

## Federal Law No. 354-FZ: new rules governing convertible loans

According to the annual rating IFLR1000 2019, EY Russia Law was ranked as a **leading law firm** in the categories: *Corporate law: mergers and acquisitions, PPP and Private Financing, Project Development: Power Generation and Restructuring and Insolvency.*

Follow us



[facebook.com/groups/EYLawRussia/](https://facebook.com/groups/EYLawRussia/)

Federal Law No. 354-FZ of 2 July 2021 "On Amendments to Certain Legislative Acts of the Russian Federation" (hereinafter, "the Law"), which introduces provisions regarding convertible loans as an instrument of investment to Russian legislation, came into force on 13 July 2021. The Law makes amendments to the following acts:

- ▶ The Fundamental Principles of the Legislation of the Russian Federation Concerning Notaries (Law No. 4462-1 of 11 February 1993)
- ▶ Federal Law No. 208-FZ of 26 December 1995 "Concerning Joint Stock Companies"
- ▶ Federal Law No. 39-FZ of 22 April 1996 "Concerning the Securities Market"
- ▶ Federal Law No. 14-FZ of 8 February 1998 "Concerning Limited Liability Companies"
- ▶ Federal Law No. 129-FZ of 8 August 2001 "Concerning the State Registration of Legal Entities and Private Entrepreneurs"

## Purpose of the Law

Convertible loan mechanisms are nothing new and are widely used in foreign jurisdictions. According to information supplied by the authors of the law, the world's top venture funds make up to 35% of their investments through convertible loan arrangements. In Russia, however, the lack of direct regulation of this mechanism or safeguards for the parties to such agreements has forced many start-ups to apply for foreign financing, making their arrangements subject to foreign law, or to seek work-arounds and mechanisms provided for in Russian law, which placed major constraints on business activity and the development of domestic start-ups. The new Law is intended to address this problem, stimulate the growth of private investments in business projects at the initial stages and balance the interests of the investor and the investment recipient, particularly in the area of high-risk high-technology projects.

## What's new?

### 1. Essence of a convertible loan

A convertible loan is a loan taken out by a business company that gives the lender the right to opt for the acquisition of an equity interest in that company in place of repayment of the loan principal and interest (or part of the loan principal and interest due) when a certain date specified in the agreement is reached and (or) other events occur.

The acquisition of the equity interest occurs as follows:

Joint stock companies (non-public)	Limited liability companies
The acquisition of the equity interest occurs through the allocation to the lender of shares of a particular class (type) by means of a private subscription, i.e., charter capital is increased by means of an issue (additional issue) of shares.	The acquisition of the equity interest occurs through an increase of charter capital and the acquisition of an ownership share (an increase in the amount of an ownership share if the lender is a member of the company) accompanied by a reduction of the ownership shares of company members.

### 2. Restrictions on attracting investments through a convertible loan

In accordance with the Law, the following types of companies are barred from acting as borrowers under convertible loan agreements:

- ▶ public joint stock companies
- ▶ credit organizations
- ▶ non-credit financial organizations
- ▶ companies that are of strategic significance for national defence and state security
- ▶ companies that were created in the process of privatization and whose shares are state or municipally owned and account for more than 25 per cent of votes at the general meeting of shareholders

The charter of a limited liability company may restrict third parties that are not company members from acting as lenders.

### 3. Conditions and procedure for raising investments through a convertible loan

#### *General conditions for joint stock companies and limited liability companies:*

- ▶ The general meeting of members/shareholders must give unanimous prior consent to the conclusion of a convertible loan agreement by all members (all shareholders holding all classes/types of shares) by passing a decision to increase charter capital. The decision must set out all the essential terms of the convertible loan agreement and the parties to the convertible loan agreement.
- ▶ The essential terms of a convertible loan agreement (besides the essential terms of the loan agreement itself) include:
  - ▶ the date and/or other events at the occurrence of which the lender has the right to present a demand to acquire an equity interest
  - ▶ the amount or method for determining the amount of the nominal value of the equity interest

to be acquired by the lender (in the case of an LLC) / the price at which additional shares will be issued pursuant to the convertible loan agreement or the method for determining it (in the case of a JSC)

- ▶ Information on the conclusion of the convertible loan agreement must be entered in the Unified State Register of Legal Entities (USRLE) (in the case of an LLC the information is entered by the notary who registers the convertible loan agreement; in the case of a JSC it is entered by the register-keeper).
- ▶ A demand to acquire an equity interest in a company may be presented by the lender within three months (unless the convertible loan agreement specifies a lesser period) after the occurrence of the date and/or other events that trigger the lender's right (in the case of an LLC the demand is presented to the notary; in the case of a JSC it is presented to the register-keeper).
- ▶ The lender's claims against the borrower under the convertible loan agreement are offset against the cost of the equity interest/shares in the company acquired by the lender.
- ▶ If no objections are raised by the company and its members/shareholders, the notary will make amendments to information in the USRLE to reflect the increase in charter capital and the acquisition of an

equity interest by the lender (in the case of an LLC) / the register-keeper will allocate shares to the lender (in the case of a JSC). If the lender's demand is not met, the lender may seek to enforce its rights through the courts.

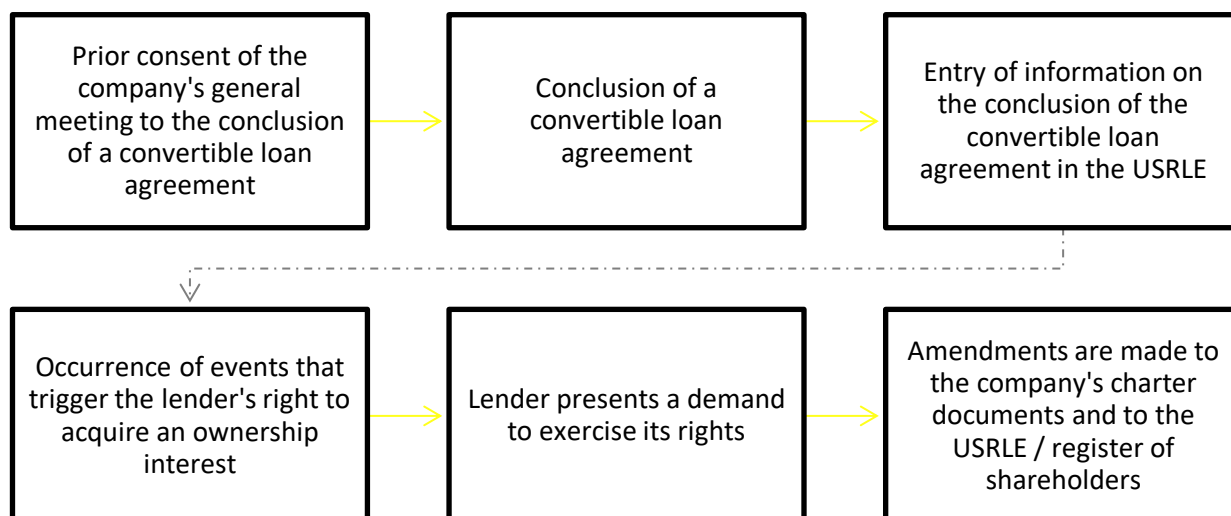
#### ***Particular aspects of the conclusion of a convertible loan agreement***

The Law requires the participation of a notary in the process of the conclusion and performance of a convertible loan agreement in which the borrower is a limited liability company. A convertible loan agreement must be concluded in written notarial form by means of the drawing up of a single document signed by the parties. Failure to meet the notarial form requirement will render the agreement void.

#### ***Other features of a convertible loan agreement***

As a rule, if the lender assigns rights under the convertible loan agreement the equity interest does not pass to the assignee (unless otherwise provided by the convertible loan agreement or an agreement on the assignment of the right to compulsory acquisition of an interest, which must likewise be unanimously approved by the general meeting of members/shareholders).

#### **4. Process of the acquisition of an ownership share in a company with the aid of a convertible loan agreement**



### What are the implications?

The changes made by the Law will aid the development of Russia's investment and business infrastructure. They provide a convenient mechanism that accommodates the interests both of the investment recipient, which needs immediate access to funds for its development with a minimum of delay and difficulty in obtaining investments, and of the investor, which has a choice of options for the settlement of its claim on the borrower depending on the borrower's economic

performance and development. The authors of the Law predict that the use of convertible loans should soon account for between 70% and 90% of transactions and will fuel a large percentage of successful business projects.

#### *Authors:*

*Georgy Kovalenko  
Angelina Travianko  
Elizaveta Inzartseva*

For more information, contact the author of this publication:

**Georgy Kovalenko**  
+ 7 (495) 287 6511  
[Georgy.Kovalenko@ru.ey.com](mailto:Georgy.Kovalenko@ru.ey.com)

## Inquiries may be directed to one of the following executives:

### Moscow

CIS Tax & Law Leader  
Irina Bykhovskaya +7 (495) 755 9886

Oil & Gas, Power & Utilities  
Alexei Ryabov +7 (495) 641 2913  
Marina Belyakova +7 (495) 755 9948

Financial Services  
Irina Bykhovskaya +7 (495) 755 9886  
Alexei Kuznetsov +7 (495) 755 9687  
Maria Frolova +7 (495) 641 2997  
Ivan Sychev +7 (495) 755 9795

Advanced Manufacturing & Mobility  
Andrei Sulin +7 (495) 755 9743

Consumer Products & Retail, Life Sciences & Healthcare  
Dmitry Khalilov +7 (495) 755 9757

Real Estate, Hospitality & Construction, Infrastructure,  
Transportation  
Anna Strelnichenko +7 (495) 705 9744

Technology, Telecommunications, Media &  
Entertainment; Tax Performance Advisory  
Ivan Rodionov +7 (495) 755 9719

Tax Technology  
Andrei Ignatov +7 (495) 755 9694

People Advisory Services  
Ekaterina Ukhova +7 (495) 641 2932  
Gueladjo Dicko +7 (495) 755 9961  
Sergei Makeev +7 (495) 755 9707

Private Client Services  
Anton Ionov +7 (495) 755 9747  
Dmitri Babiner +7 (812) 703 7839

Customs & Indirect Tax  
Vadim Ilyin +7 (495) 648 9670

International Tax and Transaction Services  
Yuri Nechuyatov +7 (495) 664 7884  
Vladimir Zheltonogov +7 (495) 705 9737

Transfer Pricing and Operating Model Effectiveness  
Evgenia Veter +7 (495) 660 4880  
Maxim Maximov +7 (495) 662 9317

Tax Policy & Controversy  
Alexandra Lobova +7 (495) 705 9730  
Alexei Nesterenko +7 (495) 622 9319

Global Compliance and Reporting  
Yulia Timonina +7 (495) 755 9838  
Alexei Malenkin +7 (495) 755 9898

Law  
Georgy Kovalenko +7 (495) 287 6511  
Alexey Markov +7 (495) 641 2965  
Pavel Koutovoi +7 (495) 664 7899

**St. Petersburg**  
Dmitri Babiner +7 (812) 703 7839

**Vladivostok**  
Alexey Erokhin +7 (914) 727 1174

**Ekaterinburg**  
Irina Borodina +7 (343) 378 4900

**Krasnodar**  
Alexei Malenkin +7 (495) 755 9898  
Alexei Nesterenko +7 (495) 622 9319

For information about Foreign Countries Business  
centers in EY Moscow office please follow the [link](#).

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.

## EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via [ey.com/privacy](https://ey.com/privacy). For more information about our organization, please visit [ey.com](https://ey.com).

EY works together with companies across the CIS and assists them in realizing their business goals. 5,500 professionals work at 19 CIS offices (in Moscow, Ekaterinburg, Kazan, Krasnodar, Novosibirsk, Rostov-on-Don, St. Petersburg, Togliatti, Vladivostok, Almaty, Atyrau, Nur-Sultan, Baku, Bishkek, Kyiv, Minsk, Tashkent, Tbilisi, Yerevan).

© 2021 Ernst & Young Valuation and Advisory Services LLC

ED None.

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global EY organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.

[ey.com/ru](https://ey.com/ru)