

Client Alert

DEBT TO EQUITY SWAP

January 2010

On 31 December 2009 a much anticipated federal law permitting “debt to equity” swap for Russian companies came into effect. The law is part of the Russian legislative reform that has resulted during the current financial downturn, and which may assist borrowers looking to avoid insolvency.

The new law introduces certain other provisions regulating the maintenance by companies of their assets and relations with the creditors.

The amendments have been introduced to the Civil Code of the Russian Federation (the “*Civil Code*”), Federal Law No. 14-FZ on Limited Liability Companies (the “*LLC Law*”), Federal Law No. 208-FZ on Joint Stock Companies (the “*JSC Law*”), Federal Law No. 39-FZ on the Securities Market (the “*Securities Market Law*”), Federal Law No. 395-1 on Banks and Banking Activity, Federal Law No. 129-FZ on the State Registration of Legal Entities and Entrepreneurs.

The Duma adopted the law on 23 December and it was signed by the Council of the Federation on 25 December 2009.

Set-off as payment of charter capital

The Civil Code is amended to allow the set-off of payment obligations between the company and its shareholder (or participant, as the case may be) and the provisions of the JSC Law and the LLC Law are redrafted to support this. The JSC Law and the LLC law are correspondingly amended to allow the application of the “right of claim” from the shareholder against the obligation of the shareholder/participant to pay its stake of the charter capital in the company. Also, the companies are now entitled to increase the charter capital in order to cover the incurred loss.

Previously, due to prohibitions in Russian law against “debt to equity swaps” companies and their creditors sometimes looked to structure relatively complicated (usually offshore) schemes to effect debt to equity

conversion. These approaches would appear now less relevant.

It should be noted that the decision of payment of the increased charter capital in the limited liability company by set-off must be adopted by the unanimous decision of the participants of the company.

In the case of joint stock companies, the set-off is possible in the case of private offering of the additional share issue.

One point worth noting, during legal reform discussion earlier in 2009, there was concern to limit the availability of “debt to equity” only for “sophisticated investors”, such limits are not a feature of the enacted law.

Company’s asset to charter capital deficiency

The existing provisions under Russian corporate law, with regard to where a company’s assets remain less than the registered charter capital during the period of two or more financial years have been revised as follows.

If the company’s assets:

- remain less than the registered charter capital during the period of two financial years or more, the company is obliged to include the information on the assets of the company into its annual financial report, and such information shall include: (i) the company’s assets value for the three preceding financial years (or all preceding financial years in respect of the newly registered companies); (ii) analysis of the reasons of

decrease of the charter capital; and (iii) arrangements to be undertaken to fix the assets to capital ratio;

- remain less than the minimum charter capital permitted by law during the period of two financial years or more, the company is obliged to file for its insolvency within six months of the end of the latest financial year;
- remain less by more than 25% than the registered charter capital after three, six, nine or twelve months after the two financial years or more, during which the assets value remained less than the charter capital, the company is obliged to publish twice (once a month) the relevant notifications on the decrease of the company's assets;
- remain less than the registered charter capital during the period of three financial years or more (previously - two years), the company is obliged to either adopt the decision (i) to decrease the charter capital to eliminate the discrepancy, or (ii) to file for insolvency.

If a company adopts a decision to decrease its charter capital, it is obliged to ensure that this information is revealed to public: by way of (i) filing the information into the Unified State Register of Legal Entities, and (ii) recurrent publishing in the media.

Decrease of charter capital or assets – creditors' rights verified

Where a company elects to decrease its charter capital, the creditors of the company (whose rights of claim existed before the publication of a decrease of the charter capital or the decrease of the company's assets) shall be entitled to request the performance of the obligations owed to them by the company during the 30 days period from the latest publication (limitation period is six months). However, the creditors' right to claim shall cease if the company proves that (i) the creditors' rights are not affected by the fact of decrease of the charter capital or assets and/or (only in the case of decrease of the charter capital) the security is sufficient - this is aiming to eliminate the speculative right of the creditors to file for insolvency on purely formal grounds.

At the same time, if the company fails to observe the requirements listed in section *Company's asset to charter capital deficiency* above, the creditors shall have the right to claim the performance of obligations owed to them by the company, and the relevant authorities are entitled to file for insolvency of such failing debtor. And the defence suggested above shall not be applicable in this case.

Amendments to Securities Market Law

The amendments also introduce enhanced procedures and requirements related to the issuance of bonds by Russian legal entities. The revisions to the Securities Market Law offer more relaxed rules for bond issuance in certain cases. For example, the issuance of the unsecured bonds should now be permitted in case the issuer is (i) a listed or a sufficiently (as defined by the FSFM) rated company, or (ii) a company with fully paid charter capital – if the issued bonds do not exceed the value of the charter capital, etc.

If you have any questions on the matters referred to in this Alert, please do not hesitate to contact CMS, Russian Partners: *Grant Williams, Leonid Zubarev or John Hammond* at +7 (495) 786 4000 or your regular contact at CMS.

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