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Shareholders' agreements with respect to Russian assets: current trends

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It is estimated that approximately 70 percent of assets controlled by Russian financial and industrial groups are held through offshore holding structures, according to Russian newspaper Vedomosti. Direct holding of assets by ultimate beneficiary owners is rare in the Russian market, as it contains certain inflexibilities. Without wishing to contribute to the choir of voices alarming the business world about the potential unenforceability of shareholders' agreements (SHAs) in Russia, this article touches upon past, present and possible future practices of SHAs in Russia's M&A and private equity markets, including in light of the new draft Civil Code.

Past

New corporate Russia emerged in the early 1990s, when in the absence of specific provisions on SHAs in the Joint-Stock Companies Law of 1995 (JSC Law), and even before that, the owners of the new Russian economy started to move ownership to various offshore jurisdictions such as Cyprus, Jersey, BVI, Bahamas and Gibraltar. In most cases they explained their actions by citing confidentiality, political risk, tax planning and flexible corporate governance. By the time controlling stakes were in the hands of foreign holding companies (FHCs), the reasonable argument arose that an SHA may well be entered into with respect to shares in such FHC, and governed by foreign law (preferably, with arbitration of disputes in a reputable international tribunal).

The legal position back then was based on the freedom of contract and the fact that despite questionable enforceability, SHAs were not prohibited. Therefore, in legal theory, they could have been entered into with Russian companies themselves, not just in respect of FHCs. And of course, as foreign holdings of Russian companies varied, operating a structure with a controlling FHC was not always possible. Therefore, the practice at the time, despite the mutual consensus in favour of SHAs with respect to FHCs, involved numerous SHAs entered into with Russian companies (mainly existing in the form of joint stock companies), including under foreign governing laws.

This continued through the early to mid-2000s, when Russian court practice made two things more or less clear: (i) foreign or offshore structuring may not always be helpful to the extent title to shares or assets may be challenged on the Russian level; and (ii) foreign law governed SHAs with respect to Russian companies would not be enforced by Russian courts. This obviously created motivation for SHAs drafted under Russian law.

Although the Yukos case, which could be viewed as supporting the development of Russian law SHAs is usually singled out, the decision in the Megafon case is viewed as removing completely the possibility of having a foreign law governed SHA with respect to a Russian company. The Megafon case was later confirmed by other decisions, such as Russian Standard Strahovanie. Further, it became clear that 'contracting out' from imperative provisions of the Civil Code and the JSC Law is not welcome in Russian practice. The underlying logic in the decision is based on the conflict between the personal statute of a Russian legal entity (which is defined as the place of incorporation by the Russian Civil Code) and the selection of foreign law to govern various corporate relations (where personal statute prescribes a different imperative norm or provision of the charter).

In parallel with developing negative court practice, the Russian government promulgated the introduction of the concept of SHAs into the JSC Law, as amended (aktsionernoye soglashenie, in this article, to separate from a wider notion, referred to as 'agreement of shareholders'). Currently, there appear to be both negative and positive motivations for the use of Russian law governed SHAs.

Present

These days, the discussion about Russian SHAs is usually more focused. Separate discussions of Russian law SHAs surround both joint-stock companies (JSCs) and limited liability companies (LLCs), as each are regulated by relevant companies acts. Further, recent trends in court practice have increased demand for a unified approach to SHAs drafted in respect of FHCs.

JSCs

For JSCs, Article 32.1 of the JSC Law, effective 8 June 2009, now prescribes certain imperatives for an agreement of shareholders. For example, the agreement may only be entered into with respect to all shares held by a relevant party and binds only the parties to such agreement (and not the company).The agreement of shareholders can provide certain voting arrangements and agreements on the purchase of shares at a certain predefined price or circumstance, or to provide for certain other coordinated efforts regarding managing the company, or its liquidation or reorganisation.

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This, of course, provided additional limited flexibility in dealings between the owners, but introduction of new Article 32.1 left unanswered some questions which to date are still untested in Russian courts. For example, lawyers debate whether a non-shareholder could be a signatory to an agreement of shareholders and when and whether JSC law compliant SHAs could be entered into under foreign law. Another grey area is the scope of potential liability for breach of the agreement between shareholders; the doctrine is split between fines or penalties prescribed by the JSC Law and possibility of specific performance as 'other' possible measures of relief.

In practice, SHAs in respect of FHCs remain the primary solution to questions usually raised by business people: despite the positive motivation, only the brave are willing to test the new provisions on their investments (in particular given the history of negative practice).

LLCs

The situation with LLCs is even more interesting. The LLC Law was always more flexible in its Russian law corporate governance framework. Agreements between participants (Russian LLCs do not issue shares, and equity interests are referred to as 'participatory interests' and equity owners as 'participants') allowed for a wider scope of corporate governance principles to be agreed, even prior to the 2009 LLC Law reform.

However, historically LLCs were viewed as a legal form for smaller scale business and indeed were rarely seen in larger scale corporate transactions until the mid-2000s.

However, the main shift to Russian law 'agreement on performance of rights of participants' (in this article, 'participants' agreement') is usually associated with introduction of new paragraph 3 to Article 8 of the LLC Law which specifically allows entering into such agreements and providing for their scope, which is similar to JSC Law Article 32.1. It includes agreements to perform rights as participants in a specific way, provide for voting arrangements, agree lock-up and coordination of management, reorganisation or liquidation.

This LLC Law reform of 2009 also brought other changes, in particular to regulation of pre-emptive rights and transfers of participatory interest, with the latter starting to require notarial form. The requirement to bring in notary on discussions regarding the participants' agreement has complicated matters. Also, the decision in the LLC Verny Znak case casts substantial doubt on the possibility of 'contracting out' from the provisions of an LLC's charter via the participants' agreement. However, it should be noted that participants' agreements become widely used where the FHC structure is unavailable or undesirable, for example, for political reasons when dealing with state corporations or where there is no foreign shareholder.

The future

Predicting the future is not a favourable task for lawyers, but SHA practice is set to develop on two, at a first glance mutually exclusive, lines: (i) increasing use of Russian law for political, state-sponsored transactions and LLCs; and (ii) continuing use of FHC structures, which in many cases proved their viability and served their purpose.

The new draft Civil Code, at least in the published draft which is reported to be undergoing further amendment, does not appear to advance the subject. To a certain degree, it can be viewed as a drawback in terms of its focus on the charter and reinstating the requirement for the registration authorities to review the charter for conformity with laws – even on the vague basis of 'legal order and morality'. Further, the current draft contains requirements on depositing the disclosure of ultimate beneficiary owners of foreign companies, which are registered in jurisdictions with favourable tax regimes, as a condition of activity in Russia, which could impact FHC structures.

Another conclusion could be made: by introducing agreement of shareholders and participants' agreements in the relevant companies' acts, Russian legislators provided positive confirmation of SHAs. Clearly, the desire of legislators was to suggest a Russian law alternative to the market for foreign law governed SHAs in FHC structures. However, the market will have to select when it becomes confident in the credibility of Russia's legal system to use Russian law governed SHAs as a viable alternative to FHC structures. The current draft of the new Civil Code appears to support the views that FHC structures and foreign law governed SHAs could continue to play an important role for corporate Russia in the foreseeable future.

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