

# Minority shareholdings

By Denis Korolev, Partner, IVJ Legal Bureau.

**D**espite certain political risks the Russian domestic equity market remains being subject to, as has recently been evidenced by the Government investigation into alleged tax abuse by Yukos Oil Company, effectively resulting in collapse of the company's stock prices and high equity market volatility generally, international investment community appears to remain, broad and large, convinced of potential attractiveness, as well as undervalued status, of Russian companies' stocks.

At the same time full-scale cross-border acquisitions in the Russian domestic corporate market are relatively few; albeit not yet to be named a prevailing tendency, still a wider interest is being displayed towards acquisition of minority shareholdings in Russian joint-stock companies, which raises the natural issues of strategic expectations and legal implications inherent in such acquisitions.

## **Minority shareholding acquisition strategies**

Most typically, acquisition of minority shareholding in Russian joint-stock companies is guided by either short term venture investment considerations or strategic investment intents.

## **Venture investment interest**

Just like in the more advanced markets, venture investment into Russian companies' stocks is performed in anticipation of either high re-sale yield or high dividends, or both; as a general rule, such acquisitions are not intended to provide investor with an involvement into the target company's business affairs and/or internal decision-making. With liquidity of the target stocks being the critical consideration for such investment, relative acquisitions are effectively confined to publicly traded instruments; hence, legal due diligence of a target company by an

investor is rather rudimentary, if performed at all, in reliance on stock exchanges' monitoring and control instrumentaria, including, inter alia, trade clearing and settlements and issuers' information disclosure compliance control. Apart from matters of legality of title transfer and recording, legal aspects of venture acquisitions are of little or no interest for a relevant investor.

However, as Table 1 below clearly demonstrates, Russian stock exchange market remains extremely narrow: trading through consolidated equity markets of RTS (Russian Trading System) and St. Petersburg Stock Exchange, the major national exchange traded stocks market place, is limited to 246 stocks (common and preferred), while MICEX (Moscow Inter-Bank Currency Exchange), the second biggest securities exchange, is largely dedicated to corporate and government (municipal) debentures with only 32 corporate stocks (common and preferred) listed.

As a result, venture equity acquisition through Russian domestic stock exchanges is essentially limited to a relatively small number of national blue chip corporations' stocks publicly traded in the highly volatile market, while the vast majority of domestic businesses incorporated in form of joint-stock companies are not listed with any of the national or foreign stock exchanges, with their shares only available in the OTC market.

While being by far less exposed to political volatility factors as compared to publicly traded stocks, Russian OTC stock market, however, secures generally a substantially lower degree of immediate liquidity. It is for this reason that acquisition of minority shareholding in a non-public Russian company is more frequently contemplated by foreign investors as a strategic, rather than venture, acquisition.

## **Strategic investment**

As opposed to venture investment in Russian

**Table 1**

	Companies listed	Monthly reported stock trades (June 2004)	Monthly stock trade volume (June 2004)	Monthly trade volume, Millions (June 2004)
Consolidated stock exchange market of RTS and St. Petersburg Stock Exchange (with clearing through RTS)	170 (August 2004)	61,462 (including REPO)	988,012,558	\$1,896
NYSE	2,750 (2003 annual report)	74,010,200	28,799,100,000	\$914,200
LSE	2,757 (July 2004)	5,085,539	164,116,400,000	£376,572

equities, strategic acquisitions of minority shareholdings are frequently performed with a view to future take-over or, at least, gradual buildup of a majority or controlling shareholding. Such strategy is usually employed where a company's equity is widely held as a result of the issuer transformation into a joint-stock company in the course of the "first wave" of privatization of Russian Government owned enterprises in 1991 – 1993 or for other reasons.

Minority shareholding acquisitions may also be considered with respect to Government owned enterprises undergoing gradual privatization; in such cases holding of a minority stake may secure better position during subsequent offerings of Government-held stocks. Moreover, acquisition of a relatively significant (preferably, over 25%) minority stake in similar companies would most frequently result in obtaining effective control over the company's business affairs as the Government's involvement in such companies' management is rarely extensive.

Recently, however, acquisition of minority shareholdings has notably developed into a tool for entering industry-specific Russian domestic markets by way of setting up a long-term corporate relationship with existing company shareholders. The value of such acquisitions is rarely created through dividends distribution policy, but evolves through sharing in the company's cash flows by establishment (in concert with domestic majority shareholders) of commercial relationship between the target company and the relevant minority shareholder's enterprise (in form of exclusive supply and/or distribution contractual arrangements, provision of various IP rights, technology and/or know-how access, etc.).

Minority shareholdings are sometimes acquired in holding vehicles for the purpose of bartering the same at a later date for majority or controlling stake in an operating subsidiary within the group.

Finally, minority shareholdings may be acquired with a view to build up an "exit pre-

mium" value by employing greenmail techniques or by way of "tendering" the strategically attractive minority shareholding among other company shareholders striving for control position.

### **Strategic investment: legal implications**

Regardless of background considerations leading to strategic acquisition of a minority shareholding it requires a by far more extensive awareness of the target company's business affairs status, internal management and decision-making procedures, as well as minority shareholders' legal position.

Legal status of shareholders in Russian joint-stock companies is rather extensively regulated by national corporate law statutes, with a general tendency of expanding minority shareholders' rights protection instrumentaria. Featured below is a brief overview of principal rights and remedies that acquisition of minority shareholding provides access to.

### **General**

Each ordinary share in a Russian joint-stock company confers to its holder a standard set of rights, including:

- (i) right to attend (personally or by proxy) shareholders' meetings and to vote on any matter of business transacted at such meeting;
- (ii) right to receive dividends (where so resolved by a shareholders' meeting);
- (iii) right to share in a company's assets remaining available for distribution upon company winding-up and liquidation;
- (iv) right of access to certain company information and documents (with certain restrictions discussed below);
- (v) right to demand redemption of his shares in an event a shareholders' meeting shall approve company reorganization or a major transaction, provided the relevant shareholder shall vote against such resolutions or fail to vote (abstain from voting);
- (vi) right to demand redemption of his shares in

an event a company shall reduce its registered capital or redeem up to 10% of its outstanding stocks without such reduction;

(vii) in case of public allotment and placement of new shares, right of pre-emptive acquisition of such shares pro rata to his existing shareholding (of the same category and type);

(viii) in case of private allotment and placement of new shares, right of pre-emptive acquisition of such shares pro rata to his existing shareholding (of the same category and type), provided the relevant shareholder shall vote against such placement or fail to vote (abstain from voting).

Certain additional rights are granted by law to certain categories of minority shareholders depending on the size of their shareholding.

### **Where shareholding is at least 2%**

A holder of at least 2% of a company's voting stock is entitled to propose business to be transacted at annual shareholders' meetings, candidates to be elected members of the board of directors, management board (if any), internal auditing committee, counting commission

(if any), and/or the company general director (CEO).

### **Where shareholding is at least 10%**

A holder of 10% of voting stock is entitled to demand at any time that an extraordinary shareholders' meeting shall be convened, and, shall such demand be rejected or ignored, shall be entitled to convene a meeting and for this purpose to exercise appropriate authority of the company's board of directors.

In addition, a holder of at least 10% of voting stock is entitled to demand at any time audit of a company's financial and business affairs.

### **Where shareholding is in excess of 25%**

Shareholding in excess of 25% would provide control over resolutions of shareholders' meetings requiring a 3/4 majority vote, in particular:

- (i) to amend a company's charter;
- (ii) to reorganize a company;
- (iii) to wind up a company, appoint a liquidator and approve interim and final liquidation accounts;



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(iv) to determine number, face value, category (type) of declared (unallotted) shares, as well as scope of rights such shares shall convey;

(v) to redeem company's shares;

(vi) to approve a major transaction in excess of 50% of a company's assets balance sheet value;

(vii) to perform private placement of a company's shares (unless a higher majority is required by the company charter);

(viii) to perform public placement of a company's ordinary shares in excess of 25% of earlier allotted ordinary shares (unless a higher majority is required by the company charter); and

(ix) to perform public placement of securities convertible into ordinary shares of a company in excess of 25% of earlier allotted ordinary shares (unless a higher majority is required by the company charter).

Besides, holders of over 25% stake enjoy wider rights of access to accounting books and records, as well as minutes of the management board (if any) of a company.

### **Appointment of the Board**

According to Russian corporate law, a board of directors shall be appointed by cumulative vote of a shareholders' meeting, i.e. each voting shareholder shall be entitled to a number of votes determined by multiplying number of voting shares such shareholder holds and a number of members to be elected to the board of directors (with the statutory minimum of 5).

Therefore, a holder of at least of 1/5 of a company's voting stock is entitled to nominate at least one member of the board.

### **Pre-emption**

In addition, shareholders in closed joint-stock companies are entitled to the statutory pre-emption right (right of first refusal) with respect to shares of stock offered for sale by existing shareholders; it should be noted, however, that pre-emption rights are only enforceable with respect to disposal of relevant shares for value, i.e. no demand for pre-emptive acquisition shall be legal (or enforceable) where a selling shareholder makes a disposal of his shares without any consideration (e.g. by gift). Moreover, right of first refusal is only applicable with respect to selling shares to a third party and shall not extend to cover transfer of shares from a shareholder to another shareholder of a company. ☐

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