



The Role Of Convertible Loan Agreements In Business Financing And Their Legal Regulation

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ABSTRACT

This article explores the legal nature of the Convertible Loan Agreement (CLA)—an innovative financing tool for startups—and the issues surrounding its implementation into the legislation of Uzbekistan. The primary objective of the study is to elucidate the theoretical and practical aspects of this "hybrid" institute, which emerges at the intersection of the law of obligations and corporate law. The article provides a detailed analysis of three fundamental elements that distinguish a CLA from a traditional loan: the conversion trigger, the valuation cap (deferred valuation mechanism), and the investor's special non-proprietary powers. Interpreting the CLA based on the German legal concept of Gestaltungsrecht (transformative right), the author argues that it should be viewed not as a simple debt, but as an agreement for deferred corporate participation. The study compares the experiences of the United States, the United Kingdom, Germany, and Russia, while also examining critical norms for the startup ecosystem within EU Regulation 2017/1129 and Directive 2017/1132. As a scientific novelty, the article advocates for the introduction of the "Specific Performance" institute to guarantee the execution of CLAs in Uzbekistan's legal system, emphasizes the importance of the "Most Favored Nation" (MFN) clause, and analyzes corporate restrictions in the assignment of rights process.

In conclusion, the author provides specific proposals for improving the Civil Code and corporate legislation of the Republic of Uzbekistan, particularly by recognizing the CLA as a "mixed contract" and reducing bureaucratic barriers in the conversion process.

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**Konvertatsiya qilinadigan qarz shartnomasining
tadbirkorlik faoliyatini moliyalashtirishdagi o‘rni va uning
huquqiy tartibga solinishi**

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Annotatsiya: Ushbu maqola startaplarni moliyalashtirishning innovatsion vositasi — konvertatsiya qilinadigan qarz shartnomasining (KQSh) huquqiy tabiati va uni O'zbekiston qonunchiligiga implementatsiya qilish masalalariga bag'ishlangan. Tadqiqotning asosiy maqsadi — majburiyat huquqi va korporativ huquq kesimida vujudga kelgan ushbu “gbrid” institutining nazariy-amaliy jihatlarini ochib berishdan iborat. Maqolada KQShning an'anaviy qarzdin farqlovchi uchta fundamental elementi: konvertatsiya triggeri, baholashni kechiktirish mexanizmi va investorning maxsus nomulkiy vakolatlari atroflicha tahlil qilingan. Muallif KQShni nemis huquqidagi “Gestaltungsrecht” (o'zgartiruvchi huquq) konsepsiyasi asosida talqin qilib, uni oddiy qarz emas, balki kechiktirilgan korporativ ishtirok bitimi sifatida asoslab beradi. Tadqiqot doirasida AQSh, Buyuk Britaniya, Germaniya va Rossiya tajribasi qiyoslanib, Yevropa Ittifoqining 2017/1129-sonli Reglamenti hamda 2017/1132-sonli Direktivasining startap ekotizimi uchun muhim normalari tadqiq etilgan. Maqolaning ilmiy yangiligi sifatida, O'zbekiston huquq tizimida KQSh ijrosini kafolatlovchi “Specific Performance” (majburiyatni aslida ijro etish) instituti, “Most Favored Nation” (MFN) shartining ahamiyati hamda huquqlar transferi (Assignment of Rights) jarayonidagi korporativ cheklovlar ilgari surilgan.

Yakunda muallif tomonidan O'zbekiston Respublikasi Fuqarolik kodeksi va korporativ qonunchilikni takomillashtirish, xususan, KQShni “aralash shartnoma” sifatida tan olish va konvertatsiya jarayonidagi byurokratik to'siqlarni kamaytirish bo'yicha aniq takliflar berilgan.

Kalit so'zlar: gbrid kapital, konvertatsiya qilinadigan qarz, huquqiy tartibga solish, tadbirkorlik, investor, korporativ huquq, Fuqarolik kodeksi.

Роль Договора Конвертируемого Займа В Финансировании Предпринимательской Деятельности И Его Правовое Регулирование

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Аннотация: Данная статья посвящена правовой природе инновационного инструмента финансирования стартапов — договора конвертируемого займа (ДКЗ) — и вопросам его имплементации в законодательство Узбекистана. Основная цель исследования заключается в раскрытии теоретико-практических аспектов этого «гибридного» института, возникшего на стыке обязательственного и корпоративного права. В статье подробно анализируются три фундаментальных элемента, отличающих ДКЗ от традиционного займа: триггер конвертации, механизм отложенной оценки и специальные неимущественные полномочия инвестора. Автор интерпретирует ДКЗ на основе концепции германского права Gestaltungsrecht (преобразовательное право), обосновывая его не как простой заем, а как соглашение об отложенном корпоративном участии. В рамках исследования проводится сравнительный анализ опыта США, Великобритании, Германии и России, а также изучаются важные для стартап-экосистемы нормы Регламента ЕС 2017/1129 и Директивы 2017/1132.

В качестве научной новизны выдвигаются предложения по внедрению института «Specific Performance» (исполнение обязательства в натуре) для обеспечения исполнения ДКЗ в правовой системе Узбекистана, обосновывается значимость условия «Most Favored Nation» (MFN) и рассматриваются корпоративные ограничения в процессе уступки прав (цессии).

В заключении автором даны конкретные предложения по совершенствованию Гражданского кодекса и корпоративного законодательства Республики Узбекистан, в частности, по признанию ДКЗ в качестве «смешанного договора» и снижению бюрократических барьеров в процессе конвертации.

Ключевые слова: гибридный капитал, конвертируемый заем, правовое регулирование, предпринимательство, инвестор, корпоративное право, Гражданский кодекс.

Introduction

The transition to an innovative economy and the implementation of modern financing instruments for business entities, particularly startups, necessitate not only economic shifts but also fundamental legal reforms. In global practice, alongside traditional methods of entrepreneurial financing (such as bank loans and direct investments), "hybrid" financial instruments that integrate elements of both debt and corporate law—specifically Convertible Loan Agreements (CLA)—have become increasingly prominent.

The legal nature of this instrument lies in its dual capacity: it simultaneously represents a debt obligation and a future right to participate in the company's equity (share capital). However, the lack of a clearly defined legal status for this type of contract within the current civil and corporate legislation of the Republic of Uzbekistan leads to various legal uncertainties and practical conflicts when formalizing relations between investors and business entities.

The relevance of this study stems from the inherent difficulties in valuing company assets during the early stages of a startup's lifecycle and the presence of high investment risks, which often complicate the execution of standard investment agreements. In such contexts, the convertible loan serves as an optimal legal mechanism, allowing the investor to mitigate risks by either reclaiming the funds as debt or, should the venture succeed, converting the debt into an ownership stake in the enterprise.

Within the framework of the objectives set forth in the relevant decrees and resolutions of the President of the Republic of Uzbekistan, as well as the "Digital Uzbekistan – 2030" strategy, establishing a legal framework for venture financing has been designated as a priority for improving the investment climate. Nevertheless, the material and procedural aspects of Convertible Loan Agreements (CLA)—specifically the subject matter of the contract, conversion conditions (trigger events), the investor's corporate rights, and specialized methods of enforcement—remain insufficiently studied within the national legal system.

From a scholarly perspective, the convertible loan agreement is a complex institute that requires a precise balance between civil and corporate law. In this article, we analyze the legal nature of the CLA not merely from the viewpoint of economic benefit but through the lens of fundamental concepts of civil law.

Furthermore, this study examines how the CLA functions as a mechanism for preventing corporate disputes within the legal systems of developed nations and investigates the legal implications of implementing such practices into Uzbek legislation. Our primary objective is to substantiate the CLA not merely as a derivative of a loan agreement, but as an independent and innovative instrument for the legal safeguarding of entrepreneurial activity.

The proposed solutions to the objectives set out in this article shall serve as a scientific basis for introducing conceptual amendments to the Civil code of the Republic of Uzbekistan, as well as the Laws “On limited liability companies” and “On joint-stock companies and the protection of shareholders’ rights”.

Materials and Methods

This research article encompasses a comprehensive analysis of various primary and secondary sources. The study explores specialized scientific concepts, the theoretical perspectives of legal scholars and practitioners, as well as their findings and insights. Furthermore, a comparative legal analysis was conducted regarding the regulation of convertible debt across various jurisdictions.

The study begins with an examination of the core thematic concepts, followed by an elaboration on the procedures for financing entrepreneurial activities through convertible debt, the rights and obligations of the

parties, and the mechanics of contract formation. It further evaluates the advantages of this instrument and compares its respective legal regulatory frameworks.

Additionally, the research provides conclusions aimed at the widespread implementation of this novel financing mechanism and the enhancement of relevant legislative acts. The realization of these findings is intended to facilitate the development of robust financial-legal solutions for entrepreneurs, foster a competitive environment among financial institutions and investors, guarantee the protection of investor rights, and establish a framework of institutional trust between investors and business entities.

Research Results

A convertible loan is a complex hybrid instrument that integrates two distinct legal and financial mechanisms: a standard debt obligation and a call option granting the right to acquire equity.

According to leading U.S. legal scholars John Coyle and Jacob Green, the primary significance of convertible instruments (specifically SAFE and Notes) lies in valuation deferral. From a legal perspective, this reduces "transaction costs" and enables startups to rapidly mobilize capital without expending excessive time on legal formalities [1].

In a direct equity purchase, the parties must reach an agreement on the company's valuation. For early-stage or nascent companies, such a determination is often practically impossible. A convertible loan legally "defers" this issue to a future date [2].

According to Mayers [3], the CLA (Convertible Loan Agreement) serves as an instrument of "legal control" that facilitates the sequential financing of a project. Should the company fail to achieve success in the initial stage, the investor refrains from conversion and opts for the repayment of the principal. This legal mechanism functions as a form of fiduciary oversight, restricting the management (founders) from the unjustified expenditure of capital.

Under the conceptual framework of Jalan and Barone-Adesi [4], the utilization of a CLA acts as a legal signal of the company's "good faith" and credibility. If the founders are confident in the company's prospects, they prefer a debt instrument that permits conversion at a later date (at a higher valuation) rather than granting an immediate, undervalued equity stake to the investor.

The Convertible Loan Agreement (CLA) is, by its legal nature, a complex transaction situated at the intersection of party autonomy (dispositivity) and corporate guarantees. Its essence can be delineated through two fundamental stages:

The Obligatory Stage: At the time of execution, the agreement possesses the characteristics of a classic loan contract (pursuant to Article 732 of the Civil Code). The investor provides capital to the company, and the company undertakes the obligation to repay the principal along with interest. At this juncture, the investor maintains the status of a "creditor" and does not exercise direct interference in the company's management.

The Transformation Stage: Upon the occurrence of specific conditions (triggering events), the debt obligation is extinguished, and in its place, an equity interest (share) in the company's authorized capital is created. At this point, the law of obligations transforms into corporate law.

Accordingly, the agreement serves three critical functions:

1. **Efficiency (Speed):** Executing a loan agreement is legally more streamlined than negotiating and signing a comprehensive Shareholders' Agreement (SHA).
2. **Cost-effectiveness:** It minimizes the administrative and legal expenses associated with the immediate re-formalization of corporate documents.
3. **Risk Management:** In the event of the company's insolvency or bankruptcy, the investor retains priority in the recovery of funds as a "creditor" rather than a "shareholder", thereby mitigating potential losses [5].

Within the framework of a convertible loan agreement, the right to convert held by the investor is considered a sophisticated concept in civil law theory. It is scholarly sound to interpret this right through the lens of the "Gestaltungsrecht" (formative or transformative right) concept, characteristic of the German legal tradition. According to this doctrine, the investor possesses the authority to extinguish the existing legal relationship (debt) and bring a new legal relationship (corporate participation) into existence through a unilateral declaration of will. In this context, the investor's notice functions not merely as the performance of a contractual obligation but as a juridical fact that alters the company's authorized capital.

By its legal nature, a Convertible Loan Agreement (CLA) is distinguished from a standard loan agreement by the presence of three fundamental “hybrid” conditions. These conditions enrich the classical principles of the law of obligations with elements of corporate law, elevating the relationship between the investor and the company to a new paradigm.

Firstly, the agreement defines the conversion trigger (Trigger Event) and its legal inevitability. While a conventional loan obligation typically concludes with the repayment of funds, in a CLA, the occurrence of a specific juridical fact initiates the transformation of debt into equity. This trigger is commonly linked to events such as the company raising a subsequent major investment round (Qualified Financing) or a change of control (sale of a controlling interest).

Secondly, the agreement incorporates legal mechanisms for company valuation, specifically the Valuation Cap and Discount. Although traditional debt relationships involve strictly defined principal and interest amounts, the CLA introduces specialized financial-legal formulas to determine the value of the investor's future equity stake. The principle of “valuation deferral”, widely utilized in U.S. and European practice, enables the investor to inject capital at a stage when the company’s true market value remains uncertain. In doing so, the investor is guaranteed the right to acquire shares on more favorable terms compared to future shareholders (through a discount or a valuation cap).

Thirdly, the agreement grants the creditor non-proprietary powers, such as supervisory and veto rights. In a classic loan, the creditor does not interfere in the debtor's internal management and merely monitors solvency. However, under a CLA, even before attaining the status of a company participant, the investor acquires corporate powers such as approving significant transactions, demanding financial reports, or vetoing amendments to the company’s charter. This “hybrid” status places the investor in an intermediate legal position (prospective participant status) – higher than a general creditor but lower than a full shareholder. This allows for the protection of the investor's strategic interests at the intersection of contractual and corporate law while preserving the founders' operational autonomy [6].

Analysis of research results

The study of the legal nature of the Convertible Loan Agreement (CLA) demonstrates that this institute is a complex legal construct situated at the intersection of various fields of civil law — namely, the law of obligations and corporate law. During the process of transforming contractual obligations into corporate rights within the framework of a CLA, certain legal conflicts inevitably arise. Specifically, the principle of “pacta sunt servanda” (agreements must be kept), which is inherent to debt relations, may conflict with the imperative norms of company law, particularly regarding the pre-emptive rights of existing shareholders to acquire new shares.

Under the framework of Directive (EU) 2017/1132 [7] (the Company Law Directive), “capital maintenance” rules are strictly defined to protect the pre-emptive rights of existing shareholders. In implementing the CLA into practice, and based on the requirements of this Directive, the conversion process should be classified as the “prior corporate consent” of the shareholders. This mechanism legally safeguards the investor's future equity stake from subsequent objections by existing shareholders.

In investment relations, the fact that the investor and the startup may be subject to different national jurisdictions creates a risk of legal fragmentation. According to the EU “Rome I” Regulation (593/2008), while contractual obligations may be governed by the law chosen by the parties (*lex loci contractus*), corporate matters are strictly governed by the law of the state where the company is incorporated (*lex societatis*).

To resolve this conflict-of-laws issue, it is essential that the conversion condition within a CLA be recognized as a juridical fact, the execution of which is mandatory for local registration authorities. In this context, ensuring that the corporate performance of a contractual obligation assumes an “automatic character” serves as the primary guarantee for preventing international investment disputes.

Table

Legal Status of Convertible Loan Agreements (CLA) Across Jurisdictions

Country / Jurisdiction	Legal Status and Instrument Form	Legal Mechanism of Conversion	Key Legal Characteristics
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USA (Delaware Law)	SAFE (Simple Agreement for Future Equity) and Convertible Notes .	Automatic conversion of debt into equity upon a subsequent investment round (trigger event).	Highest level of dispositivity (party autonomy). Employment of valuation deferral principles.
UK	ASAS (Advanced Subscription Agreement).	Treated as an advance payment for future equity rather than a classic debt obligation.	Closely linked to tax incentives (SEIS/EIS). Investor holds the status of a "prospective shareholder" rather than a creditor.
Germany (EU Experience)	Wandeldarlehen (Convertible Loan).	Conversion is initiated via the investor's unilateral declaration of will .	Mandatory notarial authentication . Strict protection of existing shareholders' rights based on EU Directive 2017/1132 .
Russian Federation	Convertible Loan Agreement (lex specialis).	The demand for conversion is filed through a notary to the registration authority.	The CLA is codified as a distinct contract type. It is integrated with elements of corporate shareholder agreements .

As the holder of a Convertible Loan Agreement (CLA) is not a mere creditor but a “potential shareholder”, startup directors must be bound by a specific obligation to refrain from actions that could dilute or diminish the value of the investor’s prospective equity stake from the moment of the CLA’s execution. This constitutes a vital legal restraint that ensures the principle of good faith within startup governance.

The “European startup nations standard of excellence” (EU SNS) declaration, adopted in 2021 [8], serves as a leading example of the standardization of legal instruments in startup financing. This standard advocates for the creation of "model templates" for instruments such as the CLA and requires the minimization of bureaucratic hurdles during the conversion process.

Applying this experience within the context of Uzbekistan – specifically by introducing state-recognized model forms for CLAs – would establish a unified legal approach for notaries and registration authorities. This, in turn, would ensure transparency and legal certainty within the investment environment.

Furthermore, EU Regulation 2020/1503 [9] (ECSP Regulation) establishes a specialized investor protection mechanism for offering CLA instruments through crowdfunding platforms. According to this regulation, a startup is mandated to disclose all legal risks to the investor in the format of a “Key investment information sheet” (KIIS). This mechanism could serve as a procedural foundation for the protection of investor rights within our national legislation.

One of the most distinctive features of a Convertible Loan Agreement is the inclusion of the “Most favored nation” clause. This concept, which migrated from international investment law into corporate relations, serves as a specific legal guarantee aimed at protecting the investor’s interests during the company's future financing rounds.

The essence of the MFN (Most Favored Nation) clause is that if a company, after executing a CLA with an initial investor, formalizes new convertible instruments with subsequent investors on more favorable terms (e.g., a lower valuation cap or a higher discount), the first investor retains the right to amend their agreement to reflect those preferential terms. Under this arrangement, it is a mandatory legal requirement for the company to notify the initial investor of the new, superior terms and offer a revision of the contract.

The legal basis for the MFN clause is firmly established in international practice, particularly within the SAFE (Simple Agreement for Future Equity) templates developed by Y Combinator in the United States. In the European Union, this clause is recognized as an integral part of shareholders' agreements within the framework of the principle of freedom of contract [1].

While the transfer of rights under a convertible loan agreement is a classic form of assignment of obligations (cession) in civil law, it generates specific corporate risks within the startup ecosystem. The primary issue is that a creditor (prospective shareholder) under a CLA might circumvent the regulations regarding the “pre-emptive rights” of existing participants by selling their rights to a third party.

In Russian legislation, this matter is governed by Article 19.1 of the Federal Law “On limited liability companies” and Articles 382–390 of the Civil Code. According to these provisions, the transfer of rights under a CLA requires the unanimous consent of all company participants, unless otherwise stipulated in the agreement.

In German jurisprudence, the transfer of rights under a CLA (Convertible Loan Agreement) is effectively equated with the alienation of a corporate stake. Consequently, such agreements must undergo notarial authentication, and the consent of the company’s management or the general meeting of shareholders is mandatory for any subsequent assignment of rights. This requirement, in turn, ensures corporate transparency and prevents the infringement of pre-emptive rights.

Conclusions

A comparative analysis of the international standards and legal concepts explored in the preceding sections of this article against the current legislation of Uzbekistan reveals several conceptual and procedural barriers that impede the full implementation of the CLA (Convertible Loan Agreement) within the national legal system.

In the current edition of the Civil Code of the Republic of Uzbekistan, the provisions governing the loan agreement (Article 732) solely contemplate the obligation to return property. However, the core essence of the CLA—the mechanism of “transforming an obligation into a corporate stake” – is not reflected within the Code’s framework.

Furthermore, the process for increasing authorized capital under the Law “On limited liability companies” is characterized by a complex and multi-stage regulatory procedure. The mechanism for acquiring an equity stake through the investor's unilateral declaration of will (*Gestaltungsrecht*) directly conflicts with national statutory norms requiring a “resolution of the general meeting of shareholders” for such capital increases.

The experience of the European Union demonstrates that for a CLA to function effectively, it is essential for shareholders to grant their consent to the future conversion at the time of the agreement's execution. This must be legally solidified as irrevocable consent, ensuring it cannot be rescinded in the future. Conversely, in Uzbekistan, existing participants may refuse to authorize the capital increase when the time for conversion arrives, thereby leaving the investor’s rights legally vulnerable and unprotected.

As previously emphasized, the primary advantage of a CLA lies in the valuation deferral of the company. However, the current legislation of Uzbekistan imposes rigid requirements for the valuation of any assets contributed to the authorized capital and their subsequent reflection in accounting records.

The convertible loan agreement is not merely an economic instrument but a strategic legal tool for financing innovative entrepreneurship. The implementation of this institute within the legal system of Uzbekistan, in addition to enhancing the transparency of the investment climate, fully aligns with the policy of the Ministry of Justice aimed at optimizing public services and reducing bureaucratic hurdles.

Accordingly, incorporating the proposed legal solutions into the Civil code and the Law “On limited liability companies” will serve to strengthen the environment of mutual trust between startups and investors, while ensuring the robust protection of the rights of all parties involved.

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