Chapter 12

Material **Corporate Transactions**

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The Chairman's Checklist

Extraordinary Transactions:

- ✓ Do all directors understand the concept of extraordinary transactions? Does the company charter specify additional criteria for identifying transactions that are to be treated as extraordinary beyond the minimum criteria mandated by law? Does the Supervisory Board distinguish between extraordinary transactions and those entered into in the ordinary course of business?
- ✓ How does the Supervisory Board ensure that extraordinary transactions are properly evaluated and approved by the Supervisory Board or shareholders? Does the Supervisory Board ensure that an Independent Appraiser is engaged to ascertain the market value of assets involved in the transaction?
- ✓ What steps are taken to protect the rights of shareholders who do not approve of extraordinary transactions?
- ✓ Does the company properly disclose information on completed extraordinary transactions?

Control Transactions:

- ✓ Has the company ever been involved in control transactions? How does the Supervisory Board make sure that minority shareholder rights are properly protected in control transactions?
- ✓ Does the Supervisory Board take adequate measures to inform shareholders of the advantages and disadvantages of a change in control? Does the Supervisory Board allow unwarranted takeover defenses?
- ✓ Does the Supervisory Board ensure that any new controlling shareholder extends a mandatory bid at a fair price for outstanding common shares and convertible securities?

Related Party Transactions:

- ✓ Does the Supervisory Board ensure that related parties properly disclose their interest in transactions? Do related parties abstain from participating in discussing and voting on such transactions?
- ✓ Does the Supervisory Board ensure that all legal requirements for the approval of related party transactions are adhered to? What role do independent directors play in related party transactions?

- ✓ Does the Supervisory Board take adequate measures to disclose information on related party transactions and related parties?
- ✓ Do all directors understand their liability for violating procedures for approving related party transactions?

Shareholders are legally protected when the company is involved in extraordinary, control, and/or related party transactions. Such protection is essential because of the impact that these transactions can have on the value of the company, the price of its shares, and the property rights of shareholders. Nevertheless, corporate governance abuses in these types of transactions continue to take place. For example, beneficial ownership structures typically remain non-transparent, making it near impossible to identify related parties in a transaction. In the meantime, insiders continue to develop complex structures and sophisticated techniques that allow them to tunnel assets, profits, and corporate opportunities away from the company and its shareholders.

The protection of shareholders under these circumstances receives considerable attention in the Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code) and is described in detail in this chapter.

A. Extraordinary Transactions

1. Definition

The Company Law refers to and defines extraordinary transactions.[465] The Supreme Arbitration Court has interpreted the legal definition and applied it to specific transactions.[466] Furthemore, companies have the right to set additional criteria for defining extraordinary transactions, which is most commonly done in the company charter.

[465] Law on Joint Stock Companies (LJSC), Article 78, Clause 1.

[466] Information Letter No. 62, Overview of Practices of Resolving Disputes Related to the Conclusion by Commercial Companies of Extraordinary and Related Party Transactions, the Presidium of the Supreme Arbitration Court of the Russian Federation, 13 March 2001, Sections 1, 4 and 6.

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A transaction (or several related transactions) is extraordinary when it meets all five of the following criteria:

a) The Nature of the Transaction

- The transaction directly or indirectly involves the acquisition, sale, or the possibility of sale of corporate assets;
- The transaction is a credit, pledge, or guarantee transaction; and
- The transaction is not related to the issue of additional common shares or securities convertible into common shares.

b) The Value of the Transaction

The assets involved have a value of 25% or more of the book value of the company's assets as determined by financial statements as of the most recent reporting date.

c) The Relation of the Transaction to the Business of the Company

The transaction is not being carried out in the "ordinary course of business" of the company.

The Company Law does not define the "ordinary course of business." Whether a transaction qualifies as such will depend on company-specific factors. For example, the purchase of real estate may be an extraordinary transaction if the company is generally engaged in the trade of consumer goods. However, the same transaction would not be extraordinary if the core business is trading in real estate. In other words, the same transaction that could be in the ordinary course of business for one company may not be for another. The Supreme Arbitration Court lists some transactions that could fall under the "ordinary course of business."[467] In particular, they are:

- Transactions to acquire raw materials and materials necessary for company's business activities;
- Sale of produced goods; and
- Obtaining loans to fund its ordinary operations.

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[467] Resolution No. 19, the Plenum of the Supreme Arbitration Court, on Certain Issues of Application of the Law on Joint Stock Companies (Resolution No. 19), 18 November 2003, Section 30.

d) Related Transactions

Two or more related transactions involving company's assets totaling 25% or more of the book value of the company's assets are considered a single extraordinary transaction.[468] Factors that determine whether several transactions must be considered as a single transaction extraordinary include:

- The purpose of the transactions;
- The market conditions under which the transactions have been concluded;
- The sphere of activities of the company; and
- The duration of relationships between the company and its transactional counterpart.

e) Additional Charter Criteria

The charter may define additional transactions that should be treated as extraordinary transactions.[469] For example, the charter may specify that transactions involving assets with a lower percentage of the book value be considered an extraordinary transaction. The charter can also provide that certain types of contracts (e.g. all loan agreements or all pledges of company shares) must be treated as extraordinary transactions, regardless of their nature. However, the company has no right to change the legal definition of an extraordinary transaction to limit cases of extraordinary transactions. For example, the company cannot provide that only transactions involving assets with a value in excess of 30% of the book value of the company's assets will be considered as extraordinary transactions.

Best Practices: There are many cases when transactions should be subject to special procedures for extraordinary transactions, even though they fall well below the legislated threshold of 25%. For example, the sale of a subsidiary of a large petroleum company that holds significant oil drilling rights may be of such size and strategic importance that it should be considered an extraordinary transaction regardless of the percentage of asset value it represents.

Legislation establishes a minimum standard of behavior, and there is some room for various interpretations regarding what is extraordinary and what is not. For this reason, it is good practice for charters to include provisions that "transac-

[468] LJSC, Article 78, Clause 1, Paragraph 1.

[469] LJSC, Article 78, Clause 1.

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tions that may have a significant effect on the company" be treated as extraordinary (except for transactions that are concluded in the ordinary course of business).[470]

It is also recommended that the sale of shares of a subsidiary where the company would lose its majority stake be considered extraordinary transactions.

When two companies are engaged in a transaction, each company must separately apply the criteria for extraordinary transactions. This means that the same transaction may conceivably be an extraordinary transaction for one company but not for the other.

2. Exempted Transactions

Under certain circumstances, companies are not required to follow all the approval procedures for concluding an extraordinary transaction. Exceptions are granted when the extraordinary transaction is:

- Executed by a company owned by a single shareholder who is also the General Director;[471] or
- Simultaneously a related party transaction.[472] In this case, the company follows the procedures for related party transactions.

➜ *For more information on related party transactions, see Section C of this Chapter.*

3. Valuing Extraordinary Transactions

An important aspect in determining whether a transaction is an extraordinary transaction is to value the assets involved in the transaction. The value of these assets must be determined to ascertain which governing body approves the transaction before the company can conclude the transaction. The Supervisory Board

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470 Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code), Chapter 6, Section 1.1.

471 LJSC, Article 79, Clause 7.

472 LJSC, Article 79, Clause 5.

473 LJSC, Article 77; 78, Clause 2.

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has the authority to determine the value of assets or services.[473] In doing so, the Supervisory Board must compare the book value of the assets involved in the transaction with the book value of the company's assets as a whole. This comparison depends on the nature of the transaction whether it is an acquisition or a sale, as illustrated in Table 1.[474]

Table 1: Determining a Transaction's Value

Type of Transaction	Basis of Valuation
Sale, or the possibility of a sale, of assets	The value of assets involved in the transaction as determined by reference to the company's financial statements as of the most recent reporting date before the transaction.
Acquisition of assets	The acquisition price of assets involved in the transaction.

Best Practices: An Independent Appraiser should assist the Supervisory Board in determining the value of assets.[475]

If the state or a municipal entity owns more than 2% of voting shares, the Supervisory Board is required to involve the state financial control agency in the valuation of the assets in extraordinary transactions.[476] This can be a control agency of the Ministry of Finance (such as the Department of State Financial Control and the regional Control and Revision Departments), the Chief Control Department of the President of the Russian Federation, or a local state financial body.

4. Approving Extraordinary Transactions

A transaction must be approved by different governing bodies depending on the value of assets as illustrated in Table 2.

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474 LJSC, Article 78, Clause 1, Paragraph 2.

475 LJSC, Article 77, Clause 2. See also: FCSM Code, Chapter 6, Section 1.3.

476 LJSC, Article 77, Clause 3.

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Table 2: The Approval of Extraordinary Transaction	
Value of Assets	**Approving Governing Body**
Between 25% and 50% of the book value of the company's assets	The Supervisory Board[477]
More than 50% of the book value of the company's assets	The General Meeting of Shareholders (GMS)[478]

The Supervisory Board has the authority to approve those extraordinary transactions that are defined as such by the charter.[479]

a) Transactions Involving Between 25% and 50% of the Book Value of Company Assets

Unanimous approval of all serving Supervisory Board members is required to approve an extraordinary transaction involving assets with a value between 25% and 50% of the book value of the company's assets.

If the Supervisory Board is not able to reach a unanimous decision, it can request that the GMS approve the transaction. The Supervisory Board can do this by a simple majority vote of directors participating in the Board meeting, unless the charter or by-laws require a higher percentage of votes. The GMS can then approve the transaction with a simple majority vote of participating shareholders.[480]

b) Transactions Involving More than 50% of the Book Value of Company Assets

The GMS must decide on whether to approve transactions involving more than 50% of the book value of company assets by a ¾-majority vote of participating shareholders.[481]

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[477] LJSC, Article 79, Clause 2, Paragraph 1.

[478] LJSC, Article 79, Clause 3.

[479] This decision cannot be approved by the GMS because the company charter cannot delegate additional powers to the GMS beyond those defined by law.

[480] LJSC, Article 79, Clause 2, Paragraph 2; Resolution No. 19, Section 32.

[481] LJSC, Article 79, Clause 3.

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c) Required Information for the Decision to Approve an Extraordinary Transaction

The decisions of the Supervisory Board or the GMS must include information on:[482]

- The parties that are involved in the transaction;
- Other beneficiaries of the transaction (if any);
- The price of the transaction;
- The object of the transaction; and
- Any other significant terms and conditions related to the extraordinary transaction.

5. How Shareholders Can Protest Extraordinary Transactions

If a shareholder does not agree with an extraordinary transaction conducted in full compliance with procedural requirements and the law, he may:

- **Sell his shares.** Practically, this is only possible if the company's shares are liquid, i.e. there are interested buyers and shareholders are able to sell their shares at a fair price; or
- **Demand redemption of shares in part or whole:** Shareholders have the right to have their shares redeemed by the company.[483]

6. Disclosure Requirements

Companies are required to include the following information on extraordinary transactions in their annual reports:[484]

- A list of all extraordinary transactions concluded by the company during the reporting year;

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[482] LJSC, Article 79, Clause 4.

[483] LJSC, Article 75, Clause 1 provides that redemption rights only arise when the extraordinary transaction involves assets or services, the value of which is 50% or less of the book value of company assets. However, the Plenum of the Supreme Arbitration Court has interpreted this provision to include extraordinary transactions involving assets with a value of more than 50% of the book value of company's assets (see also: Resolution No. 19, the Plenum of the Supreme Arbitration Court, on Certain Issues of Application of the Law on Joint Stock Companies, 18 November 2003, Section 29).

[484] FCSM Regulation No. 17/ps on Additional Requirements to the Procedure of Preparation, Calling, and Conducting of the General Meeting of Shareholders, 31 May 2002, Section 3.6.

- A list of transactions that are considered extraordinary based on the definition in the charter;
- Key terms of each extraordinary transaction; and
- The governing body that approved each transaction.

Companies must also disclose information on extraordinary transactions in their prospectus and quarterly reports.[485] For the registration of the secured bond issue and the report on the results of issue, the company must submit the meeting minutes of the approving body with information on the quorum and the voting results to the registration agency.[486]

Companies are required to provide information on extraordinary transactions in the "disclosure appendix" or notes to financial statements related to the acquisition or the disposition of fixed assets and investments.[487]

Audit standards provide that the External Auditor must review extraordinary transactions with related parties to identify the true conditions under which such transactions took place.[488]

7. Invalidating of Extraordinary Transactions

The company and its shareholders have the right to request the court to invalidate an extraordinary transaction if the decision-making body of the company failed to follow appropriate procedures.[489]

However, according to the Supreme Court and the Supreme Arbitration Court, an extraordinary transaction that was invalidated due to procedural violations may

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[485] Annex 4 of FCSM Regulation No. 03-32/ps on the Disclosure of Information by Issuers of Securities, 2 June 2003, Section 10.1.6; Annex 11 of FCSM Regulation No. 03-32/ps, Section 8.1.6.

[486] FCSM Regulation No. 03-30/ps on the Standards of Security Issue and Registration of Security Prospectuses, 18 June 2003, Sections 2.4.7, 6.5.1; Annex 9 of the Standards, Section 11.

[487] Decree No. 56n, the Ministry of Finance, on the Approval of Rules on Accounting Events After the Reporting Date, Section 2. It is, however, unclear whether the term "extraordinary transaction" in this act has the same meaning as in the Company Law.

[488] Audit Standard on Accounting Operations With Related Parties During an Audit, Section 4.2, a). It is not clear whether the term "major transactions" in this act has the same meaning as in the Company Law.

[489] LJSC, Article 79, Clause 6.

be re-validated if approved after the fact by the GMS (or the Supervisory Board, where applicable).

Best Practices: Russian legislation appears inadequate in protecting the interests of the company's counterparts in extraordinary transactions. If the company can seek to invalidate a transaction that was not concluded in accordance with the company's internal approval procedures then this may create undue problems for the counterpart. It is recommended to follow the example of some western jurisdictions where the company needs to prove that the counterpart in the transaction knew or must have known of the irregularity of its approval.

B. Control Transactions

Control transactions are transactions in which a person (or a group of affiliated persons) acquires a controlling block of shares, defined in the Company Law as 30% or more of the company's common shares.[490] Control transactions are also referred to as takeovers.

Best Practices: The market for corporate control, together with the product, labor, and capital markets, is a distinct feature of a market economy. Generally, markets for corporate control represent the historical development of a distinct fourth type of market, in which the trading of corporate equity occurs on a very large scale and bestows the power to control these corporations. Takeovers are a key mechanism in the dynamic allocation of corporate control; they allow the removal of inefficient managers (against their will) and exploitation of synergies between firms. Moreover, the mere threat of a takeover affects the behavior of those entrusted with control, i.e. disciplines them. Consequently, a functioning takeover market is widely considered an important component of — if not a prerequisite for — an effective governance system.

Over the last several decades, the issue of regulating takeovers has become increasingly important. In the EU, for example, the Thirteenth Company Law

[490] LJSC, Article 80, Clause 1.

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Directive on Takeover Bids was recently adopted. In contrast to Russian law, it attempts to apply takeover rules to listed companies and specifically deals with voluntary bids, which are not regulated by Russian legislation. Voluntary bids, which are also called tender offers, are a means of public offer to acquire shares of the company leading to a change of control. There are specific rules that deal with the disclosure and terms of such bids.[491]

Takeovers result in changes to company control, strategy, decision-making, and, generally, lead to the replacement of the acquired company's directors and senior managers. One of the economic benefits of takeovers is that they may result in improved utilization of company assets. This, in turn, should benefit all shareholders. On the other hand, takeovers have considerable potential for abusing minority shareholder rights.

Best Practices: Changes of control may occur on a voluntary basis by consolidation or merger, as agreed upon by shareholders and managers of participating companies. Control can, however, also pass hands in a hostile manner, i.e. when directors and managers of the target company resist the takeover attempt. The negative implications of change of control situations not only relate to pre-change possibilities of abuse (for example, two-step tender offers, during which the acquiring company offers different prices to different groups of shareholders), but also to post-change challenges that non-controlling shareholders might face (for example, changes to the dividend policy or increases in executive remuneration, to the detriment of minorities).

In case of voluntary change of control, shareholders have a say in the results and expressly agree with all consequences. In case of hostile takeovers, directors and managers typically have more opportunities to resist the value-increasing changes of control in their own interests. At the same time, if a hostile takeover attempt succeeds, minority shareholders who did not agree with the change of control risk being in the situation where the new controlling shareholder may abuse its position and retaliate for such behavior of shareholders.

[491] For more information on EU Thirteenth Directive and voluntary bids, see http://europa.eu.int/eur-lex/en/archive/2004/1_14220040430en.html.

In Russia, companies with more than 1,000 shareholders with common shares must follow special procedures both before and after the acquisition of 30% or more of common shares.[492] Companies are also required to follow procedures for control transactions each time the controlling shareholder(s) acquires an additional 5% or more of common shares (e.g. 35%, 40%, 45%, and 50%).[493]

Company Practices in Russia: Control transactions are of particular concern to many Russian companies today, given the current consolidation wave taking place in many sectors. More specifically, smaller, successful companies and their (minority) shareholders often become subjects of abuse by large companies through hostile takeovers. In many instances, however, takeovers are not carried out through the typical market mechanisms (e.g. by extending a tender offer to shareholders) but rather through block sales. Moreover, certain illegal methods to overrule privatization results are used to circumvent proper control transactions, e.g. dubious lawsuits that paralyze the company and often bring it to the verge of bankruptcy. Under these circumstances, the role of the judiciary, the FCSM, and other enforcement bodies becomes particularly important in protecting companies and shareholders.

1. Affiliated Persons

The concept of affiliated persons is important in the context of control transactions because shares acquired by affiliated persons are added up when determining whether a transaction is a control transaction. An affiliated person is defined as an individual or a legal entity that can influence the activity of legal entities, and/or individual engaged in entrepreneurial activity.[494] Consequently, the following are considered affiliated persons of a legal entity:

- A Supervisory Board member;
- The General Director or an Executive Board member;
- The External Manager;

[492] LJSC, Article 80, Clause 1.

[493] LJSC, Article 80, Clause 7.

[494] Law on Competition and Limitation of Monopolistic Activities in Commodities Markets (Antimonopoly Law), Article 4.

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- Any legal entity that is part of the same group of companies[495] to which the company belongs;
- Any individual who possesses more than 20% of votes in the company;
- Any legal entity, in which the company possesses 20% of votes; and
- A member of the Supervisory Board or the Executive Board, the General Director, and the External Manager of other members of the company's Financial and Industrial Group (FIG).

➜ *For more information on FIGs, see Part V, Chapter 15, Section B.4.*

The following persons are considered affiliated persons of an individual, e.g. Individual (B) who carries out entrepreneurial activity:

- Any individual or legal entity belonging to the same group to which Individual (B) belongs; and
- Any legal entity in which Individual (B) has more than 20% of voting shares (participatory shares, units).

➜ *For more information on disclosure requirements of affiliated persons, see Part IV, Chapter 13, Section B.3.*

2. Pre-Acquisition Requirements

An individual, legal entity, or group of affiliated persons must notify the company in writing when they intend to acquire:

- 30% or more of the company's common shares; or
- Shares that will lead to the ownership of 30% or more of common shares.[496]

This notification must be sent to the company no earlier than 90 days before the shares will be acquired, and no later than 30 days before the acquisition.[497]

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[495] Antimonopoly Law, Article 4.

➜ *For more on groups of companies, see Chapter 15.*

[496] LJSC, Article 80. Note that the Company Law refers only to common shares and does not include voting preferred shares and convertible securities. Since control transactions are aimed at acquiring control of the target company, buyers seek to acquire voting shares.

[497] LJSC, Article 80, Clause 1. Russian legislation does not specify what information must be included in the notice of the intention to acquire 30% or more of common shares.

Best Practices: If notice of an intent to acquire control is received by the company, the Supervisory Board should:[498]

- Have an Independent Appraiser determine the market value of common shares; and
- Inform shareholders of the possible consequences of the acquisition of shares.

This should enable shareholders to make an informed decision regarding whether to sell their shares to the person who intends to acquire a controlling block.

3. Post-Acquisition Requirements

A far more important procedural requirement found in the Company Law arises after the acquisition of a controlling block of shares.

a) Mandatory Bid

The controlling shareholder (or group of affiliated persons) is obliged to make an offer to purchase or buyout the remaining common shares (and other securities convertible into common shares) within 30 days after the acquisition of a controlling block. This is referred to as a "mandatory bid" or a "fair price requirement."

The mandatory bid must be sent to all common shareholders in writing and must include:[499]

- The name and address of the acquirer of the controlling block of shares;
- The number of acquired common shares;
- The price offered by the acquirer to shareholders (the buyout price);
- The period for accepting the mandatory bid; and
- The period for making the payment for shares and convertible securities.

Best Practices: It is good practice to submit the mandatory bid to shareholders not directly but through the company. The Corporate Secretary can assist in

[498] FCSM Code, Chapter 6, Section 2.1.1.

[499] LJSC, Article 80, Clauses 3 and 5.

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forwarding the mandatory bid to shareholders in accordance with the notification procedures for the GMS.[500]

➜ *See also Chapter 8, Section B.4 on notification procedures for the GMS.*

Non-controlling shareholders have the right to accept the mandatory bid in no later than 30 days after they receive it. If accepted, the controlling shareholder is obliged to purchase the shares and/or convertible securities within 15 days of the non-controlling shareholder's acceptance of the mandatory bid at the buyout price.[501]

b) The Buyout Price

The buyout price for common shares and convertible securities must be at market value. At the same time, the price for common shares may not be below their average weighted market price over the six months preceding the acquisition.[502]

Best Practices: Control transactions usually include a so-called control premium, which is paid by the acquirer of control to selling shareholders. Some commentators argue that equal treatment of shareholders should also lead to sharing the control premium. Hence, the City Code on Takeovers and Mergers of the U.K. and EU Thirteenth Directive require that the mandatory bid equal the highest price that was paid for buying the control.[503]

c) Waiver of the Mandatory Bid Requirement

The acquirer of a controlling block of shares can be released from the obligation to make the mandatory bid in the following two situations:[504]

- **Charter exemption.** The charter may exempt the acquirer from the obligation to make a mandatory bid in relation to control transactions; or

[500] FCSM Code, Chapter 6, Section 2.4.

[501] LJSC, Article 80, Clause 4.

[502] LJSC, Article 80, Clause 2, Paragraph 1. Note that this article does not specify the date on which the market value of shares must be determined.

[503] For more information on mandatory bids, see the EU Thirteenth Directive at http://europa.eu.int/eur-lex/en/archive/2004/1_14220040430en.html.

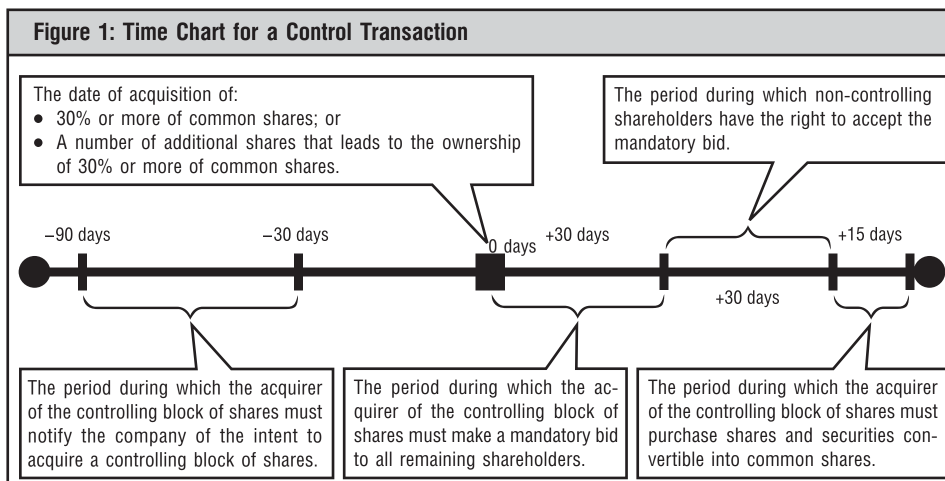
[504] LJSC, Article 80, Clause 2, Paragraph 2.

- **Transaction-specific exemption.** The GMS can exempt the acquirer from the obligation to make a mandatory bid. A simple majority vote of participating shareholders (excluding the votes of the acquirer of the controlling block of shares) is sufficient.

Best Practices: Neither the charter nor GMS should release the controlling shareholder(s) from the responsibility to buyout the shares of non-controlling shareholders.[505]

The timelines for carrying out control transactions are summarised in Figure 1.

Figure 1: Time Chart for a Control Transaction



Source: IFC, March 2004

Best Practices: In addition to the mandatory bid rule, legislation in western jurisdictions provides for an additional shareholder protection mechanism, the sell-out right.[506] The sell-out right allows minority shareholders to force the controlling shareholders (typically those with 90–95% of the charter capital) to purchase all their shares. The sell-out right is usually mirrored by a correspond-

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505 FCSM Code, Chapter 6, Section 2.3.

506 For more information on sell-out and squeeze-out rights, see the EU Thirteenth Directive at http://europa.eu.int/eur-lex/en/archive/2004/1_14220040430en.html.

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ing right of the controlling shareholder to force the exit of minority shareholders, the so-called squeeze-out right, if he owns 90–95% of the company's charter capital.

Companies wishing to follow good corporate governance practices will include both the sell-out and squeeze-out rights in their charter.

4. Anti-Takeover Measures

There are many legitimate reasons for opposing takeovers. Potential acquirers may not have credible business plans, or the price offered for the company may be too low. However, managers and directors often oppose takeovers simply because they will likely lose their jobs.

Best Practices: A guiding principle for Supervisory Boards to follow is for companies to never employ anti-takeover measures at the expense of shareholder rights and interests. There are different takeover defenses available under various legal systems. In any given jurisdiction, the application of various defenses depends on the national legal and regulatory framework, and judicial practice. Anti-takeover measures range from pre-takeover to post-takeover mechanisms. Some of the more famous measures include poison pills, crown jewels, golden parachutes, and white knights.[507]

The Supervisory Board should not issue additional shares, convertible securities, or securities that entitle holders to purchase shares of the company during the acquisition period of a controlling block of shares (even if an issue is authorized by the charter).[508]

[507] Poison pills are designed to make a hostile takeover prohibitively expensive. For instance, a company may issue a new series of preferred shares that grant its shareholders the right to redeem shares at a premium price after a takeover or allow all existing shareholders of the target company to buy additional shares at a bargain price, thereby deterring a takeover bid by raising the acquisition cost and causing dilution. White knight provisions include the issuance of preferred shares that the Supervisory Board may issue at any time to a "white knight" investor, i.e. a friendly investor sought out by the target firm. For more information on these and other anti-takeover provisions and their corporate governance implications, see the Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids, 10 January 2002, Annex 4, Overview of the Most Important Barriers to Takeover Bids, p. 74. See also: http://europa.eu.int/comm/internal-market/en/company/company/news/hlg01-2002.pdf.

[508] FCSM Code, Chapter 6, Section 2.2.

5. Consequences of Procedural Violations

The acquirer of a controlling block may not vote shares acquired in violation of the legal procedures for control transactions.[509] Thus, the acquirer may only exercise rights attached to shares that were lawfully acquired below the 30% threshold.

If a controlling shareholder (who already owns at least 30% of common shares) acquires an additional 5% or more of common shares without advance notification or without offering to buy out the remaining common shares, he may only exercise the rights attached to the shares that were lawfully acquired.[510]

C. Related Party Transactions

Related party transactions involve insiders, such as directors, managers, large shareholders, or parties related to them. Some related party transactions have legitimate purposes and can be conducted fairly. Others do not. Regardless, they are easily abused and warrant particular attention since they may reduce the value of the company and expropriate shareholder rights. Legislation contains detailed procedures to discourage insiders from entering into related party transactions, and to help ensure fairness when a related party transaction does take place.

Related party transactions not only occur between the company and its directors, managers, and large shareholders, but more importantly, within groups of companies (holding structures), where transactions between the parent and subsidiary companies frequently occur.

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[509] LJSC, Article 80, Clause 6.

[510] Note that the Company Law refers to the limitation of voting rights attached to the controlling block of shares that were acquired in violation of procedures for control transactions. This means that all other rights, including the right to receive dividends, can be exercised. To enforce the buyout requirement, the law could require that shares acquired while violating the procedures for control transactions lose all rights and that they must be disposed of within a specified period.

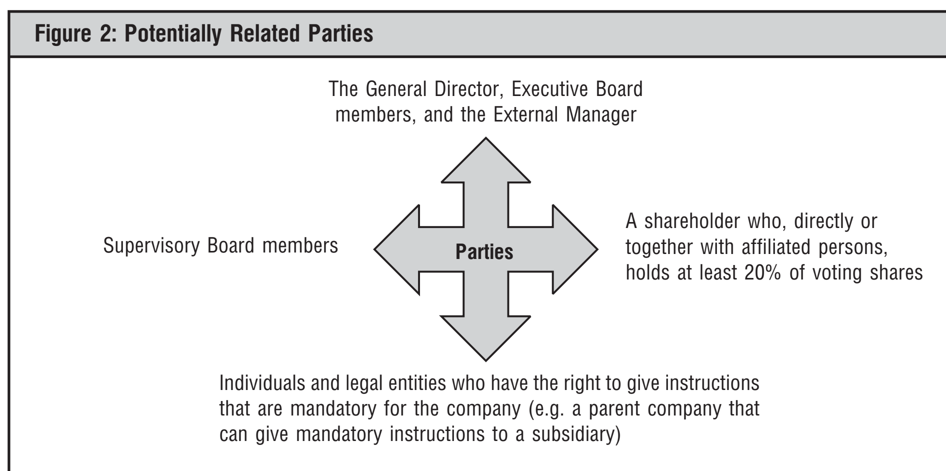
1. Definition

For a transaction to be considered a related party transaction, each company involved in the transaction must check whether two conditions are met.

a) Potentially Related Parties

A number of parties can be defined as related if they play a role in a transaction. Such parties are presented in Figure 2.[511]

Figure 2: Potentially Related Parties



Source: IFC, March 2004

Best Practices: The list of parties defined by the Company Law as related fails to cover key company officers in positions of control. For example, Deputy General Directors, Chief Accountants, and directors of representative offices and branches are not covered by the legal definition, unless they happen to also sit on the Executive Board. Companies wishing to follow good corporate governance practices may consequently wish to expand the list of potentially related parties in their charter.

The OECD Principles of Corporate Governance provide a general definition of related parties, including entities under common control, significant shareholders

[511] LJSC, Article 81, Clause 1.

including members of their families and business associates, and key management personnel.[512]

International Accounting Standard (IAS) Number 24.9 provides a more detailed definition, and thus parties are considered to be related if one party has the ability to control the other party or to exercise significant influence or joint control over the other party in making financial and operating decisions.[513] A party is related to an entity if:

1. Directly, or indirectly through one or more intermediaries, the party:
   - Controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries, and fellow subsidiaries);
   - Has an interest in the entity that gives it significant influence over the entity; or
   - Has joint control over the entity;
2. The party is an associate (as defined in IAS 28 Investments in Associates) of the entity;
3. The party is a joint venture in which the entity is a venturer (see IAS 31 Interests in Joint Ventures);
4. The party is a member of the key management personnel of the entity or its parent;
5. The party is a close member of the family of any individual referred to in (1) or (4);
6. The party is an entity that is controlled, jointly controlled, or significantly influenced by or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (4) or (5); or
7. The party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

At the same time, IAS 24.11 specifies which parties are not deemed related:

- Two enterprises simply because they have a director or key manager in common;
- Two venturers who share joint control over a joint venture;
- Providers of finance, trade unions, public utilities, government departments, and agencies in the course of their normal dealings with an enterprise; and
- A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence.

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[512] See 2004 OECD Principles of Corporate Governance on www.oecd.org/dataoecd/32/18/31557724.pdf.

[513] See also: the International Accounting Standard Board's website under www.iasb.co.uk.

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The Financial Accounting Standards Board's (FASB) Statement No. 57 finally defines a related party as affiliates of an enterprise, trusts for benefits of employees, owners and their family members, investment entities accounted for by the equity method by the firm, management, and other large shareholders or parties that influence firm policy.

b) Related Parties Are Involved in the Transaction

For the purposes of defining related party transactions, the parties specified in the previous section as well as spouses, parents, children, sisters and brothers, adopted children, and adoptive parents of other potentially related parties listed in this Figure must be involved in the transaction in one of the following capacities:[514]

- Act as a transacting party, a beneficiary, an intermediary, or an agent in the transaction;
- Own at least 20% of voting shares (participatory shares, units)[515] in a legal entity which is a party, beneficiary, intermediary, or agent in the transaction;
- Hold a position in a governing body of a legal entity which is a party, beneficiary, intermediary, or agent in the transaction; or
- Other instances specified in the charter.

Mini-Case 1: Company (X) concludes a contract with Company (Y) that Company (Y) will sell products of Company (X) on-line. Mr. (A) is a Supervisory Board member of Company (X) and is also the General Director of Company (Z), which will receive a special discount on products of Company (Y) sold to Company (Z) if the transaction between Company (X) and Company (Y) is concluded. In such a transaction between Company (X) and Company (Y), Mr. (A) is considered a related party who is a beneficiary of the transaction. The transaction will be a related party transaction for Company (X) and will require approval. At the same time, it is not a related party transaction for Company (Y).

As illustrated in Mini-Case 1, it is important to note that the same transaction can be a related party transaction for one company but not for another. In this case, only one company needs to approve the transaction as a related party transaction.

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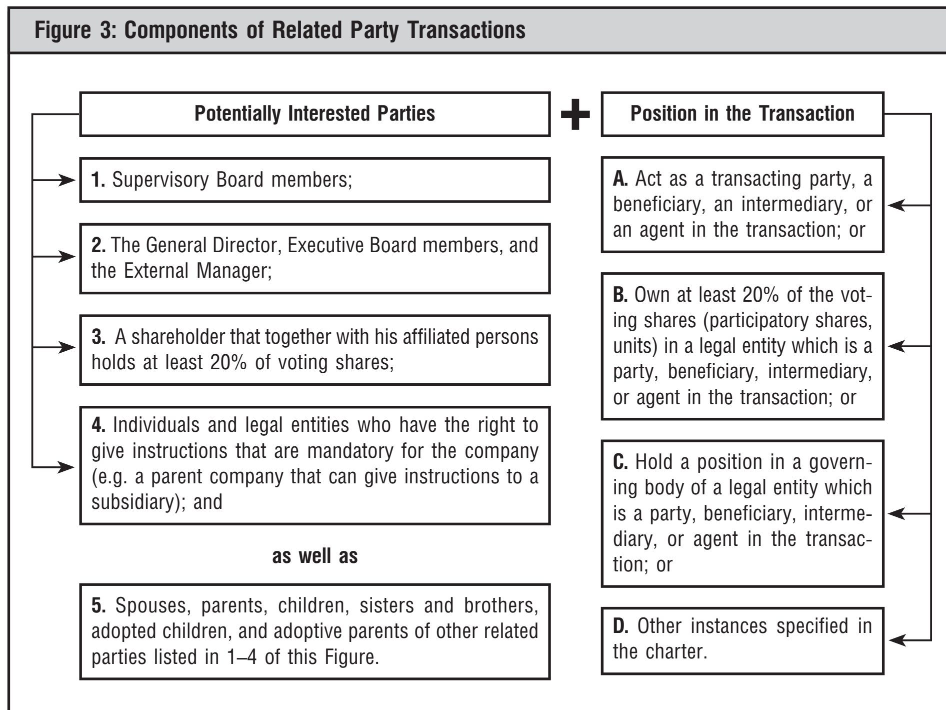
[514] LJSC, Article 81, Clause 1.

[515] Participatory shares refer to limited liability companies, while units refer to production co-operatives.

Figure 3 depicts components of related party transactions, which must be present in a transaction.

Figure 3: Components of Related Party Transactions



Source: IFC, March 2004

To determine whether a transaction is a related party transaction, it is necessary for an interested party from the left column of Figure 3, be involved in the transaction as indicated in the right column of Figure 3. In practice, this means that a company must create a list of potentially interested parties and always check whether any of these parties (1–4 of the left column) or their affiliated persons (5 of the left column) is involved in each and every transaction carried out by the company, as mentioned in A — D of the right column.

Best Practices: Related party transactions are common in the context of groups of companies, e.g. in parent-subsidiary relations. If one company dominates another, there is a risk that the parent will utilize the subsidiary for its own busi-

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ness objectives, without care for the subsidiary's long-term financial viability. In these cases, the creditors and shareholders of both the subsidiary and parent may be put at risk — often unknowingly.

- The risk for creditors at the subsidiary level is obvious. But the risk is present at the parent level as well, as the subsidiary's insolvency can greatly damage the surviving parent.
- Shareholders are also put at risk, although the position of shareholders at the subsidiary level is weaker. On the one hand, shareholders at the subsidiary level often benefit from being part of the parent's business. On the other, they may have to contribute to the parent's welfare to their own detriment.

➜ *For more information on intra-group transactions, and the important role the Supervisory Board plays, see Part V, Chapter 15, Sections B and C.*

2. Exempted Transactions

Companies are not required to comply with approval procedures if:[516]

- The transaction is executed by a company consisting of a single shareholder who is simultaneously the General Director;
- All shareholders are related parties in the transaction;
- The transaction is the exercise of pre-emptive rights by shareholders;
- The transaction is the buyback or the redemption of shares; or
- The transaction is a reorganization through merger (consolidation), and the other entity that participates in the merger (consolidation) owns more than 75% of voting shares of the company being reorganized.

3. Approving Related Party Transactions

Best Practices: There are different means of regulating related party transactions. Prohibitions of specific types of transactions are found in the U.K., where the U.K. Companies' Act prohibits directors from entering into certain transac-

[516] LJSC, Article 81, Clause 2.

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tions that are deemed detrimental to the company.[517] The advantage of this first approach is clear: all practitioners know where the boundaries are. There will be no fine analysis as to the possibilities to circumvent the prohibition. The disadvantage is the rule's lack of flexibility: even economically useful transactions may not come into being when the law contains a flat prohibition. Additionally, parties may also make great efforts to circumvent the rule.

In some jurisdictions there have been calls to change the approach and foster more substantive criteria of fairness: transactions with conflicting interests should always be open to challenge on the basis of unfairness, at least gross unfairness. This second approach is frequently found in U.S. law, and in the U.K.[518]

Russia seems to have chosen a third option, also present in developed jurisdictions — to require specific approval procedures for related party transactions.

Related party transactions have to be approved by the GMS or the Supervisory Board, respectively, as illustrated in Table 3.

Table 3: The Approval of Related Party Transaction

Nature of the Transaction	Approving Body
• Value of assets involved in the sale (or the offer price) is 2% or more of the book value of the company's assets according to its financial statements for the last reporting period; or • Transaction relates to the placement by subscription or a sale of shares that are more than 2% of issued common shares and convertible securities; or • Transaction relates to the placement by subscription or a sale of convertible securities that are more than 2% of issued common shares and convertible securities.	The GMS[519]
• All other related party transactions.	The Supervisory Board[520]

517 Section 330 (2), U.K. Companies Act.

518 See in the U.K., the Law Commission, Company directors: Regulating conflicts of interest and formulating a statement of duty, September 1999, p. 282, document Law Com No. 261.

519 LJSC, Article 83, Clause 4.

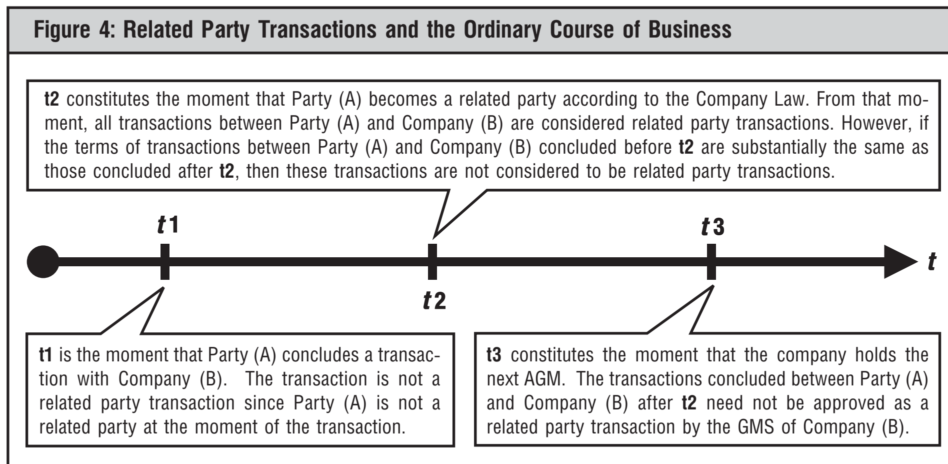
520 LJSC, Article 83, Clause 2; Article 83, Clause 3, Paragraph 1.

a) Approval by the GMS

A simple majority vote of shareholders participating in the GMS (excluding votes of related parties) is required to approve a related party transaction. The GMS may adopt a decision to approve a future transaction between the company and a related party, as long as it is concluded in the course of the company's ordinary business activities. In this case, the decision of the GMS must specify the maximum amount of the transaction. The decision remains in force until the next Annual General Meeting of Shareholders (AGM).[521]

The GMS is not required to approve a related party transaction if the terms of the transaction are substantially similar to past transactions with a person before such person became a related party.[522] This exception applies to related party transactions until the next AGM, as illustrated in Figure 4.

Figure 4: Related Party Transactions and the Ordinary Course of Business



Source: IFC, March 2004

b) Approval by the Supervisory Board

The Supervisory Board has the authority to approve related party transactions if they do not fall under the authority of the GMS. The legal requirements for decision-making thresholds differ depending upon the number of shareholders in the company:

[521] LJSC, Article 83, Clause 6, Paragraph 2.

[522] LJSC, Article 83, Clause 5.

- **In companies with 1,000 and fewer shareholders with voting rights**, the decision to conclude a related party transaction must be made by a majority of directors participating in the Supervisory Board meeting and who are not related parties.[523] This means that directors who are related parties:[524]
  - Must inform the Supervisory Board about their interest in the transaction; and
  - Must abstain from participating in the decision of the Supervisory Board on the transaction.

"Interested" members are not counted for the quorum. The decision to approve a related party transaction must be adopted by the GMS if the number of disinterested directors is insufficient to meet the quorum.[525]

- **In companies with more than 1,000 shareholders with voting rights**, the decision to conclude related party transactions must be made by a majority of independent directors who are not related parties.[526] Again, this means that directors must inform the Supervisory Board of their interest in the transaction and must abstain from voting. Furthermore, directors who are not independent must abstain from participating in the discussion and from voting on the issue. These members are not counted for the quorum. If all directors are either interested or non-independent, the decision to approve the related party transaction must be adopted by the GMS.

Mini-Cases 2 and 3:

2. The only shareholder of Company (B) is the brother of the Chairman of the Supervisory Board of Company (A). Company (A) sold its shares to Company (B) at a price that is below market. This is a related party transaction for Company (A). The Chairman of Company (A) is a related party and should not take part in decision-making on the approval of this transaction.

[523] LJSC, Article 83, Clause 2.

[524] FCSM Code, Chapter 3, Section 3.1.4.

[525] LJSC, Article 83, Clause 2.

[526] LJSC, Article 83, Clause 3. The independence of directors during a related party transaction is not to be confused with independent directors as such. See Part II, Chapter 4, Section C.4 for a definition and discussion on independent directors.

3. Company (A) transferred a significant amount of assets to Company (C), in which companies (A) and (B) both receive shares: Company (A) receives 55% and Company (B) receives 45% without any consideration. The managers of Company (A) own Company (B).

   One year later, Company (A) sold 38% of its shares in Company (C) to Company (B) for the total price of U.S. $ 2,000. In reality, these shares were worth about U.S. $ 600 million.

   The sale of a 38% stake in Company (C) by Company (A) to Company (B) is a related party transaction and managers of Company (A) should not participate in decision-making on the approval of this transaction.

c) Required Information for the Decision to Approve Related Party Transactions

Depending on the nature of a related party transaction, either the GMS or the Supervisory Board must adopt a decision on the transaction. Regardless of which body approves, the decision must include information on:[527]

- The parties that are involved in the transaction;
- Other beneficiaries of the transaction (if any);
- The value of the transaction;
- The assets and services involved in the transaction; and
- Any other significant terms and conditions related to the transaction.

4. Identifying Related Party Transactions

Any related party transaction should be properly approved before it can be concluded. However, in practice not all transactions follow such procedures. There are different reasons for this, including the fact that the Supervisory Board and shareholders may not always know whether the transaction involves related parties, in particular when insiders concealed their affiliation and personal interest. In such cases, non-executive and independent directors will need to play the lead role in identifying and disclosing related party transactions. Creating the list of related parties and their position in the transaction is but one aspect, made difficult

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[527] LJSC, Article 83, Clause 6.

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by the fact that most ownership structures remain opaque. The materiality of these transactions is another important issue. Indeed, while the nature of some related party transactions is easily identifiable, others are structured in an elaborate manner, involving complicated off-shore schemes.

Best Practices: The Supervisory Board's composition and experience will largely determine the success in identifying such related party transactions. Non-executive, independent directors who enjoy an arms-length relationship with managers will certainly play a key role in this respect. The External Auditor also plays a key supporting role, and the Supervisory Board and its Audit Committee will want to ensure that the company's External Auditor uses the full range of audit procedures to evaluate managerial self-dealings. For example, the American Institute of Certified Public Accountants' (AICPA) Statement of Auditing Standard No. 45, AU Sec. 334 (2001) sets forth criteria for identifying material transactions, such as interest free borrowing, asset sales that diverge from appraisal value, in-kind transactions, and loans made without scheduled terms.

5. Disclosure Requirements

The Company Law requires persons who are potential related parties to disclose information to the Supervisory Board, the Revision Commission, and the External Auditor regarding:[528]

- Legal entities in which they, either independently or together with affiliated persons, own 20% or more of voting shares (participatory shares, units);
- Legal entities in which they hold managerial positions; and
- Pending or planned transactions in which they may be considered a related party.

Moreover, the disclosure of beneficial ownership is an important aspect in detecting related party transactions. If the identity of the company's true owners is hidden, then it is difficult, if not impossible, to establish whether the parties in the transaction are related (as mentioned in Section C.1.a of this Chapter).

[528] LJSC, Article 82.

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> **Best Practices:** To protect shareholder interests, the Supervisory Board members (especially independent directors) should demand that all owners of 5% and more of common shares comply with the relevant disclosure requirements.

➜ *For more information on the disclosure of beneficial ownership, see Part IV, Chapter 13, Section B.3.*

The FCSM addresses the issue of related party transactions and requires that companies include the following information regarding related party transactions in their annual report:[529]

- A list of related party transactions concluded by the company during the reporting year;
- Significant terms and conditions of each related party transaction; and
- The governing body that approved related party transactions.

In addition, securities legislation requires that companies disclose the following information on related party transactions:[530]

- Copies of the minutes of the meeting of the approving body, including information on the quorum and the voting results, for the registration of secured bond issue and the report on the results of issue;
- The list of persons, with whom transactions may be qualified as related party transactions, and the list of those persons with whom transactions have already been approved by the company, in case of an open subscription to securities;
- Information on related parties before the placement starts, in case of an open subscription through intermediaries; and
- The prospectus and quarterly reports must provide information on related party transactions.[531]

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[529] FCSM Regulation No. 17/ps on Additional Requirements to the Procedure of Preparation, Calling, and Conducting of the General Meeting of Shareholders, 31 May 2002, Section 3.6.

[530] FCSM Regulation No. 03-30/ps on the Standards of Security Issue and Registration of Security Prospectuses, 18 June 2003, Sections 2.4.7, 2.5.3, 6.4.7, 6.5.1; Annex 9 of the Standards, Section 11.

[531] Annex 4 of FCSM Regulation No. 03-32/ps on the Disclosure of Information by Issuers of Securities, 2 June 2003, Section VII; Annex 11 of FCSM Regulation No. 03-32/ps, Section VI.

Finally, accounting legislation requires companies to disclose information on operations with related parties in their accounting documents.[532]

6. Invalidation of Related Party Transactions

A court may nullify a related party transaction in a legal action filed by the company or a shareholder if procedural requirements were violated.[533]

Best Practices: Russian legislation seems to fall short in protecting the interests of the company's counterparts in related party transactions. If the company can seek to invalidate a transaction that was not concluded in accordance with its internal approval procedures then this may create undue problems for the counterpart. It is recommended to follow the example of some western jurisdictions where the company needs to prove that the counterpart in the transaction knew or must have known of the irregularity of its approval.

7. Liability for the Violation of Procedural Requirements

Related parties can be held liable for losses caused to the company because of a transaction that was concluded in violation of procedural requirements. If several persons are held responsible for losses, they are jointly and severally liable.[534]

Best Practices: A company may wish to codify its policy regarding related party transactions in its company-level corporate governance code, charter, or by-laws. More importantly, the company may codify a director's duty of care to properly handle related party transactions, i.e. not to authorize, procure, or permit the company to enter into a transaction if he has an interest in the transaction and has not disclosed this interest.

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[532] Ministry of Finance Decree No. 5n, on the Approval of Rules on Accounting, "Information on Affiliated Persons," Rules on Accounting 11/2000, Section 5.

[533] LJSC, Article 84, Clause 1.

[534] LJSC, Article 84, Clause 2.

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