

## business &amp; finance lawflash

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## Key Reforms of the Russian Civil Code for Legal Entities

*The changes address corporate governance, liability, and other issues.*

Russia continues to pursue a series of reforms to modernise its civil and commercial laws and improve the business environment. Recent amendments to the Russian Civil Code relating to legal entities are summarized below.

### Types of Entities

Starting 1 September 2014, important changes to Chapter 4 of the Civil Code, which governs legal entities, will take effect.<sup>1</sup> Legal entities are now classified as either corporate entities, which have members (such as shareholders), or unitary entities, which do not. The latter category is mainly for state enterprises and nonprofit organizations of various types.<sup>2</sup>

Corporate entities (corporations) include public and nonpublic companies as well as certain types of nonprofit organizations. A public company is a stock company whose shares are publicly traded or whose charter or name refers to it as public.<sup>3</sup> The main forms of nonpublic companies include the limited liability company (LLC or OOO, using the Russian acronym), which is already widely used, and the new nonpublic stock company. Certain former types of entities will no longer be available, including open stock companies (whose Russian acronym is OAO) and closed stock companies (in Russian, ZAO).

The new public companies are subject to many of the same rules that have applied to OAOs. For example, a public corporation must have a board of directors (or similar governing body) with at least five members. In contrast, nonpublic stock companies and LLCs enjoy greater flexibility. A board of directors is optional, although some form of management body is required. There is also greater leeway in determining the types of decisions that shareholders make (or, the board, if applicable) in nonpublic companies.

### Transition Period

Existing companies will be governed by the new rules. For example, an existing OAO will be treated as a public stock company if it fits the public company criteria. Companies are expected to amend their names, charters, and other governing documents to comply with the new legislation, but there is no fixed deadline, and the changes should be implemented as soon as any other changes to the charter are made. Until this is done, if the Civil Code conflicts with a company charter's existing provisions, the Civil Code will prevail.<sup>4</sup> The current Stock Companies Law<sup>5</sup> will continue to apply to ZAOs until such companies change their charters. Similarly, the existing rules of the Stock Companies Law that relate to OAOs will now apply to public stock companies to the extent that this does not contradict the Civil Code.<sup>6</sup> (Eventually, the Stock Companies Law will be amended to correspond to the new

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1. Federal Law No. 99-FZ, "On Introduction of Changes to Chapter 4 of the First Part of the Civil Code of the Russian Federation and Invalidation of Certain Provisions of Legislation", dated 5 May 2014 (Law No. 99-FZ).

2. Article 65<sup>1</sup> of the Civil Code.

3. Article 66<sup>3</sup> of the Civil Code.

4. Article 3 of Law No. 99-FZ.

5. Federal Law No. 208-FZ, "On Stock Companies", dated 26 December 1995, as amended (the Stock Companies Law).

6. See Federal Law No. 218-FZ, "On Introduction of Changes to Certain Legal Acts of the Russian Federation", dated 21 July 2014.

Civil Code changes.)

## Shareholder Voting Rights

Additional protections are available for shareholders in nonpublic companies, as set forth in revised Article 66 of the Civil Code. Voting rights may differ from the percentage of equity ownership, thus allowing a minority shareholder to have “disproportional” veto rights over certain decisions. Such rights must be expressly provided in the charter or a corporate agreement (see details below), and a description of the rights or such agreement must be formally recorded in the Unified State Register of Legal Entities, which is a publicly available database of all legal entities.

## Shareholder Obligations

New Article 65<sup>2</sup> imposes certain mandatory duties for all members of a corporation, such as a shareholder in a stock company or “participant” in an LLC. These duties include abstaining from disclosing confidential information, participating in decisions essential for the entity’s continued existence, and refraining from actions that are known to be harmful for the entity or that would “materially complicate” or render impossible the pursuit of the entity’s fundamental goals. These obligations are drafted somewhat more broadly than in prior Russian company laws and should be reviewed carefully by potential investors. Although no monetary liability is specified for breach, claims may presumably be brought for damages under general civil law principles, Russian company laws, or an entity’s own internal governance documents.

## Right to Expel a Shareholder

Under a well-established rule, Article 10 of the LLC Law<sup>7</sup> allows the participants in an LLC to force the mandatory withdrawal of a participant who has substantially breached his or her obligations or materially complicated or rendered impossible the entity’s activities. Now, revised Article 67 of the Civil Code grants corresponding rights to shareholders in nonpublic stock companies. A shareholder who has committed such misconduct may be required to sell his or her shares back to the company and, in exchange, will receive the shares’ “actual value” (which is not defined in the Civil Code, but may be interpreted by reference to the equivalent rule in the LLC Law<sup>8</sup>). Such expulsion is a new concept for Russian stock companies.

## Rights of Board Members

New Article 65<sup>3</sup> of the Civil Code establishes certain rights for the members of a board of directors (or similar governing body) of a public or nonpublic corporation, with the goal to improve corporate governance and compliance. These include the right to receive information about the business, review accounting and other internal documentation, challenge certain transactions that may be harmful to the company, and initiate damage claims on behalf of the company against officers, executives, or controlling persons whose actions have caused harm. This is an important new provision that strengthens and clarifies directors’ power to protect the company’s interests.

## Shareholder Meetings

New Articles 65<sup>3</sup> and 67<sup>1</sup> address various aspects of the formal meetings held by shareholders or other members. Notably, Article 67<sup>1</sup> imposes new requirements for documenting the quorum, voting, and decisions made at a meeting, with the goal to reduce fraud and minimize disputes about corporate actions. For public stock companies, an independent registrar<sup>9</sup> must certify the meeting minutes. For nonpublic companies under certain

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7. Federal Law No. 14-FZ, “On Limited Liability Companies”, of 8 February 1998, as amended (the LLC Law).

8. Under Article 14 of the LLC Law, the “actual value” of a participant’s share is equal to a pro rata share of the company’s net assets.

9. Because of an earlier amendment to the Civil Code, all stock companies must arrange for a licensed, independent registrar to maintain their share registers by 1 October 2014. See Article 149 of the Civil Code and Article 3 of Federal Law No. 142-FZ, dated 2 July 2013.

circumstances, a notary must do so.<sup>10</sup>

## Corporate Agreements

Although shareholder agreements have been recognized in Russian law since at least 2009, new Article 67<sup>2</sup> introduces the concept of a corporate agreement, which is a generic concept that covers agreements between shareholders in a stock company, participants in an LLC, and certain agreements that include third parties. Such an agreement may impose obligations with respect to voting, corporate governance, restrictions on share transfers, put-and-call options, and exit mechanisms. The new Civil Code amendments also address the following related matters:

- Creditors and certain other third parties may enter into a corporate agreement with shareholders to secure their “legitimate interests”. For example, this rule may apparently be used by lenders to enforce covenants in finance documents or counterparties in acquisition agreements that wish to enforce precompletion covenants regarding business conduct. Such a concept is new in Russian law.
- Foreign law may be chosen to govern a corporate agreement under certain circumstances, such as when one of the parties is a non-Russian person or entity (subject to a number of limitations).<sup>11</sup>

Certain disclosure requirements apply. Shareholders who are parties to a corporate agreement must inform the company, and public companies may be required to disclose further details under the Stock Companies Law or securities legislation. When a corporate agreement results in certain parties obtaining effective majority control of a company or exceeding certain thresholds of voting power, prior approval from the Russian competition authority or other bodies may be required.<sup>12</sup>

## Company Representatives and Joint Signatures

Several new provisions in the Civil Code will facilitate internal controls, for example, so that a company may require dual or multiple persons to sign contracts or manage bank accounts if it desires. In particular, under Articles 53 and 65<sup>3</sup>, a corporation may authorize one or more persons to act on its behalf, either separately or jointly, without a power of attorney. Corresponding information must be included in the charter and the Unified State Register of Legal Entities. Previously, such “joint signature” and similar arrangements were difficult to implement in Russian companies.

## Liability of Shareholders or Controlling Persons

Several new provisions address liability issues. Under new Article 53<sup>1</sup> of the Civil Code, a “controlling person” of a legal entity may be held directly liable for losses that the entity suffers because of his or her “fault”, and any agreement that seeks to limit or waive such liability will not be valid. Generally, a controlling person is anyone who holds the power to determine the entity’s actions, including the right to direct the actions of officers or executives. When a controlling person causes losses, officers and executives may all be held jointly and severally liable. (A parent entity may also be held jointly liable with a subsidiary for actions directed by the parent or made with its consent.<sup>13</sup>) Liability may also apply to shareholders or controlling persons when the company is a foreign legal entity but conducts its business primarily in Russia.<sup>14</sup>

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10. For nonpublic stock companies, in some cases, an independent registrar or the company itself may certify the minutes. For LLCs, a notary is required unless the charter or a unanimous decision of participants states otherwise.

11. Amended Article 1214 of the Civil Code. Certain matters must be governed by Russian law, such as the company’s legal status and form, issues of shareholder liability, and relations between the company and shareholders. Other issues relating to the choice of law are beyond the scope of this LawFlash.

12. Notably, the Federal Antimonopoly Service must approve the acquisition of voting power above certain thresholds in applicable circumstances, and, if the company involved is a “strategic enterprise”, approval from a special government commission may be required where a foreign investor acquires a controlling interest or in certain other circumstances.

13. Article 67<sup>3</sup> of the Civil Code.

14. Article 1202 of the Civil Code, due to a change made in 2013.

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## Liability of Officers and Directors

Existing Russian company laws already address the potential liability of officers and directors.<sup>15</sup> New Article 53<sup>1</sup> clarifies that such liability may not be waived or avoided by agreement (such as a clause in an employment agreement) for actions not taken in good faith (and, for a public corporation, when the actions were not reasonable).

## Mandatory Audits

All public and nonpublic stock companies must now have their annual financial statements reviewed by an independent, licensed auditor under Article 67<sup>1</sup>.

## Corporate Reorganizations

Under amended Article 57, the means for reorganizing different types of entities have been streamlined, making it easier to merge or convert different types of companies. For example, a stock company may now be merged directly into an LLC; this was not previously possible without a cumbersome, multi-step process.

## Charter Capital

New rules address the formation of charter capital for certain corporations. Company founders are required to pay in at least three-quarters of the initial charter capital before registration and must pay the balance within one year,<sup>16</sup> unless otherwise stated in specific company laws (which vary depending on the type of entity<sup>17</sup>). The minimum amount of charter capital must now be paid in cash.<sup>18</sup> (Such amounts have not changed: 10,000 Rubles for LLCs and 100,000 Rubles for stock companies [approximately USD277 and USD2,773, respectively]. Higher amounts apply for banks, insurance companies, and other regulated entities.)

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15. For example, Article 71 of the Stock Companies Law.

16. Article 66<sup>2</sup> of the Civil Code.

17. For stock companies, the rule has not changed: at least one-half is due within three months after registration and the balance within one year, under Article 34 of the Stock Companies Law. For LLCs, there is a new rule: full payment is due within four months after registration, under Article 16 of the LLC Law.

18. Article 66<sup>2</sup> of the Civil Code.

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