley establishing an entrepreneurial ecosystem for startups operating in five major fields: energy efficiency, strategic computer technologies, biomedicine, nuclear technologies, and space technologies. See <https://www.skolkovo.ru>; <https://old.sk.ru/foundation/about/>.

⁷⁵ Art. 7 of the Federal Law No. 244-FZ as of September 28, 2010, “On the Skolkovo Innovation Center”.

Following the same path and in order to pursue the same goal of supporting development of growing small technological businesses, it seems obvious that it is necessary to exempt certain companies satisfying particular criteria from the mentioned highly bureaucratic procedures. Similarly to Skolkovo residents, it is possible to establish a specific group of companies subject to specific regulation in the field of venture capital investments and outline the criteria upon meeting of which the company could be considered as exempted. In particular, the following procedural and administrative requirements are proposed to be lifted:

(1) *The necessity to conduct two separate meetings of shareholders before execution of the note agreement as well as before its actual conversion into company's shares.* To protect the interests of investors and to reduce the need for forced conversion, decisions related to both execution and conversion of the note should be taken simultaneously. For the investee, such change will reduce additional paperwork and the necessity to revert to notary public to legalize the documents involved into the transaction several times. As a result of reduction of corporate meetings, the need for the forced conversion upon occurrence of a conversion event will decrease drastically.

(2) *The requirement to submit certain documents involved into the convertible note transaction to notary public for legalization and further registration.* Further on, such changes will also uphold the possibility of semi-automatic conversion of the note without the need to revert to notary public to register the increase in company's charter capital. As a result, the conversion will occur immediately upon commencement of a conversion event by means of a plain notice of conversion issued on the books of the company semi-similarly to the U.S. model.

(3) *The requirement of regulation and dividing corporate rights and obligations only by means of a corporate agreement.* In order to solve the issue with the control to be transferred to investor upon conversion of a note, it is necessary to distinguish the scope of

rights between several types of company's shareholders, i. e. founders and investors. Currently such distinction could only be established within a corporate agreement, while in the U.S. the rights of investors regarding corporate governance can be established in the very text of the note.

However, it should be noted that proposed changes are not aimed at all companies in general, but rather on companies conforming with the following criteria of micro and small enterprises:

- (1) Company has no shareholders that are public entities, governmental authorities, and non-profit organizations;
- (2) Company's shares are not traded publicly;
- (3) The number of company's employees does not exceed 100; and
- (4) Company's annual revenue does not exceed 800,000,000 RUB⁷⁶.

Upon adoption of such mechanism, the overall system of implementation of convertible notes within the framework of venture capital investments in Russia will resemble those applicable to C-corporations in the U.S. under Regulation S and Regulation D. As a result, since C-corporation, especially Delaware ones, are commonly used by Russian startup founders to attract investments, such changes will help to achieve the goals primarily put before the Russian legislators prior to the introduction of the Law on Convertibles.

⁷⁶ Article 4 of Federal Law No. 209-FZ as of July 24, 2007, "On the development of small and medium-sized businesses in the Russian Federation".

CONCLUSION

As it stems from the analysis above, disadvantages and risks of the Russian model of convertible notes in general are similar to the already actively used instruments of pledging a participant's share upon receiving a loan by the company, as well as the classical disproportionate increase of the authorized capital.

The same economic objectives were also achievable with the help of available legal instruments before the introduction of the Law on Convertibles. One can hardly expect a drastic rise in the use of convertible notes since the main problem in all such cases is not the complete absence of a legal framework but rather the flaws of existing corporate governance structure adopted in Russia. In particular, the issue of loss of corporate control and members' ability to participate in corporate management was not resolved and no solutions were proposed by the legislators rather than formation of a highly detailed corporate agreements. For corporate system that has traditionally developed in Russia, this approach to financing is not very typical. In Russian corporate system, businesses prefer to seek financing for corporate projects without the loss of corporate control, such as obtaining loans, issuing bonds, entering into leasing agreements, establishing installment payments with traditional financial institutions, etc⁷⁷.

In instances where it is important for the parties to establish a legal connection between themselves, but there is still no clarity about the subject and content of the future commitment, the conclusion of a contract with a *obligatio incerti*⁷⁸ allowed the parties to plan their activities, while retaining considerable freedom of maneuver, even prior to the introduction of the Law on Convertibles.

⁷⁷ Inshakova A. O., Kagalnitskova N.V. Venture capital as a basis for financing small and medium entrepreneurship in nanotechnology in an unfavorable economic environment: the legal aspect. *Vlast' Zakona* No. 2 (34), 2018.

⁷⁸ Undefined obligation.

As it was discussed in Chapter 3 of this thesis, current legal framework of the implementation of venture capital instruments, including convertible notes, is highly unwelcoming to small and startup companies. Consequently, we face a strong need in liberalization of the red-tape requirements to pursue the goals set for the implementation of the Law on Convertibles.

In particular, certain restrictions have to be lifted in order to make the Russian model of convertible notes resemblant to the one adopted in the US. These restrictions invoke (1) the need of multiple notarized actions to convert a debt into equity and (2) the impossibility to impose certain restrictions on the rights and obligations of the parties by means of a single instrument – convertible note.

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