

Important changes to the law on Limited Liability Companies in Russia

January 2009

Federal Law No. 312-FZ (the “**new law**”) was signed by the President of the Russian Federation on 30 December 2008, and significantly changes the way limited liability companies (“**LLCs**”) are regulated in Russia. It introduces amendments to the Russian Civil Code, the Federal Law “On Limited Liability Companies”, the “Fundamental Principles of Russian Legislation on Notaries” and the Federal Law “On State Registration of Legal Entities and Individual Entrepreneurs”.

The amendments will come into force on 1 July 2009. Prior to this date, LLCs will be regulated by the current legislation. From 1 July 2009 to 1 January 2010, all LLCs in Russia will be required to conform their constitutional documents to comply with the new regime.

The following is a summary of the key factual changes to the law.

Major Focus Points:

1. Definition of Constitutional Documents

The new law eliminates the ambiguity in the current legislation by defining the charter as the company’s sole constitutional document. This does not remove the requirement for a LLC with more than one participant to have a founders’ agreement, but will remove the necessity to amend the founders’ agreement thereafter during the company’s existence.

2. Introduction of the Register of Participants

Under the current law, the list of participants and details of their respective participation interest is recorded in the company’s charter. In practice this means that the charter must be amended and re-registered whenever there is a change in the participation interest.

The new law introduces a registration mechanism similar to that applying to joint stock companies, where the company’s executive body (or other body specified in the company’s charter) will be required to maintain a Register of Participants. This terminates the requirement to record changes in the participation interest in the charter. It appears that the “other body” appointed to maintain the Register of Participants must be an internal body and that this amendment to the law does not allow for an external registrar for LLCs. The responsible body will be obliged to ensure that information contained in the Russian Unified Register of Legal Entities conforms to the information provided in the Register of Participants.

3. Transfer of Participation Interests

The new law has significantly changed the procedure for the transfer of participation interests. With effect from 1 July 2009, most agreements for the transfer of participation interests will need to be notarised. The notary will be obliged to verify the seller’s authority to dispose of the participation interest and to provide the registration authorities and the company itself with copies of the transaction documents. A corresponding entry in the Russian Unified Register of Legal Entities will be made.

The participation interest will be transferred upon certification by the notary. In cases defined by the new law, and where a notarial certification of the transfer agreement is not required (for example on transfers by participants to the company itself), title will transfer upon entry into the Russian Unified Register of Legal Entities.

4. Pledge of Participation Interests

Pledge agreements of participation interests in a LLC created after 1 July 2009 will need to be notarised in order to be valid. The notary will provide the registration authorities and the company itself with copies of the transaction documents. Following this a pledge entry in the Russian Unified Register of Legal Entities will be made.

5. Notary's Liability

The new law amends the Fundamental Principles of Russian Legislation on Notaries. A notary will be fully liable in damages for losses caused by unlawful notarisation or a refusal to notarise. The minimum professional indemnity insurance coverage for the private city practice notary is set at 1,500,000 RUR.

6. Participants' Agreements

The new law allows participants of a LLC to enter into contractual arrangements to regulate the rights of participants (i.e. "shareholders" agreements). This was thought to be unenforceable under the old law. The scope for such agreements seems to be broad as the text contains non-exclusive wording. Specifically, the new law states that such agreements may: regulate the exercise of voting rights; the sale of participation interests at a price defined in the agreement and/or upon the occurrence of specific events (we will be looking at this to understand if it can provide a legal framework for share options); and to suspend the right to sell participation interests until the occurrence of a specified event (a legal framework for a "lock in").

At first sight these reforms open the way for "shareholders" agreements in relation to LLCs, enabling joint ventures to be structured domestically in Russia without the imposition of an offshore holding structure (particularly with the abolition of the Exit Right, see section 7.2 below).

7. Miscellaneous Provisions

The new law also provides a number of other changes to the existing regime that are of varying significance, including the following:

- 7.1 The charter may define the sale price at which the participation interests in the company will be sold to other participants (participant), exercising their preemptive right. The new law further enables the charter of a LLC to allow transfers of participation interests to third parties, subject to participants' consent.

Under the current law, the charter may include a prohibition on the sale of participation interests to third parties, but does not give the option to allow them subject to the consent of participants. This has meant that participants must amend the charter each time they wish to allow a transfer under the current law;

- 7.2 Abolition of the 'Exit Right' so that a participant may no longer withdraw from the company unless such a right is explicitly given by the charter;

- 7.3 The new law further establishes a statutory time limit for a participant to challenge a decision taken by the board of directors. This brings the regime in line with the regime for challenging decisions of the general meeting of participants. The claim must be filed within two months of the date from which the claimant became aware of the decision, or from the date at which it should have become aware of the decision;
- 7.4 Changes to the powers of the Board of Directors have been endorsed, clarifying that the charter may expand the list of competencies to include those that are not expressly stated by law as reserved to the general meeting or to the general director;
- 7.5 The amendments extend the list of exemptions from the requirement for major/interested party transaction approval; and
- 7.6 There is some codification in the new law with regard to the protection and remedies available to the purchasers of participation interests.

8. Our initial reaction to the new law

These are some of the most significant changes to Russian corporate law since the rafts of legislation seen in the 1990s, and time is needed to understand their full impact. The new procedures for notarisation upon the agreement to transfer participation interests may create stronger protection against non-transparent takeovers, but in a way that we believe may have significant practical implications for the way transactions are carried out. The ability to control and manage completion of the transfer of a legal interest in participation units in real time is a clear advance. However, the application of the procedure to agreements for sale, rather than to the instrument of transfer, is likely to be troublesome in the context of many transactions, e.g. where completion of the transfer is subject to the fulfillment of specific conditions.

Indeed, depending upon the approach taken by notaries to their new role, the new procedures may provide further incentive for inward investments to continue to be made through offshore holdings, contrary to what appears to be the intent of many of the other reforms.

The new approach to agreements regulating the exercise of stockholders' rights is significant. The shortcomings of the inflexible regime which most practitioners believe exists under the old law (seemingly confirmed in the *Megafon* case) have been recognized by legislators, and a new trend towards encouraging direct investments in Russian entities seems to be under way. However, as Russian law generally operates on a prescriptive basis, the new law needs to be carefully analysed to ensure that the new regime is sufficiently flexible in reality. We may also note that similar concessions have not been enacted for closed joint stock companies. With the disappearance of the troublesome Exit Rights, the LLC may become a more attractive vehicle for Russian onshore direct investments.

A comprehensive registration regime for pledge agreements affecting participation interests, backed by legislation protecting the purchaser in good faith without notice, would have been a major advance. The reforms in the new law may be a first step in that direction, but we are not there yet. This note is limited in scope to the new law on pledges, but this new law is a small part of new legislation simultaneously enacted to reform Russian law and approaches to security instruments and their general enforcement.

A substantial body of subordinate legislation for the practical implementation of the new law is necessary over the coming months for the new law to operate effectively once it comes into force on 1 July 2009.

CMS will analyse these important developments and update you with our views over the coming weeks.

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