In Bulgaria, like in other countries, the convertible loan become an increasingly common instrument to have start-ups financed by an investor who is a party external to the company.

The subject-matter of a convertible loan agreement is the lending of funds on condition of repayment or conversion into equity or shares of the borrower at a future date. Unlike direct capital investment, a convertible loan is a debt financing instrument through which the borrower could absorb the funds much faster, and which is characterized by deferred acquisition of equity by the investor. Acquisition takes place upon the loan maturity date at a price agreed in advance or, more frequently, in the case of a subsequent "qualifying investment" by another investor at a further investment round, at a discount on the par value of the shares/the equity market value (typically around 20–25 percent). This is precisely what determines the investor's interest in providing a convertible loan to a company at an early stage of its development.

It is essential for the parties to set out the conditions, including the thresholds, under which the loan is subject to conversion. The investor is interested in negotiating higher threshold amount of the subsequent investment to make it a qualified investment since the objective is to acquire equity in a company with a promising business and financial stability. On the other hand, it is in the interest of the borrower/investee to agree on a realistic and feasible amount.

The typical maturity is up to 24 months, which depends on the use of the convertible loan as a bridge financing instrument before a subsequent qualifying round of equity funding. It is justifiable to anticipate that over this period the company will have developed enough to enable a qualifying investment round. Convertible loans are interest-bearing and it is a common practice to negotiate a one-off payment of the interest accrued on the maturity date rather than to make regular interest payments. It is possible, although not necessary, for a preliminary evaluation of the company to be made but it would be rather difficult to evaluate it at its early development stages.

It is a common practice to include a clause that the borrower may repay the loan earlier, before its maturity date, only with the consent of the lender or in the cases in which the loan becomes callable due to default or other circumstances agreed explicitly between the parties, e.g. change of control, adverse material change of the company's condition, etc. This

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practice is based on the lender's interest in acquiring equity for investment purposes.

The essential provisions of a convertible loan agreement cover the rights and obligations of the parties before and after the equity acquisition by the investor. Prior to the conversion of the loan into equity, the investor is entitled to information about the condition of the investee company. For this purpose, the agreement includes clauses on the obligation of the company to make available information and documents on its financial condition, the development of its business, the existence of pending litigation or out-of-court disputes, etc.

It is only after the conversion of the loan into equity that the investor becomes a partner or a shareholder and may take active part in the management of the investee company to the extent to which it has been agreed by the parties in advance. Typically, the agreement provides for preferential rights which guarantee liquidation preferences, approval of certain decisions concerning the legal status and activities of the company, participation in the corporate management bodies, and others. The liquidation preference puts the investor in a more favourable position as compared to the other partners or shareholders in case of liquidation or insolvency of the company. Nevertheless, insofar as the convertible loan is unsecured, when secured corporate debt exists (e.g., a bank loan agreement with a pledge of going concern or assets or a mortgage on immovable properties), the relevant privileged creditor is satisfied first and then the investor is satisfied from the remaining property, if any.

Since the Commerce Act does not provide for an automatic conversion of debt into equity, the debt should be contributed to the equity of the investee company pursuant to Article 72 of the Commerce Act which sets out the procedure of making non-cash contributions. For this purpose, three independent experts appointed by the Registry Agency make an evaluation of the loan and establish the maximum number of shares which the lender can subscribe on the grounds of the non-cash contribution. In reality, investors subscribe shares in a much lower amount than the threshold established by the experts, unless the investee company has big equity. Otherwise, the participation of the existing partners or shareholders would be diluted substantially.

A risk to the investor's interests is the fact that, for the purposes of the procedure for the contribution to be made and for the equity of the investee company to be increased and – in

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the case of a limited liability company – the investor to be admitted as a partner, it is necessary to ensure the cooperation of the investee company. Investors may initiate the procedure of evaluation of the convertible loan by experts appointed by the Registry Agency, but as early as that stage of the procedure, the experts would need the borrower's accounting documentation with a view to ascertaining the rights of the non-cash contributor. Furthermore, in limited liability companies, a decision to admit a new partner will require a three-quarters majority of equity holders, while a decision on capital increase must be taken unanimously by all partners. As to shareholding companies, the Commerce Act requires a majority of two-thirds of the equity represented at the General Shareholders' Meeting for making a decision to increase the capital. These majorities are applicable unless the Memorandum of Association or the Articles of Association of the borrower require a larger majority. For all those reasons, investors do not have a legal instrument at their disposal for unilateral conversion of the convertible loan into equity of the investee company. Therefore, forfeiture clauses are included in the agreement in case of failure of the borrower to be cooperative in the conversion of the loan. These clauses are a substantial incentive for the bona fide implementation of the convertible loan agreement but, in the final analysis, they are no absolute guarantees that the borrower will honour the obligation to convert the loan into equity. In practice, the image risk for the borrower in case of non-performance is a material incentive to act in good faith.

A way to avoid the lengthy non-cash contribution procedure and the risk of possible adverse tax effects is the common practice of the borrower to repay the loan and then the investor will pay the same amount for the acquisition of the shares on the following day. This approach, however, entails some unnecessary costs like bank fees and others.

The opportunities for the parties to identify a more flexible solution for the conversion of the debt into equity should be assessed on a case-by-case basis with a view to possible tax implications.

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