

Private Equity Investing Under Russia's Amended Law On Joint Stock Companies

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Only three years after suffering a devastating financial crisis and despite a stagnant global economy, Russia was one of the best performing markets in 2001. Last year, Russia's GDP grew by approximately 5 percent, and 4 percent growth is expected this year. However, foreign direct investment in Russia historically has been low compared to other emerging markets, in part due to legal uncertainties and concerns about minority shareholder protections. In 2001, foreign direct investment in Russia was estimated to be approximately US\$6.9 billion, compared to US\$24.2 billion in Brazil and US\$7.4 billion in Poland. Today, a growing number of Russian companies have been making strides to establish and better adhere to corporate governance procedures.

An increasing number of emerging Russian companies are seeking financing through venture capital and private equity transactions. Some of the most promising sectors currently include communications, software and IT, consumer goods and energy. To date, the international public markets have been inaccessible to all but some of the largest Russian companies. The domestic market has seen the emergence of ruble-denominated bond issuances and bank lending.

Today's direct equity investors in Russian companies often prefer to purchase controlling or blocking interests in order to better manage the company's operations and control risk exposure. Strategic investors often seek to purchase 100 percent of a Russian company's stock. Most direct investments in Russian companies are made in either open or closed joint stock companies (analogous to corporations). Closed joint stock companies cannot have more than 50 shareholders and are common for start-ups and early stage companies. All joint stock companies are governed by Russia's Law on Joint Stock Companies, amendments to which became effective on January 1, 2002 (the Amended JSC Law). The Amended JSC Law was adopted primarily to give greater protections to minority shareholders. However, in some cases, as discussed below, the Amended JSC Law has undermined some minority shareholder protections.

This article provides a broad summary on how private equity investments in joint stock companies may be affected by the Amended JSC Law. This article does not, however, address a host of other legal issues that must be considered when contemplating an investment in a joint stock company. Other issues beyond the scope of this article include Russian securities law considerations, currency and tax issues, and any

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required anti-monopoly approvals.

Structure

As an initial matter, a venture capital or private equity fund seeking to invest in a Russian joint stock company will need to determine the optimal structure for the transaction. Often, the structure will be largely driven by tax and other considerations that pertain to both the investment vehicle and the investor base. As a result of a favorable double taxation treaty, many investments in Russian securities have been effected through subsidiaries formed in countries such as Cyprus. Cyprus was reportedly the largest foreign investor in Russia in 2001, accounting for approximately US\$2.3 billion of investments. Other countries, such as Germany, also offer favorable double taxation treaties with Russia, and in some cases, may be preferable from a legal standpoint.

Common And Preferred Stock

Most U.S. venture capital and private equity transactions involve the issuance of convertible preferred stock, primarily to provide a priority over the company's common stock and to offer anti-dilution protection upon conversion. Russian law permits a joint stock company to issue both common stock and convertible preferred stock, and to issue one or more series of preferred stock with different rights and preferences. However, a joint stock company may issue only one class of common stock, with each share having the same rights and preferences. The Amended JSC Law has eliminated most of the voting rights associated with preferred stock, which now may only vote at shareholders' meetings on issues specified by the Amended JSC Law (e.g., reorganizations or liquidations). As a result, companies cannot give newly issued preferred stock more expansive voting rights, and preferred stock will likely only be issued in limited circumstances to give an investor an economic, nonvoting right. Anti-dilution price protection is not permitted under Russian law, although preferred stock may be given a liquidation preference over the common stock.

Issuing Shares And Amending The Charter

In many U.S. transactions, strategic investors purchasing minority interests often seek veto rights over future share issuances. In the past, minority interests in Russian companies held by some foreign investors were significantly diluted through the actions of majority holders (in many cases, the Russian managers or founders). The Amended JSC Law seeks to prevent dilution of minority interests by strengthening the thresholds needed to issue new shares. Under the current law, decisions to increase the company's authorized capital must be approved by at least 66 2/3 percent of the shareholders. Private placements of shares in amounts that exceed 25 percent of the company's outstanding shares require at least 75 percent shareholder approval,



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although the charter may contemplate a larger threshold.

Preemptive Rights

Most venture capitalists and private equity investors seek preemptive rights to ensure that they will be able to maintain their ownership interests in connection with a new issuance of stock. Under the Amended JSC Law, if a joint stock company plans to issue shares to a third party, shareholders that vote against or do not vote on the decision to privately place shares will receive preemptive rights to acquire their pro rata portion of shares.

Veto Rights And Voting

In the typical U.S. venture capital/private equity transaction, strategic investors that hold preferred stock often vote as a separate class on a delineated set of proposed significant corporate transactions or decisions, thereby ensuring a veto right. Preferred shareholders in U.S. companies usually also vote together with the common stock on an "as converted" basis. However, as stated above, a joint stock company's preferred stock generally lacks voting rights. Therefore, investors in joint stock companies generally will only vote shares of common stock along with the company's other shareholders. Prior to the effectiveness of the Amended JSC Law, shareholders of a joint stock company could agree to implement supermajority or unanimous voting in their charters. However, under the Amended JSC Law, shareholders are to take decisions by simple majority, other than as contemplated by the law. The number of instances where the Amended JSC Law provides for supermajority voting is not nearly as comprehensive as the list of actions over which today's venture capitalists and private equity investors often seek to have veto rights.

Board Representation

Venture capitalists and private equity investors often seek board representation in connection with their investments in order to play a more active role in the company's management, strategic development and direction. A joint stock company's charter can provide for cumulative voting to ensure a minimum board representation for a minority investor. Board representation rights may also be reflected in a shareholders agreement. However, as discussed below, the enforceability of shareholders agreement under Russian law is largely untested.

Dividends

As discussed above, preferred stock has limited voting rights, but can be issued to evidence economic rights. If preferred stock is issued, the dividend must be specified in the company's charter as a fixed amount or as a percentage of the preferred stock's par value. Under the Amended JSC Law, dividends may only be paid annually.



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Redemption

Redemption rights typically require or permit companies to repurchase shares of their issued and outstanding stock at a fixed date. Russian companies may redeem their stock, subject to certain limits set by the Amended JSC Law. It should be noted, however, that all redemptions must be approved by the company's shareholders (excluding the shareholder(s) whose shares are to be redeemed), unless the charter provides that the company's board of directors may authorize a redemption with certain thresholds.

Shareholders Agreements

U.S. strategic investors will often seek to embody co-sale or "tag along" and "drag along" rights in shareholders agreements. The enforceability of shareholders agreements between foreign investors and Russian shareholders and/or a Russian company are largely untested in Russia. In almost all cases, foreign investors will utilize U.S., English or another non-Russian law to govern the shareholders agreement. It remains largely untested whether a shareholders agreement relating to a Russian company that is not governed by Russian law would be enforced by a Russian court. For this reason, we expect that non-Russian parties to shareholders agreements will seek to include an arbitration provision in the agreement that provides for arbitration of disputes related to the shareholders agreement in a jurisdiction outside the Russian Federation.

Liquidity Events And Registration Rights

Similar to investments in private U.S. companies, investors should provide for "demand" or "piggyback" registration rights in the event that the joint stock company goes public. As the domestic IPO market is relatively non-existent in Russia, typical registration rights agreements will contemplate the joint stock company's IPO taking place internationally on the New York Stock Exchange, the Nasdaq National Market, the London Stock Exchange or the Neuer Markt.

Loans

As an alternative to or in conjunction with equity transactions, entities contemplating private investments in joint stock companies may utilize other types of financing, such as secured or unsecured loans. Loans granted to Russian companies will generally have priority over equity in the event of the company's bankruptcy, liquidation or winding-up.

Conclusion

The Amended JSC Law is a step in the right direction for foreign direct investment in Russia. However, because the law is still developing and its enforcement remains unclear, an investor considering taking a minority position in a Russian company should focus more on management's commitment to corporate governance and shareholder rights than on the protections afforded by the current law.

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