Pledge of equity shares in Russian joint-stock companies & exercise of corporate control

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The taking of Russian joint-stock companies' (JSC) equity shares as collateral for a credit or a loan facility is gradually becoming an issue attracting increasing interest from foreign investors contemplating expansion into the Russian financial services market.

However, as yet relatively few Russian companies are listed with national stock exchanges and the shares are largely traded in the OTC market. The OTC market reduces the level of independent control over an issuer's affairs and creates the potential risk of the pledged shares' value being reduced to virtually zero through fraudulent disposal of issuer's assets without the pledgee becoming aware of the same until a borrower defaults under its obligations towards a secured creditor. Potential exposure to such risk emphasises the issue of a secured creditor exercising corporate control over affairs of a company shares of which are held in pledge.

General

The taking of Russian JSC's equity shares as collateral for credit or loan facilities with the intention of a pledgee to control the disposal of the issuer's assets requires attention to be paid to provisions of at least three areas of Russian statutory regulations:

- general civil law assets pledge regulations;
- specifics of equity securities pledge under securities market regulations; and
- corporate governance regulations.

Assets pledge regulations

As a matter of Russian civil law, a pledgee may exercise a different degree of control over pledged assets depending on the provisions of a relevant pledge contract with regard to allocation of legal possession of the pledged assets during the term of the contract. Generally, movable assets may be pledged in terms of (i) a pledgor retaining possession of the pledged assets or, alternatively, (ii) such possession being transferred to a pledgee. By default, pledged assets are left in the hands (i.e. in legal possession) of a pledgor.

Specifics of equity shares pledge: securities marker regulations

According to Russian civil law, securities (including equity shares) are qualified as movable property or assets and are therefore equally subject to general civil law rules and provisions (including pledge of assets), unless otherwise provided by federal laws.

With regards to Russian securities market regulations, equity shares may only be issued in a registered form. Therefore, corporate rights conveyed by equity shares, including the right to attend and to vote at general meetings of company stockholders, are vested with respective holders of company shares who are properly identified in a stockholders register or on depository books (as the case may be).

Moreover, as most of Russian companies' equity shares have been issued (and as from December 30, 2002, may only be so issued unless otherwise provided by federal law) in uncertificated form, stockholders registers or depository books remain the only instrument confirming title of a holder to certain equity shares or encumbrance or transfer of such title.

Pledge without transfer of possession

According to the Russian Federal Securities Market Commission (national securities market regulator (the "Commission")) rules, any encumbrances over registered securities shall be properly recorded in a shareholders register or on depository books.

In the case of the pledge of shares without transfer of possession to a pledgee, the encumbrance created by the pledge shall be registered by a registrar or a depository; however, the pledged securities will remain recorded in the name of the pledgor, and the pledgor will retain all corporate rights and powers conveyed by pledged shares (except for free disposal). This will include the power to attend stockholders meetings and to vote at its own discretion.

A secured creditor may therefore only exercise control over the disposal of an issuer's assets (subject to certain restrictions as discussed in the 'corporate governance regulations' section of this article) by attending stockholders meetings and voting on any business legally transacted, as the secured creditor sees fit in the capacity of the pledgor's attorney-in-fact appointed by proxy.

Nevertheless, issue and delivery of a relevant proxy only provides for minimum coverage with respect to the risk in question because, as a matter of Russian civil law, a proxy may be withdrawn at any

time by simple notice to a proxyholder and the relevant company. In practice, notices to proxyholders are often caused by bad faith debtors and delivered with significant delay, effectively depriving the secured creditors of the right to control the issuer's assets disposal created by a proxy.

Recent amendments to the Securities Market Law endeavor to curb this regulatory deficiency by providing that a registrar or a depository shall be notified of any transfer of rights conveyed by registered securities, apparently including transfer of voting power by proxy. Neither the law or the Commission regulations provide for either an obligation of a registrar or a depository (as the case may be) to notify a proxyholder of withdrawal of the relevant proxy, or any liability for having failed to do so.

Pledge with transfer of possession

Albeit not straightforwardly prohibited or restricted by any statute or statutory instrument, the pledge of uncertificated equity shares on terms of transfer of legal possession thereof to a pledgee is entirely unregulated.

As the shareholders register or depository books are the only instruments confirming legal title to equity shares, the transfer of legal possession of such shares to a pledgee may only be effected by way of recording the same in the name of the pledgee in a shareholders register or on depository books, which shall have the legal effect of a securities 'sale and purchase' transaction and shall therefore constitute transfer of full legal and beneficial title to the pledgee.

In practice, a pledge of uncertificated equity shares with the transfer of possession thereof to a pledgee is normally performed in either of the two ways:

- transfer of equity shares to a pledgee with simultaneous pledge of the same shares in favour of the pledgor in the account of the pledgee; or
- REPO transaction.

However, REPO schemes shall be used to secure a debt with a certain degree of care as the existing case law features several cases where Russian courts have qualified such transactions as a sham intended to cover a pledge (according to the Russian Civil Code, sham transactions are null and void whether or not their invalidity is proved in court); in particular, the courts are likely to apply the test of whether the buyer (the secured creditor) under the first part of a REPO transaction actually intended to become a shareholder of a relevant company or whether the

shares in such company have been taken as collateral for a debt.

Pledge of rights attaching to equity shares

As a matter of Russian civil law and securities market regulations, a shareholder may, generally, secure its obligations by pledge of property rights attaching to equity shares.

According to the RF Civil Code, such a pledge shall be performed by way of transfer to a pledgee or a notary public of legal possession of relevant shares. Hence, the relevant procedures and legal effect thereof shall be the same as discussed above in the previous 'pledge with transfer of possession' section of this article.

Corporate governance regulations

It should be taken into consideration that, as a matter of Russian corporate law, shareholders are only allowed to vote on the company's assets disposal matters in a limited number of cases, in particular:

- when disposal of company assets shall qualify as a major transaction; or
- when disposal of company assets shall qualify as an interested party transaction.

A major transaction shall require the shareholders approval if the value of assets subject to disposal shall exceed 50% of the company assets' aggregate balance sheet value (in which case a 3/4 majority vote will be needed) or if the value of such assets shall exceed 25% of the company assets' aggregate balance sheet value and the company Board of Directors would have failed to approve such disposal by a unanimous vote (in which case a simple majority of attending stockholders shall be sufficient).

An interested party transaction shall require the shareholders approval if:

- the total number of voting stock holders is 1,000 or less and the total number of uninterested members of the Board of Directors is less than a Board quorum as defined by the company articles; or
- the total number of voting stock holder exceeds 1,000 and all of the members of the company Board of Directors qualify as interested parties or neither of such members qualify as independent directors;

provided (in each case) that the balance sheet value of the relevant assets exceed 2% of the company assets' aggregate balance sheet value.

In the event that a shareholder shall oppose a major transaction or shall not vote on it and such major transaction shall nevertheless be approved by the shareholders' meeting, the relevant shareholder shall be entitled to demand redemption of his shares; no similar statutory remedy is available with respect to the interested party transactions.

Additional remedies

Any shareholder holding at least 10% of a company's voting stock (individually or jointly with other shareholders) may at any time demand that the company's performance shall be audited by internal auditing board (or individual auditor). However, such an audit shall be generally confined to verification of the company books and records' accuracy and compliance with applicable regulations. It is arguable whether the audit may also extend to the issues of the company's management performance outside the discussed issues, but, even if it may, company managers shall only be liable for damages sustained by the company in connection with their performance and may, in certain cases, be subject to criminal prosecution (e.g. for inspiring bankruptcy of a solvent company).

A creditor secured by pledge is entitled to a statutory remedy of terminating a facility in case of deterioration of collateral securing such facility. The law does not define deterioration of collateral; therefore, where equity shares are pledged, such deterioration may be deemed to occur in case of decrease of the shares' market value resulting from disposal of the issuing company assets.

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