

I. The need to adopt a new form of incorporation

Recent amendments (August 1st, 2023) to the Commerce Act of the Republic of Bulgaria enable the creation of a new, sixth type of business entity: the Variable Capital Company (VCC).

The rationale for introducing this type of company derives from the fact that a startup business, as one that seeks rapid economic growth, needs a new form of incorporation that would be as attainable as an LLC while at the same time benefitting from the advantages of the purely capital nature of a JSC. While the most preferred legal form of incorporation of a startup company is the LLC, owing to the low minimum capital required, such a company cannot satisfy the requirements associated with the performance of an innovative small enterprise.

II. A partnership or an incorporated entity?

While the new term 'variable capital company' has been added to CA article 64 (1), subpar. 6, where the forms of incorporation allowed under the Commerce Act are listed, paragraph 3 of the same clause remains unchanged, failing to determine whether the newly adopted variable capital company should be defined as a partnership or an incorporated entity. A VCC should, in our view, be defined as an incorporated entity; below are some arguments in support of that determination:

- Firstly, if we interpret ex contrario the provision of CA article 263т (8), namely: 'Where a variable capital company is involved in a conversion, the rules governing partnerships shall apply to it', had the legislator regarded the new type of entity as a partnership, such a reference would hardly be necessary.
- Pursuant to the provision of CA article 260ю, if a company is found to have an average payroll of over 50 employees and an annual turnover or total assets in excess of BGN 4 million, a variable capital company would no longer be able to exist in that form and should mandatorily be converted to an LLC or a JSC. Such a mandatory conversion would bring the VCC closer to an incorporated entity.
- Lastly, the law prescribes no personal, joint or unlimited liability for the partners in a VCC, i.e., one of the defining elements of a partnership is missing. No matter that the law contains no provision to the contrary either, i.e., the partners in a VCC have limited liability to the company's creditors, we can assume that their liability is indeed limited as a result of the

separation of the company's assets from those of its members, and if anything else were applicable, it would have been explicitly provided in the law.

III. Capital.

While 'capital' is a legal term – cf. CA article 161 (1)-(4), it has no legal definition. Capital is a quantifiable value that reflects the contributions made by the partners/shareholders.

The most significant difference between the newly introduced variable capital company and the LLC or JSC concerns their capital. In an LLC or a JSC the capital is defined as static, i.e., it is stated in the articles of association or the company statutes and recorded in the Commercial Register, and any changes in, or re-distribution of, such capital is only possible by way of a formal procedure.

In a VCC the capital is variable, i.e., it is not fixed by the articles of association and is not recorded in the CR. This peculiarity of a VCC makes it similar to the capital of a cooperative enterprise (cf. article 1 of the Law on Cooperatives).

The capital is divided into shares of nominal value; though variable, it does have value. The value of the capital can be established at any moment in time. The law imposes an obligation upon the annual general meeting convened to review the annual financial statement (AFS) to establish the value of the capital upon closure of the fiscal year and any changes in it over the preceding fiscal year. The obligation of the regular general meeting to determine the value of the capital is significant, firstly, as it enables the meeting to approve the AFS, and secondly, as a basis for determining the corporate tax owed by the company in relation to the AFS.

The partners' contributions to the company can be financial or non-financial (in kind). The procedure of making in-kind contributions is simplified in the extreme, with the evaluation of the assets contributed being entrusted to appraisers hired by the company's management body.

IV. Company share.

1. Manner of transferring a company share

Comparison between VCC and LLC:

Limited Liability Company Variable Capital Company

While capital can be freely transferred between partners, when it is to be transferred to a

third party, the company must apply the procedure of admitting a new partner. The principle of free transferability of company shares applies, unless otherwise provided in the articles of association.

A written form is provided that must be notarized in terms of signature and content. The form of validity is simplified in comparison with the LLC: a written form requiring notarization of signatures.

The freedom of negotiation among partners is limited and it is forbidden to claim that a written form only is sufficient. The articles of association may provide that a written form is sufficient for the transfer of company shares.

In a JSC, the principle of free transferability of shares also applies, except for shares that are vinculated (tied, of restricted transferability).

2. Inheriting a company share

Company shares may be inheritable, unless otherwise provided in the articles of association by agreement among the partners. To become partners in the company, the heirs to a deceased partner must apply within a 3-month limitation period from the inheritance becoming open; failing to do so will result in the company compensating them to the extent of the cash value of the company share of the deceased at the time of their death.

Here again, there is a difference between a VCC and an LLC, where a company may refuse to admit an heir as a partner. There is constant case law of the Supreme Court of Cassation ruling that, when seeking to inherit a company share, an heir must follow the procedure of admission of a new partner – filing under CA article 122, decision of the General Partners' Meeting/Sole Owner of the Capital (cf. SCC Ruling No. 161/11.01.2011 passed in respect of Commercial Case No. 28/2010, Commercial College, 1st Commercial Division of the Supreme Court of Cassation).

In the case of a VCC, in principle, where an heir has exercised their conversion right in due course and within the time period provided by law, the company cannot refuse to admit them as a partner.

3. Acquiring a company share (option pools).

Following the pattern of the JSC, the Commerce Act allows the newly introduced variable capital company to possess its own shares.

The purpose is for the company to be in a position to accord to hired personnel the right to acquire shares, which can only be exercised if the company transfers its own shares to them. Such transferable shares are called 'option pools'. Since more often than not a startup company is largely a high-risk business venture, these option pools provide an incentive for ambitious individuals to become employees and sign a so-called options or vesting contract. By virtue of signing a vesting contract employees may acquire up to 15% of all shares in a VCC subject to satisfying certain conditions and following a certain period of time. Among the conditions a VCC may determine for becoming a partner can be a certain length of service with the company or a certain level of performance. The strike price at which the company issues shares is determined in advance and is usually lower than their market value, the idea being for the employer to incentivize more ambitious employees to assume personal responsibility and become more engaged in the prosperity of the business enterprise.

4. Preferred shares

Another similarity between a VCC and a JSC is the option for the company to issue shares with various preferences, including to employees, for example having more than one vote in the general partners' meeting, or carrying additional or guaranteed dividend. Partners cannot enjoy different rights within the same class of shares.

5. Convertible shares.

The law explicitly allows a VCC to enter into a loan agreement with another person or entity with the option of converting and repaying the amount of the loan in company shares.

More information on convertible loans can be found in this article at the following link <https://www.legaldl.com/en/convertible-loan/>.

6. Obligations and restrictions concerning the sale of shares (drag-along; tag-along; right of first refusal).

Here contractual practice precedes regulation, with these mechanisms being practiced thus far without being governed by legislation. The one exception is the 'right of first refusal' clause, which strongly resembles vinculated shares.

6.1. The right of first refusal amounts to the option, whenever a partner initiates transfer of shares in their possession, for other partners to acquire such shares subject to no less favorable terms and conditions before said shares are offered to a third party.

6.2. The drag along / co-sale right allows a majority shareholder to obligate the remaining minority shareholders to accept a third-party offer to acquire the entire company. The mechanism of a drag-along agreement is reviewed in detail in this article at the following link <https://www.legaldl.com/en/drag-along-clause-in-relations-between-content//>.

6.3. The tag along right is a mirror-image option to the drag-along, whereby non-transferring partners may require the third party to acquire their company shares subject to the same terms and conditions.

V. Rights and obligations of partners. Consequences of non-compliance.

1. There is nothing out of the ordinary as far as the partners' rights and obligations are concerned. The law stipulates the familiar right to receive a dividend, a liquidation quota etc., and in that respect a variable capital company resembles more strongly an LLC.

2. The logic of expelling a partner similarly follows that for an LLC. The only grounds on which a partner can be expelled is failure on their part to make the contribution due to the company. The voting rights of a partner pending expulsion are suspended when calculating the quorum for a general meeting or the majority of a vote, but such suspension creates practical problems, as it makes it possible for a minority shareholder to expel a majority one. Conversely, if the voting rights of a partner pending expulsion were not suspended, this would likewise create problems, because in such a situation a majority shareholder could never be expelled. The law also provides an option for a partner to quit; such an option exists in an LLC but not in a JSC.

VI. Shareholders book.

Just like a joint stock company keeps a shareholders' book, the newly introduced varying capital company is mandated to keep a partners' book, which constitutes a private certification document. Entering an entity into that book does not have a constituting effect, i.e., partners acquire membership rights outside and independently of their being entered therein.

The partners must have access to the information in the book, so each one of them is entitled to request a transcript. Third parties applying for access to the information in the partners' book must prove they have a legal interest in doing so. The reason for third parties to be granted access to the partners' book is that the names of partners and their shares in the

company capital are not recorded in the Commercial Register, whereas the whole idea behind public registers is to provide protection to third parties. This is why third parties may request, and be granted, information as to whether a particular person is a partner in the company and about the nominal value of their share. Such a legal interest may arise if, for example, a partner offers shares in a VCC as collateral; or if enforcement proceedings are underway or if a third party chooses to initiate enforcement proceedings against a partner's share, etc.

VII. Structure and bodies of management

The new variable capital company is based on the principle of autonomy of will in determining the structure, competences and functioning of its management bodies.

1. General Meeting

While in terms of its competences, the General Meeting is not substantially different from similar bodies in an LLC or a JSC, the procedure of convening and conducting it is updated and administratively simplified.

1.1. The General Meeting is convened by the management body of the company, whether at its own initiative or upon request by 5% of the partners. Failure by the management board/manager of the company to satisfy a request by the minority to convene a general meeting will result in the partners themselves recording an invitation to that meeting in the Commercial Register. Unlike the provision of CA article 223 (2) concerning a joint stock company, whereby refusal by management to convene a general shareholders' meeting may result in shareholders filing a request for legal assistance with the District Court, in a VCC there is no requirement for a court intervention.

1.2. A novelty in corporate law is the option to convene a general meeting online, have online participation and cast an electronic vote.

2. Governance.

2.1. The underlying principle is that the company is governed by a collective management body, but unlike a JSC, the law does not prescribe a minimum number of members of that governing body, i.e., at least two. A VCC may also be governed by a single manager, but this must be explicitly provided in the articles of association. Besides, the manager or any member of the management board may also be a legal entity.

2.2. Following the model of a JSC, if a collective governing body is provided for, one or two of its members can be entrusted to represent it.

2.3. Responsibilities of board members.

Due diligence of a good merchant is required of all board members. All board members are to be held jointly liable to creditors for any damages sustained by the company.

Whether the liability of board members should be contractual or tort, is debatable. The prevailing opinion is that theirs should be a special tort liability, because it is a type of liability to third-parties.

VIII. Summary.

It follows from all of the above that the newly introduced variable capital company has been conceived as an incorporated entity that will engage in small-scale economic activity, inasmuch as its scope of application is quite limited: it can only exist as a small or micro enterprise, and if it attracts larger investments, it should mandatorily be converted into another type of capital company.

The new variable capital company combines the advantages of an LLC and a JSC. Although conceptually (through the use of terms such as 'share' and 'partner') it more closely resembles an LLC, a VCC is closer to a JSC owing to its ability to acquire its own shares, issue shares, categorize its shares in different classes etc.

In conclusion, the key benefits of a VCC are: A. The lack of obligation for the company to record its capital and partners in the Commercial Register; B. The possibility for unrestricted transfer of shares; C. The option to issue preferred shares; D. Some obligations and restrictions pertaining to the sale of shares (tag-along, drag-along, etc.); and E. The possibility for employees to enter into agreements with the company on the acquisition of shares.