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Conversion of Companies by Alteration of Their Legal Form. General Description and Composition

With the enforcement of the Commercial Code Amendments Act /published in the 'Official Gazette' No: 58 / 27.06.2003/ a new legislative reform has been adopted. The basic part of the amendments is connected with the conversion of companies. Since 01.01.2004 Chapter XVI of the Commercial Code - "Conversion of companies " /par.104 of the Transitional and Final Provisions of the Commercial Code Amendments Act/, which has gone through a complete alteration, has been into force.

The amendments implement into the Bulgarian commercial law the fundamental principles of the Third (78/855/EC) и the Sixth (82/891/EC) Directives of the European Council about Merger and Separation of Companies (1). Thus, the European standards of protection of the interests of the shareholders and third parties have been introduced in the Bulgarian commercial law. Legal safety has been implemented in the relations among the companies, which undergo or are about to undergo legal conversion (2).

The conversion of companies by alteration of their legal framework (form), or, as the phenomenon is otherwise known in the legal theory, - conversion in narrow sense (3), is regulated by the Third Part of Chapter XVI (Art.264-264n), which bears the same appellation. The subject of the present article is limited only to a general description of the conversion in narrow sense and of the elements of its composition.

The elements of the composition of the legal figure in question coincide with some of the elements of the composition of the conversion in broad sense /and especially of the constitutive reorganization of companies by means of separation and division/, regulated in the previous Second Part of Chapter XVI of the Commercial Code. The separate, considerably independent legal base of the composition of companies legal conversion in narrow and in broad sense, being situated into two consecutive parts, leads unavoidably to the establishment of normative parallelism and puts a stress over the very high importance of the legislative technique of reference. The legal base of the conversion by alteration of the legal form refers to provisions, which regulate the conversion by infusion, merger, separation and division. For this reason the Second Part, named 'Conversion by Infusion, Merger, Separation and Division of Companies' can be conditionally accepted as the basic legal fundament (4).

I. Concept and general description.

The conversion in narrow sense is a process of transformation of a commercial company's legal framework from one legal organizational form into another. The active company remains preserved. By means of universal legal succession it passes towards the newly constituted company, together with incorporation of the membership of the terminated without liquidation company.

Art.264, sub.1 of the Commercial Code provides for the first time a legal definition of the conversion in narrow sense. According to that provision a company, experiencing conversion, may be transformed by alteration of the legal framework. In this case the company will convert into a company of another type (newly constituted company). It is expressly stressed in the second sentence of the same subsection that

the newly constituted company becomes legal successor of the company that has been transformed and terminated without liquidation.

The definition clearly describes the well-known fundamental features of conversion: existence of a company /only one in this case/ which terminates without liquidation and the property of which passes through universal succession towards another, newly constituted company. In this situation, there is a legal succession as regards to the personal substance, expressed in the fact that a membership of the shareholders of the company which is being converted into a newly constituted company arises /incorporation of membership/ (5).

The so-called 'theory of the economic conversion' has been legislatively confirmed. According to that theory the conversion of companies manifests itself in the termination of the transforming company as a legal personage and the constitution of a new company (6). In the old commercial legal doctrine of G.Klechkov the 'theory of the legal identity' is being sustained. Especially as regards to the conversion by alteration of legal form - of L.Dikov as well. In the contemporary legal doctrine prior to the amendments in question, the 'theory of the legal identity' has been supported by P. Goleva, when discussing the conversion by alteration in the legal form. According to this theory, the conversion of companies includes only a change of one company form into another, while the legal personage of that company remains intact. The existence of an identity between the company that is being converted and the one already transformed excludes the necessity that the first company be terminated and the second be constituted as a completely new one, and therefore excludes the legal succession. To achieve complete conversion, it is enough only to accomplish the necessary amendment of the Articles of Association of the company (7).

The law does not allow that new shareholders of the company, which experiences conversion, be accepted simultaneously with the alteration of the legal framework. The opposite would hinder the conversion procedure and would obstruct the legal safety of the interests and status of the shareholders and the equivalent exchange proportion of the shares, determined towards a fixed date /Art.264a, sub.1, item.2 in connection with Art.264, sub.2 of the Commercial Code/. The alteration in the legal framework of the company is carried out by a decision for conversion which approves or amends the already created conversion plan. The latter has to include the exact description of shares or membership, which every shareholder achieves in the newly constituted company /Art.264r, sub.3 in connection with Art.264a, sub.2, item.4 of the Commercial Code/.

The law does not permit that an infusion or division be made by acquiring, combined simultaneously with alteration of the legal form of the accepting company /Art.262, sub.2 and Art.262b, sub.3 of the Commercial Code/. It is inadmissible that conversion by alteration of the legal form of the transforming company or of the accepting company in process of separation be carried out at one and the same time /Art.262b, sub.3 of the Commercial Code /.

II. General description of the composition.

Composition на conversion by alteration of the legal form is mixed /heterogeneous/ and follows the well-known principles of the general composition of the conversion. The relations in the case are relatively simplified in comparison with those under the Second part, because they relate only to one transforming company

and a company-successor. composition includes some fixed elements depending upon the type of the newly constituted company: capital or personal /Art.264B in connection with the clear qualification *ex lege* in Art.64, sub.3 of the Commercial Code/.

The legal composition of conversion includes a conversion plan /Art.264a of the Commercial Code/, announcement of that plan and securing access to authentic and up-dated information at the disposal of the shareholders /Art.264б of the Commercial Code/, examination report about the conversion, made by a registered auditor /Art.264B of the Commercial Code/, conversion decision /Art.264r of the Commercial Code/ and registration /Art.264ж/. Neither conversion plan, nor access to information are required, if what is altered is the legal form of a sole corporation /Art.264H, sub.1 of the Commercial Code/.

1. The conversion plan must be prepared by the ruling body of the company (Ltd, JSCo, Limited Partnership by Shares). If the company is personal, the conversion plan has to be created by the shareholders who exercise governing powers. The plan must satisfy the well-known qualified written form with a notary certification of signatures *ad solemnitatem/substantiam*.

The law foresees that the plan must contain a minimum of contents and the legal regulation is undoubtedly compulsory - *jus cogens* - /Art.264a, sub.2, items.1-6 of the Commercial Code/. The following contents are mandatory by law.

It is necessary that the conversion plan contain the legal form of the newly constituted company, its official appellation and the location of its main office, as is required by item 1.

It is necessary to provide for the proportion of the exchange of the shares, determined towards a fixed date, according to item 2. In connection with the general features of the conversion the bond between the company's termination without liquidation and the universal legal succession has already been noticed. The special importance of the succession and the incorporation of the membership has been underlined /Art.261б, sub.1/. The requirements under Art.264a, sub.2, item 2 should be taken into consideration together with the provisions of Art.261б, sub.2, II sentence. The latter requires that the shares gained by the shareholders of the transforming companies be equivalent to the fair price value of the shares possessed by them prior to the conversion. Instead of their right on liquidation quota of the pure value of the property of their terminated without liquidation company, the shareholders have the right to compensation by means of shares in the newly constituted company. That company accepts the patrimonium of the terminated company as a contributed property.

The logic conclusion of the principle of the so-called equivalent exchange proportion out of the general provisions of Chapter XVI, Art.261б, stresses on its fundamental significance for all forms of conversion, including the one by alteration of the legal form. The exchange proportion determines the distribution of the capital and the administration of the newly constituted capital company-successor. In practice, the proportion is determined according to economic indicators, the basic one among which being the real value of the property of the company which is being transformed.

When the newly transformed company is capital, or the conversion is carried out under the conditions laid out in Art.264B, sub.4 of the Commercial Code, the

composition of the conversion includes examination of the conversion plan by a registered auditor. He/she must prepare a report by which to evaluate whether the foreseen exchange proportion in the plan is adequate and reasonable and to point out the data under Art.262M, sub.2 /Art.264B, sub.2 of the Commercial Code/. According to the reference towards the general clause of Art.262M, sub.2, namely in connection with the exchange proportion, the report should contain the data that has been duly established and proved.

It is necessary that the conversion plan contain the amount of the possible financial duties according to Art.261B, sub.2, as well as the time-limit for their payment /Art.264a, sub.2, т.3 of the Commercial Code /. The membership succession principle /the incorporation of membership principle/, concluded by Art.261B, sub.1, 1 sentence, does not allow financial compensation to be paid. However, in order to avoid undue enrichment of the accepting company, Art.261B, sub.2 permits that financial payment be executed only for the sake of equalizing, and even in that case it cannot go more than 10 % of the total nominal value of the shares gained by the new shareholders. As a consequence, necessary preconditions for a financial equalizing payment to be permitted are: shares of the newly constituted company to be achieved and the equalizing to be done by a financial payment /compare to Art.5, sub.2, (b) of the Third Directive/.

It is necessary, according to Art.4, that the shares or the membership that each shareholder gains in the newly constituted company be made description of, as well as information about the existing securities and distrains.

The fifth item deals with the specific conditions and burdens, under which the incorporation of membership into the newly constituted, or the accepting company takes place. It is possible that these conditions foresee limitation of the rights of the shareholders that are incorporating /compare to Art.5, sub.2 (c) of the Third Directive /.

The sixth item requires negotiation of the rights of the preference shareholders or the third party, which possess for example convertible bonds, issued by the company that is being converted. When, for example, a newly constituted limited company concedes corresponding preference rights to the shareholders that incorporate their membership, this reflects over the legal spheres of the rest of the shareholders. That is the reason which makes the preliminary negotiating of relationships necessary /compare to Art.262Ж, sub.2, т.8 of the Commercial Code, as well as Art.5, sub.2 (f) of the Third Directive/. Art.262И bears the name 'Owners of Special Rights'. Under the provision of sub.1 the owners of securities, which are not shares and do not grant special rights, are to be given tantamount rights, enforceable towards the accepting, or the newly constituted companies after the conversion has been completed. The delivery of securities takes place according to the provisions of Art.262Ч through a depositor. Art.262И, sub.3 allows that sub.1 be not applied, if the General Assembly of the owners of securities /provided that such an Assembly exists by law, as for example, the General Assembly of the bondowners does -Art.214/ has given its consent that the rights, incorporated into the bonds, be changed, and if every single bondowner has consented that his/her rights be altered, or has been given the possibility to claim that his/her bonds be purchased back by the company.

According to Art.264, sub.3 of the Commercial Code conversion plan should be enclosed with a draft project of Articles of Association of the newly constituted company.

2. The next element of the legal composition is the announcement of the conversion plan and the providing of access to information to all shareholders /Art.264б of the Commercial Code/. The conversion plan must be presented before court at the location of the main office of the company. If the company is capital, the presented conversion plan should be published in the 'Official Gazette' at least 30 days prior to the date of the General meeting of the Assembly, at which the conversion decision is to be voted for.

The materials required by Art.264б, sub.2 of the Commercial Code must be left at the disposal of the shareholders of the converting company, if the latter is a capital one, at its main office. This must be done within a period of 30 days before the General meeting takes place. This time limit may not be complied with, provided that the conversion decision has been taken unanimously by all shareholders of the company that undergoes transformation.

3. An examination of the conversion must be accomplished by a special examiner /registered auditor/ and expressed in a report. It is a mandatory element of the conversion legal composition, if the newly constituted company is capital /Art.264в, sub.1 of the Commercial Code/. The law limits the amount of the capital of the newly constituted company-successor only up to the clear value of the property of the converted company, which the auditor is obliged to examine and to prepare a special report for /Art.264д, sub.3 refers to the provisions of the general Art.262ф, sub.2 and 3/. By this way, the legislator prevents the possibility that a decapitalization of the company by alteration of its legal form be carried out and provides protection for the interests of the third parties.

If the company that has been newly associated is not capital, the examination of the conversion by a registered auditor and, accordingly, the preparation of a report may be performed on the application of a shareholder or after a decision of a governing or controlling body of the converting company /Art.264в, sub.4 of the Commercial Code/. The second hypothesis is regulated by a provisional rule, which leaves possibility that the free will of the parties be legally respected.

4. The next element of the composition is the conversion decision /Art.264г of the Commercial Code/. In respect to the majority, necessary to accept a conversion decision, Art.264г, sub.1 of the Commercial Code refers to Art.262п (8). The questions about the eventual alterations in the status of the shareholders due to the conversion are provided for by means of reference from Art.264г, sub.2 to Art.262п as specific basic regulation of the subject. They remain uncovered by the present expose.

The subject range of the conversion decision includes approval or **amendment** of the conversion plan, adoption of the Articles of Association of the newly constituted company and election of its ruling bodies. The specific feature which makes this case distinct when compared to the general provisions of Art.262o, sub.2 of the Commercial Code, it that according to the ruling of Art.264г, sub.3 it is allowed that the conversion plan be altered by the conversion decision. This is possible because of the simplification of the relations that has been discussed above. The possible amendments of the conversion plan cannot injure the protection of the

shareholders' interests by introducing new rulings and making its substance different from the one that has been previously announced. This is a difference when this case is compared to the provisions of Art.262o, sub.2.

5. The alterations in the legal framework of the company must be registered by court. The competent court is the one determined according to the main office of the company that is being converted. The registration must take place at least 14 days after the application has been made.

The Board of directors or any shareholder who has governing powers in the newly constituted company applies for registration and submits the Appendixes in compliance with Art.264ж, sub.2 of the Commercial Code. If the newly constituted, or the converting company are capital, the registration must be published in the 'Official Gazette'. The publication has an announcing effect.

The conversion by alteration of the legal form takes effect from the moment in which it has been registered in the Commercial Registry /Art.264з of the Commercial Code/. The legal effect of the registering act manifests itself in the actual alteration of the legal organizational form. The effect of this public legal fact is constitutive. The transforming company terminates without liquidation and in the same time a new company-universal successor is constituted. An incorporation of the membership of the terminated company, which is being transformed, into the new company is carried out because of the registering act /Art.264з, sub.3 of the Commercial Code/.

The cases where the conversion legal effect takes place, when the patrimonium of the converting company includes real estate rights or real right over moveable property /ships, for example/, transactions that need to be registered to take effect, are expressly regulated by law /Art.47 in connection with Art.39 of the Commercial Navigation Code/. The judicial decision for registering the conversion must be registered in the respective registry by the registering judge, determined according to the location of the real estate or the general registry under Art.39в of the Commercial Navigation Code. Thus the conversion is enforced as regards to the aforesaid real rights.

In general, from the moment in which the conversion has been registered/carried out on, newly constituted company accepts all licenses, licenses rights and concession contractual rights, unless the law or the act that regulates the transmission provide otherwise.

The date when the conversion has been registered/carried out, is authoritative for the creation of final /for the transformed company/ and of initial /for the newly constituted company/ balance sheet.

Notes:

1./see OJ № L 295/ 20.10.1978 and OJ № L 378/ 31.12.1982/;

2./see Marinov, K., 'Conversion of Companies. Infusion and Merger', Juridical Booklet of 'Market and Law' Magazine, September 2003, p.2-3; Katzarsky, Al. Sub., 'The Company Law Amendments Enforceable Since January 1st2004 r.', Commercial Law, book 5, 2003, p.5/

3./see e. g., Stephanov, G., 'Conversion of Companies', Veliko Turnovo, 1993, p.88, etc./;

4./see Katzarsky, Al., note 2 above, p.7; Marinov, K., note 2 above, p.3-4/

5./the expression 'incorporation of membership' belongs to L. Vassilev, 'Legal Nature and Elements of Merger', Juridical Archive, year VIII, book 4-5, p.408/

6./see for detail Stephanov, G., note 2 above, p.p.12,16 etc./

7./see for detail Klechkov, G., Conversion of Companies, Sofia,1929; Dikov, L., 'Lectures on Commercial Law', volume I, Sofia,1935, p.490; Goleva P., 'Commercial Law', book I, Sofia., 2001, p.361/

8./see comparison with the repealed regulation, Marinov, K., note 2 above, p.13-14/