

Implications of the Amendments to the Law “On Limited Liability Companies” for M&A Transactions¹

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1. INTRODUCTION

By Federal Law No. 312-FZ of 30 December 2008, amendments were made to the RF Civil Code, Federal Law “On Limited Liability Companies” No. 14-FZ of 8 February 1998 (the “**LLC Law**”) and to the legislation regulating state registration of legal entities and the notariat.

The new version of the LLC Law will take effect on 1 July 2009. By 1 January 2010, every Russian limited liability company (“**LLC**”) has to bring its charter into conformity with the new version of the LLC Law.

The main aim of these extensive amendments was to address questions that have accumulated over the 10 years the LLC Law has been in force. Such questions include, for example:

- (i) the unlimited right of a participant to withdraw from an LLC;
- (ii) flaws in the procedure governing the transfer and registration of rights to and encumbrances over participatory interests;
- (iii) the consequences of alienating a participatory interest in breach of the charter;
- (iv) the legal significance of information about a company’s participants contained in the unified state register of legal entities (“**State Register**”);

¹ Based on applicable legislation as of May 2009.

- (v) recovery of a participatory interest from unlawful possession by another person (recognition of rights to a participatory interest) and numerous other issues.

As was the case with joint stock companies, the possibility of regulating the relationships between an LLC's participants in the framework of separate civil law agreements (so-called shareholders' agreements and joint venture agreements) particularly needed to be addressed. Russian courts have not taken a uniform approach to such agreements executed in relation to Russian legal entities, including under foreign law. Practicing lawyers have also expressed varying views on this issue. Consequently, as a rule, shareholders' agreements have been governed by foreign law and have related to foreign companies that control Russian LLCs.

This article focuses on the main amendments to the LLC Law and offers a short analysis of their potential impact on M&A transactions and the establishment of JVs ("**M&A Transactions**") in Russia.

2. OVERVIEW OF KEY AMENDMENTS

2.1 Agreement on the Exercise of Participants' Rights ("Shareholders' Agreement")

For the first time in a Russian legislative act the institution of an agreement among participants is introduced. In the new version of the LLC Law there is one paragraph dedicated to this (Art. 8 sec. 3 of the LLC Law):

"The founders (participants) of the company may enter into an agreement on the exercise of the rights of participants of the company under which they must exercise their rights in a certain manner and/or refrain from exercising such rights, including by voting in a certain manner at the general meeting of participants of the company, coordinating how they will vote with other participants, selling a participatory interest or part thereof at a price specified in such agreement and/or upon the occurrence of certain conditions, or refraining from alienating a participatory interest or part thereof until such time as certain conditions occur, and coordinating other actions related to management of the company or the establishment, business, reorganisation or liquidation of the company. Such agreement shall be executed in writing as a single document signed by the parties".

The legislators have thus expressly provided for contractual regulation, outside the framework of the company’s constitutive documents, of the relationships between participants of an LLC and between the participants and the LLC itself.

Clearly, the list of conditions of a Shareholders’ Agreement mentioned in the LLC Law is not exhaustive, and participants are free to include other provisions regulating their relationships in the framework of an LLC. Yet the regulation of any type of agreement by listing its possible conditions will, in practice, raise the question of the validity of any conditions not explicitly mentioned in the LLC Law. This is particularly so if they include concepts alien to Russian law. Among such provisions are the following terms and conditions that are usually included in Shareholders’ Agreements governed by foreign (e.g., English) law:

- (i) resolution of deadlock situations, ‘Russian roulette’ or ‘Texas shoot-out’;
- (ii) drag-along/tag-along rights;
- (iii) provisions establishing various alternatives for the exercise of pre-emption rights to purchase participatory interests in an LLC;
- (iv) provisions establishing the duty to provide financing to the company;
- (v) numerous other provisions.

When structuring transactions to establish joint ventures, the following should also be taken into account:

- (i) The new version of the LLC Law is silent on whether or not a Shareholders’ Agreement may be concluded among only some, rather than all, of a company’s participants.
- (ii) The possibility of stipulating that a Shareholders’ Agreement for an LLC be governed by foreign law also remains open to question. In practice, it seems likely that where there is a foreign element (such as a foreign participant) the parties may wish to have such agreements governed by foreign law of their choosing.
- (iii) However, the risk will remain that the courts could apply Russian law to such agreements based on Russian civil

legislation, which stipulates that the relationships within an LLC, including between the LLC itself and its participants, should be governed by Russian law (Art. 1202 of the Russian Civil Code).

- (iv) The new version of the LLC Law provides that transactions to alienate participatory interests must be notarised (see section 2.2 below for more detail).

This new requirement may give rise to complications in structuring transactions on establishment of joint ventures.

In particular, it may be questioned whether a Shareholders' Agreement must be notarised if the agreement contains, for example, provisions envisaging option rights in respect of participatory interests, or deadlock provisions, since such provisions per se involve the transfer of participatory interests under certain conditions. The difficulty is associated with the fact that the new version of the LLC Law not only links the time of signing of an agreement with its notarisation, but also the time the rights to participatory interests are transferred. Attempts to put such option agreements which are to be concluded in the framework of Shareholders' Agreements into a separate document may be thwarted by a provision in the new version of the LLC Law stipulating that agreements among participants on the exercise of their rights must be drawn up as a single document.

These questions may possibly be resolved by stipulating in Shareholders' Agreements that for the purpose of formalising the transfer of rights to a participatory interest, the parties, at the actual time the participatory interest is transferred, must sign a short document in agreed form formalising such transfer (essentially the same as the transfer orders used for transferring title to shares in Russian joint stock companies). The document will serve to document the transfer and be notarised, thus fixing the moment when the rights to the participatory interest pass from one party to the other.

2.2 Recording Rights to Participatory Interests

According to the new version of the LLC Law, the names of a company's participants must be set out not in the charter (which now becomes the sole constitutive document of an LLC), but rather in a list of participants to be kept by the LLC itself (the "**LLC Register**").

That said, the information contained in the State Register will still take precedence over the information in the LLC Register.

When the tax authorities register amendments made to the charters of LLCs to bring them into conformity with the new version of the LLC Law, they are to concurrently enter in the State Register the amounts and the nominal value of participatory interests of LLC participants based on their founding agreements as at the time of registration of such amendments.

In accordance with the law implementing the new version of the LLC Law, the information about the amounts and nominal value of participatory interests of company participants which is entered in the State Register will be considered true and accurate until proven otherwise on the basis of notarised documents or statements signed by all company participants specified in the State Register or on the basis of a court decision.

In case of transactions with participatory interests, the duty to submit a request that the State Register amend its records to reflect the transfer of that participatory interest rests with the notary who notarised the transaction, which must submit an application from an LLC participant that is alienating its participatory interest to the State Register.

The new version of the LLC Law provides that in cases where information in the State Register about the ownership of a participatory interest is disputed, the rights to the participatory interest will be established on the basis of the agreement or other document confirming the respective founder’s right to the participatory interest in question.

The new procedures for recording rights to participatory interests in LLCs will need to be taken into account when structuring payments in the framework of sale and purchase agreements for participatory interests.

In particular, to protect the buyer’s interests a solution may be:

- (i) to include provisions in the agreement stipulating that at closing the seller must submit: (1) the document confirming its acquisition of the participatory interest and (2) extracts from the State Register and from the LLC Register, dated as close as possible to the date of notarisation of the agreement,

in which the seller's name and the size of its participatory interest are stated; and

- (ii) to remit funds to the seller's account only after the buyer has received extracts from the State Register and the LLC Register certifying that the buyer has been included in the list of participants of the LLC; or
- (iii) to transfer the money to an escrow account concurrently with notarisation of the sale and purchase agreement, with the funds to be released from the escrow account and credited to the seller's account upon receipt of the above-mentioned extracts from the State Register and LLC Register.

Together with the amendments to the LLC Law, many other amendments have also been made to the Federal Law "On State Registration of Legal Entities and Individual Entrepreneurs". Some of these are aimed at preventing abuses such as blocking the transfer of participatory interests by launching legal proceedings. The new version of this law stipulates, among other things, that if the size of a participatory interest in an LLC or ownership of a participatory interest is disputed in court, or in the event of other disputes regarding the information about an LLC that should be recorded in the State Register, this should not constitute grounds to refuse to register amendments in the State Register on the transfer of rights to participatory interests. If, however, in practice, a claimant were to request attachment of a disputed participatory interest as injunctive relief and the court were to grant such request, the above provision of the LLC Law could be circumvented, since the tax authority cannot register any transfer of rights to a participatory interest that has been attached.

2.3 Transactions with Participatory Interests

2.3.1 Notarisation of Transactions with Participatory Interests

The amended LLC Law sets out new requirements on the form of a transaction to alienate or pledge participatory interests. Such transactions must be notarised. Without notarisation such transactions are invalid. The LLC Law not only makes the performance of a transaction dependent on its notarisation, but also establishes that the rights to a participatory interest are transferred upon notarisation.

The appearance of a public element, i.e., involving a notary public in the transfer of rights to participatory interests, is an attempt to reduce the risk of possible abuses when performing transactions with participatory interests. However, the stipulation in the LLC Law that the right to a participatory interest transfers upon notarisation of the transaction, i.e., at the same time as it is performed, will raise a number of questions in practice.

At issue are actions which under an agreement for sale and purchase of a participatory interest are to be performed before the participatory interest is transferred to the buyer, such as:

- (i) full or partial payment of the purchase price, including through an escrow account;
- (ii) fulfilment of conditions precedent (e.g., obtaining the consent of the antimonopoly authority, carrying out an audit of the target business, restructuring of the target business, etc.);
- (iii) the seller’s performance of actions pending completion, such as actions to preserve a business as an ongoing concern until conditions precedent are met.

The new version of the LLC Law puts in doubt the possibility of structuring transactions on sale and purchase of participatory interests in which there is any gap between the time of signing and the time of completion.

A possible solution to this problem may be for parties to structure transaction documents such that their relations preceding the transfer of a participatory interest are set down in a separate document which will not need to be notarised, since it will not contain provisions relating to the transfer of the participatory interest. Such separate document will enter into force upon being signed by the parties. In that case, at the time when the participatory interest is being transferred the parties will have to sign a separate short document (as in the case of a Shareholders’ Agreement referred to in section 2.1 above) documenting the transfer of the participatory interest, which will then be registered by a notary, thus fixing the time of transfer of the participatory interest.

A notarisation requirement has also been established for agreements on pledge of participatory interests in LLCs. From the standpoint of M&A Transactions, this new requirement may be important where

participatory interests in LLCs are pledged to secure performance of a seller's or buyer's obligations under a sale and purchase agreement for a participatory interest or shares or any other obligation under a Shareholders' Agreement. The requirements that participatory interest pledge agreements must be notarised and that encumbrances over participatory interests must be recorded in both the State Register and the LLC Register provide considerable comfort to pledgees in contrast to the current situation. Presently, the only way to reflect a pledge of a participatory interest in an LLC is to make a corresponding entry in the LLC's charter, which does not establish rights per se and is merely informational in character.

However, the value of pledging a participatory interest in an LLC as a security of a debtor's obligations may be substantially weakened by another provision that has been preserved in the LLC Law, enshrining the right of the LLC and its other participants to pay a creditor of a debtor participant the 'actual value' of the participatory interest when the creditor makes a claim for the recovery against such participatory interest. It is not clear whether this provision of the LLC Law applies if the creditor tries to enforce a pledge of the participatory interest. If a court applies this provision of the LLC Law to the enforcement of pledge, then the payment of the 'actual value' will terminate the effect of the pledge. In this case creditors that hold such pledges bear the risk that they might not obtain full satisfaction of their claims against the debtor, since the 'actual value' of a participatory interest is determined by reference to the accounting figures rather than to its market value; in practice, the former may be substantially lower than the proceeds which the creditor would obtain by selling it at an auction.

2.3.2 Pre-emption Right upon Transfer of Participatory Interest

The amendments also affect the procedure of exercising the pre-emption right of purchase upon alienation of participatory interests in an LLC.

The most important innovation is the possibility of specifying in an LLC's charter the price at which the other participants exercise such pre-emption right, irrespective of the price at which the participatory interest is offered to a third party. Such price may be fixed as a specific sum or based on one of the criteria used to determine the price of the participatory interest (net asset value, book value of

assets, net profit etc.). It must be the same for all participants of the LLC who intend to exercise their pre-emptive right to purchase the participatory interest. This new development may be of importance when structuring relations between partners in joint ventures based on an LLC framework.

This new development may be inconvenient however, since an LLC’s charter is a public document and the participants may wish to avoid disclosing such information to the public. The possibility of including such a provision in a Shareholders’ Agreement, which is not a public document, and its enforceability are open to question, as the LLC Law explicitly states that if the parties agree on such a provision, it must be specified in the LLC’s charter.

The new version of the LLC Law does not provide a clear answer to the question of whether or not supplementary rules on the exercise of pre-emption rights may be stipulated in Shareholders’ Agreements in addition to those set out in a company’s charter.

These may be needed, for example, when structuring a joint venture where some of the participants wish to establish additional requirements amongst themselves regarding withdrawal from the joint venture.

Changes have also been made to the time frames and procedures to be observed by participants when notifying each other and the company of the exercise of their pre-emption rights to buy participatory interests.

2.4 Acquisition of a Participatory Interest in Good Faith

Before the new version of the LLC Law was adopted it was unclear whether or not the general provisions of the civil legislation relating to vindication (recovery of property from unlawful possession by another party) and good faith acquisition could be applied to relations involving the recovery of participatory interests or recognition of rights to them.

The new version of the LLC Law sets out a special regime for recognising good faith purchasers’ rights to participatory interests of which they have been dispossessed. The relevant provisions are similar in content to the Civil Code rules on vindication of things. However, the inclusion in the LLC Law of a special regime for participatory interests in LLCs raises the practical issue of whether or not the extensive court practice to date with cases involving vindication of things may be applied to the alienation of participatory interests.

3. OTHER AMENDMENTS

3.1 Withdrawal of a Participant from a Company

The unlimited right of LLC participants to withdraw from the company, enshrined in the current version of the LLC Law, is one of the main problems in the current legislation, because upon withdrawal the company must pay the participant the actual value of the participatory interest, which may adversely affect the LLC's financial condition, while the remaining participants are unexpectedly left without their business partner.

This is a key issue when establishing a joint venture on the basis of an LLC, where the parties are looking to set out in detail the procedures through which rights to participatory interests transfer to third parties, how the joint business will be managed and how the participants may withdraw from it.

The new version of the LLC Law stipulates that a participant may withdraw from an LLC only if that right is laid down in the charter of the company. In addition, it is now prohibited for an LLC to be left without any participants as a result of withdrawal.

In practice, when a joint venture is created on the basis of an existing LLC, a new partner has to check the charter to ensure there is no right to withdraw. If such right is enshrined in the charter, then before the new participant joins the joint venture the existing participants of the LLC will have to be persuaded to amend the charter to eliminate such right to withdraw.

3.2 Buy-out of Participatory Interests

The new version of the LLC Law grants participants the right to demand that the company buy out their participatory interests in cases where the participant in question has voted against or abstained from voting on approval of major transactions or on increasing the company's charter capital by having the participants make additional contributions. The buy-out price is equal to the actual value of the participatory interest, determined on the basis of the company's accounting data.

Above (see section 2.3.1) we considered the shortcomings of this provision from a commercial standpoint.

This change needs to be taken into account when establishing joint ventures, particularly from the standpoint of actions minority participants could take if a majority participant adopts corporate resolutions with which they disagree.

3.3 Consequences of Alienating a Participatory Interest Without the Other Participants’ Consent

The current version of the LLC Law does not establish any consequences for alienating participatory interests without the other participants’ consent when such consent is required according to the charter of the company or in breach of a prohibition against alienation established by the charter. The new version of the LLC Law provides that the participatory interest must be returned to the company at the suit of any of the participants or the company itself. In that case it is the seller that must reimburse the buyer’s costs, not the company.

4. OUTSTANDING ISSUES

It is already apparent that some issues have not been clearly addressed or regulated by the new version of the LLC Law. Market participants will have to face these when structuring and performing M&A Transactions. For example:

- (i) it is still required that at least 50% of an LLC’s charter capital be paid in upon its establishment, which, in practice, is problematic when establishing an LLC whose charter capital is to be paid with non-monetary contributions;
- (ii) there remains the provision stipulating that the charter of an LLC may set out further rights of participants in addition to the rights set out in the LLC Law; if this provision of the LLC Law was not entirely clear before, now that the LLC Law retains it in parallel with the new institution of Shareholders’ Agreements that will establish specially agreed rights and obligations of participants, it is even more uncertain precisely what additional rights are meant;
- (iii) the ‘actual value’ of a participatory interest, calculated on the basis of accounting figures, continues to be used to determine its price to be paid to a participant upon its withdrawal from an LLC on various grounds or upon its being excluded from an LLC, and to determine the price of participatory interests in

- relation to which creditors are seeking recovery; as was noted above, in most cases this is much lower than its market value;
- (iv) the possibility remains that if a participant of an LLC defaults on a debt and an attempt is made to attach its participatory interest, the LLC itself or the other participants may pay the creditor the 'actual value' of the participatory interest, upon which the debtor's participatory interest will transfer to the company itself and/or its participants; this would essentially deprive the creditor of full legal recourse if there is a difference between the 'actual value' it receives and the real market value it would have otherwise been entitled to expect had the participatory interest been sold at a public auction.

On the whole, despite some of the practical difficulties in applying the new version of the LLC Law which have been discussed in this article, the amendments should largely have a positive effect and smooth the progress of M&A Transactions in Russia. That said, the effectiveness of the new version of the LLC Law will largely depend on how the courts apply it in practice.