



Chapter 9

Corporate Governance **Implications** of the **Charter Capital**



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The Chairman's Checklist

- ✓ Has the Supervisory Board ensured that the company's founders have paid their initial contributions and that in-kind contributions have been properly valued?
- ✓ Does the Supervisory Board understand the financial needs of the company and the different techniques of corporate finance? Is the Supervisory Board authorized to increase the charter capital? Is the Supervisory Board careful not to dilute the ownership of shareholders?
- ✓ Are capital increases justified?
- ✓ Does the Supervisory Board ensure that the charter capital and consequently the creditors are adequately protected in cases of charter capital decreases? In such cases, does the Supervisory Board make decisions regarding the buyback of company shares? Has the Supervisory Board ensured that all shareholders who submit their shares are treated equitably?
- ✓ How does the Supervisory Board ensure that the reserve fund is utilized in the best interests of the company? What other funds has the company established?

The concept of charter capital is still largely embedded in continental European law. The same holds true for Russia. The Company Law in particular attaches certain protective functions to charter capital, protecting shareholders from dilution and providing a minimum guarantee that obligations toward company creditors will be fulfilled. Although the charter capital per se cannot fulfill that role, it is still considered one of the elements guaranteeing the interests of creditors. Regarding shareholders, the charter capital plays an important role since many shareholder rights are directly linked to the size of their investment in the charter capital.

Charter capital has a legal, rather than economic meaning. It only exists in accounting terms, as fixed in the balance sheet. For this reason, its protective function is often criticized as a formality. Regardless, it is a legal requirement when establishing and operating a company. Legislation provides for certain rules

that govern both increases and decreases in the charter capital. In addition, there are other procedural guarantees of shareholder and creditor rights, such as the buyback by the company of its own shares, the redemption of shares, reciprocal shareholdings, and the maintenance of statutory reserves, all of which are discussed in this chapter.

A. General Provisions Related to the Charter Capital

The charter capital is an important element of the legal definition of a joint stock company, which is defined as a commercial entity, whose charter capital is divided into a specified number of shares, certifying the company participants' (shareholders') rights in relation to the company.²⁵⁴ The charter capital has important legal implications for:

- Determining the minimum amount of a shareholder's liability;²⁵⁵
- Determining shareholder rights in relation to their proportionate share in the charter capital; and
- Offering support to protect creditor rights by setting the minimum amount of assets a company must have; this is one of the legal instruments upon which creditors can rely when seeking to ensure that the company will fulfill its contractual obligations.²⁵⁶

1. The Definition of Charter Capital

The charter capital is defined as the par value of the company's shares that are issued and outstanding.²⁵⁷ Only shares that have been issued comprise the charter capital. This includes treasury shares, i.e. shares repurchased by the company for re-sale or for retirement that are issued but not outstanding. Bonds and other credit instruments are not part of the charter capital.

²⁵⁴ Civil Code (CC), Article 96, Clause 1; Law on Joint Stock Companies (LJSC), Article 2, Clause 1, Paragraph 1.

²⁵⁵ LJSC, Article 2, Clause 1, Paragraph 2.

²⁵⁶ LJSC, Article 25, Clause 1, Paragraph 3.

²⁵⁷ LJSC, Article 25, Clause 1.

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The total amount of the charter capital cannot exceed a maximum of 25% preferred shares and must contain a minimum of 75% common shares.²⁵⁸

2. Minimum Charter Capital

Legislation requires that every company have minimum charter capital of at least 1,000 times the minimum monthly wage (effective on the date of the company's state registration).²⁵⁹ This amount is intended to dissuade smaller undertakings from registering as joint stock companies, and provide start-up capital to newly established companies that cannot be distributed to shareholders.

3. Charter Capital and Authorized Shares

The Company Law provides that the charter may specify the number and nominal value of authorized shares of each type and class, as well as the rights attached to them.²⁶⁰ Authorized shares are the maximum number of shares of any class that a company may create under the terms of its charter, in addition to already issued shares.

The company is not required to issue all shares it has authorized. If the company chooses not to issue authorized shares, these shares are referred to as authorized but not issued. Only those shares that are issued constitute the charter capital.

A shareholder vote is required to increase the number of authorized shares. In order to avoid costly and time-consuming GMS organization procedures every time the company seeks additional capital, a company may issue some of its authorized but previously un-issued shares by a Supervisory Board decision.

The total authorized capital that a company sets forth in its charter is based upon the amount of money that the company requires at its establishment and the percentage of dilution its founders are willing to accept in the future.

²⁵⁸ LJSC, Article 25, Clause 2.

²⁵⁹ LJSC, Article 26; The Law on the Minimum Amount of Payment for Labor, Article 4. Currently, the minimum monthly wage is set at RUR 100.

²⁶⁰ LJSC, Article 27, Clause 1, Paragraph 2.

Best Practices: Good corporate governance practice stipulates that the charter should authorize the Supervisory Board to increase the charter capital by issuing authorized shares. When doing so, the charter should include the following information:

- Maximum number of authorized shares. In general, the maximum amount must not exceed 100% of the charter capital at the moment of the authorization for the Supervisory Board to issue authorized shares;
- Types and classes of authorized shares; and
- Form of payment for additionally issued shares.

4. Full Payment for Shares

Shares issued and placed during the establishment of the company must be paid in full within one year from the moment of the company's state registration, unless the founders' contract provides for a shorter period.²⁶¹ Full payment should guarantee that shareholders contribute the minimum amount of assets and that the charter capital is duly formed. If shares have not been fully paid upon expiration of a specified period, the unpaid shares must be returned to the company. The founders' contract may also provide penalties in cases of non-payment or failure to pay in full. At least 50% of the shares placed to the founders at the establishment of the company must be paid within three months after the company's state registration.²⁶² The company is prohibited from engaging in any activity, other than those related to the establishment of the company, before receiving payment for 50% of the shares.²⁶³

5. Contributions to the Charter Capital

The form of payment for shares during the establishment of the company must be specified by the founders' contract.²⁶⁴ In general, the shares issued during the estab-

²⁶¹ LJSC, Article 34, Clause 1.

²⁶² LJSC, Article 34, Clause 1, Paragraph 2.

²⁶³ LJSC, Article 2, Clause 2, Paragraph 2. This provision is unclear as to whether these shares have to be paid in full and who is responsible for verifying that full payment has been made.

²⁶⁴ LJSC, Article 34, Clause 2.

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ishment of the company can be paid with money or contributions in-kind, including shares and securities of other companies, tangible or intangible assets, property rights, and/or other rights that have monetary value.²⁶⁵ In-kind contributions are, however, subject to certain rules. The valuation of in-kind contributions must be agreed upon by the founders²⁶⁶ and supported by the valuation of an Independent Appraiser. Founders are prohibited from setting the value of assets, property rights, and other rights at a value higher than that determined by an Independent Appraiser.²⁶⁷ An Independent Appraiser cannot be a founder, an owner, a shareholder, an employee, a contractor, or any other person affiliated with the company.²⁶⁸ Any individual (or a legal entity) needs a license to be an Independent Appraiser. An Independent Appraiser must be insured against civil liability.²⁶⁹

In addition to the valuation of initial in-kind contributions to the charter capital, an independent appraisal is required when the company:

- Redeems shares;²⁷⁰
- Is engaged in a transaction that involves state property;²⁷¹
- Is engaged in mortgage operations;²⁷² or
- Is engaged in the sale of its assets during bankruptcy.

Best Practices: A company should use a licensed Independent Appraiser to determine the market value of property,²⁷³ value debts, and assess liabilities.²⁷⁴ An Independent Appraiser can also play an important role in assisting management and shareholders during the company reorganization.

²⁶⁵ LJSC, Article 34, Clause 2.

²⁶⁶ LJSC, Article 34, Clause 3, Paragraph 1.

²⁶⁷ LJSC, Article 34, Clause 3, Paragraph 3.

²⁶⁸ Law on Appraisal Activity, Article 16.

²⁶⁹ Law on Appraisal Activity, Article 17.

²⁷⁰ LJSC, Article 75, Clause 3.

²⁷¹ Law on Appraisal Activity, Article 8.

²⁷² Law on Appraisal Activity, Article 8; Law on Mortgage of Property, Article 14, Clause 1.

²⁷³ LJSC, Article 77, Clause 2, Paragraph 1.

²⁷⁴ Law on Appraisal Activity, Article 5.

B. Increasing the Charter Capital

A number of different factors, such as market conditions, reorganizations, and growth, may necessitate an increase of charter capital. There are two methods of increasing the charter capital:

- Utilizing external sources, such as when the company attracts financial resources from existing shareholders or third parties; and
- From internal sources when the company uses its own funds to capitalize its internal reserves.

1. Methods of Increasing the Charter Capital

Methods to increase the charter capital are summarized in Table 1.²⁷⁵

Table 1: Increasing the Charter Capital			
	Issuing additional shares for consideration	Issuing additional shares without consideration	Increasing the nominal value of shares
Source	External	Internal	Internal
Contributors	Shareholders and third parties	The company (using funds available from internal sources as defined by legislation)	The company (using funds available from internal sources as defined by legislation)
Purpose	To attract additional funding. It will, however, dilute the holdings of existing shareholders if they are unwilling/unable to make use of their pre-emptive rights	To pay stock dividends, increase the company's equity, etc.	To pay stock dividends, increase the company's equity, etc.
Recipients of new shares	Existing shareholders and third parties	Only existing shareholders	Only existing shareholders

²⁷⁵ LJSC, Article 28, Clause 1.

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Table 1: Increasing the Charter Capital			
	Issuing additional shares for consideration	Issuing additional shares without consideration	Increasing the nominal value of shares
Changing the company's ownership structure	Possibly	No	No
Method of share issue	Issue of additional (authorized) shares	Issue of additional (authorized) shares	Issue of shares with a higher nominal value
Method of placement	Subscription (open or closed)	Distribution	Conversion
Approving governing body	The General Meeting of Shareholders (GMS), unless delegated by the charter to the Supervisory Board	The GMS, unless delegated by the charter to the Supervisory Board	The GMS
Pre-emptive rights	Yes	No	No

2. Methods of Placement

There are three methods of placing shares:

- 1) Distribution of shares among shareholders;
- 2) Conversion, for example when the company increases the charter capital by increasing the nominal value of issued shares; and
- 3) Subscription, that is when the company floats shares for consideration.

3. Internal Sources for Increasing the Charter Capital

Depending on the method chosen to increase the charter capital, the company can use the funds of shareholders and/or third parties; it can also choose to capitalize using its internal resources. The company may use the following internal resources for capitalization purposes:²⁷⁶

- Additional paid-in capital;
- Special purpose funds of the company that were not used during the previous

²⁷⁶ FCSM Regulation No. 03-30/ps on the Standards of Security Issue and Registration of Security Prospectuses (FCSM Regulation No. 03-30/ps), 18 June 2003, Section 4.3.2.

year (the reserve fund and the employees' fund cannot however be used for this purpose); and

- Retained earnings/undistributed profits.

When increasing the charter capital from internal sources, the amount of the increase cannot exceed the difference between the amount of the net assets, on the one hand, and, on the other, the sum of the charter capital and the reserve fund as of the date the decision to increase the charter capital is approved.²⁷⁷

There are two types of subscription available, as shown in Table 2:²⁷⁸

Open	Closed
<ul style="list-style-type: none"> • The offer is made to an unlimited number of subscribers; • The charter or legislation cannot limit the subscription. 	<ul style="list-style-type: none"> • The offer is made to a limited number or a pre-determined group of subscribers; • The charter or legislation can limit the subscription.

4. Ownership Rights Protection When Increasing the Charter Capital

The company's ownership structure will likely change if the charter capital is increased from external sources. Issuing additional shares results in the dilution of the ownership rights of existing shareholders. Under certain circumstances, however, existing shareholders may have pre-emptive rights to protect them from dilution.²⁷⁹

→ *For a more detailed discussion on pre-emptive rights, see Chapter 7, Section B.5.*

When increasing the charter capital from internal sources, additional shares must be distributed to all owners of shares of each type and class.²⁸⁰ In addition, the number of new shares of each type and class that are distributed to each shareholder must be pro rated to the number of shares already held by him.

²⁷⁷ LJSC, Article 28, Clause 5, Paragraph 2.

²⁷⁸ LJSC, Article 39, Clause 2, Paragraph 1.

²⁷⁹ LJSC, Article 40, Clause 1, Paragraphs 1 and 2.

²⁸⁰ LJSC, Article 28, Clause 5, Paragraph 3; FCSM Regulation No. 03-30/ps, Section 4.3.4.

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Consequently, each shareholder who owns fractional shares must receive a proportionate fraction of a full share of the same type and class.²⁸¹ However, Russian legislation forbids an increase in the charter capital from internal sources if fractional shares will occur as a result.²⁸²

5. Procedural Guarantees for Increasing the Charter Capital

Company Law and securities legislation provide detailed procedures that companies must follow in order to increase the charter capital. These procedures are aimed at guaranteeing that shareholder rights are protected. The Federal Commission for the Securities Market (FCSM), by registering share issues, plays an important role in overseeing the legality of the increase, thus enforcing proper corporate governance practices in such cases.

The GMS or the Supervisory Board plays the leading role in increasing the charter capital, depending on the method chosen.

a) The GMS Makes the Decision to Place Shares

The decision to increase the charter capital by increasing the nominal value of issued shares must be approved by the GMS.²⁸³ The GMS also decides to increase the charter capital by issuing additional shares (with or without consideration), unless the charter has delegated this right to the Supervisory Board.²⁸⁴

First, if the decision to increase the charter capital by issuing additional shares (with or without consideration) falls within the authority of the GMS, legislation requires that the Supervisory Board place the proposal (or motion) to increase the charter capital on the GMS agenda. Unless the charter provides otherwise, only the Supervisory Board has the right to propose the item for the agenda.²⁸⁵ A simple majority vote of directors participating in the Supervisory Board meeting must approve the proposal unless the charter or by-laws require a higher percentage of votes.²⁸⁶

²⁸¹ FCSM Regulation No. 03-30/ps, Section 4.3.6.

²⁸² FCSM Regulation No. 03-30/ps, Section 4.3.5.

²⁸³ LJSC, Article 28, Clause 2, Paragraph 1.

²⁸⁴ LJSC, Article 28, Clause 2, Paragraph 2.

²⁸⁵ LJSC, Article 49, Clause 3.

Second, the company cannot issue shares unless it has sufficient authorized shares for this purpose.²⁸⁷ The GMS can simultaneously take the decision to increase the charter capital and the decision to either amend the charter to provide for the respective number of authorized shares or amend the charter provision concerning the number of authorized shares.²⁸⁸ The GMS decision to increase the charter capital is also called the decision to place shares. The different majority votes required for these decisions are summarized in Table 3.

3/4-Majority in the Case of:²⁸⁹	Simple Majority in the Case of:²⁹⁰
<ul style="list-style-type: none"> • An issuance of additional common shares representing more than 25% of the total issued common shares through open subscription • An issuance of additional preferred shares which can be converted into common shares representing more than 25% of the total issued common shares through open subscription • Closed subscription 	<ul style="list-style-type: none"> • All other instances

b) The Supervisory Board Decides to Place Shares

In general, the purpose of authorized shares is to enable the company to attract additional capital in an uncomplicated manner. Procedural requirements for increasing the charter capital by the decision of the GMS are cumbersome, time-consuming, and costly. This may make it harder for the company to attract financing quickly in a rapidly changing business environment. For this very purpose, the Company Law permits companies to empower the Supervisory Board to issue authorized shares (with or without consideration). In this case, a unanimous approval of all serving Supervisory Board members is, however, required.²⁹¹

²⁸⁶ LJSC, Article 68, Clause 3.

²⁸⁷ LJSC, Article 27, Clause 1, Paragraph 2.

²⁸⁸ LJSC, Article 28, Clause 3, Paragraph 2.

²⁸⁹ LJSC, Article 49, Clause 4; Article 39, Clause 4; Article 32, Clause 4, Paragraph 2. The charter may provide for a higher percentage of votes required for a decision.

²⁹⁰ LJSC, Article 28, Clause 2; Article 49, Clause 2.

²⁹¹ LJSC, Article 28, Clause 2, Paragraph 3.

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Best Practices: The Supervisory Board should conduct a meeting where directors are physically present to approve the decision to place shares.²⁹²

The Supervisory Board may only approve the decision to place shares if the number of additional shares of each type and class to be issued does not exceed the total number of authorized shares of each type and class as set forth in the charter.²⁹³

c) Information that Must Be Included in the Decision to Place Shares

Depending on the method of placement, the decision to place shares must include the information presented in Table 4.²⁹⁴

Table 4: Information that Must Be Included in the Decision to Place Shares			
Required Information	Method of Placement		
	Conversion	Distribution	Subscription (Open or Closed)
The types and classes of shares, the nominal value of which will be increased	✓		
The nominal value of shares of each type and class after the increase	✓		
Information that the increase of the charter capital is from retained earnings (if it is so provided)	✓		
The method of placement	✓	✓	✓
The number of shares of each type and class that will be issued within the limits of authorized shares		✓	✓

²⁹² Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code), Chapter 3, Section 4.4.

²⁹³ LJSC, Article 28, Clause 3, Paragraph 1.

²⁹⁴ LJSC, Article 28, Clause 4; FCSM Regulation No. 03-30/ps, Sections 4.1.3, 5.1.1, 6.1.1 and 6.1.10.

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Table 4: Information that Must Be Included in the Decision to Place Shares			
Required Information	Method of Placement		
	Conversion	Distribution	Subscription (Open or Closed)
The price of additional shares, or the procedure to determine the price, of additional shares → <i>For more information on the placement price, see Chapter 11, Section C.</i>			✓
The price of additional shares, or the procedure to determine the price, for shareholders who exercise pre-emptive rights			✓
The form of payment for additionally issued shares (if required)			✓
The list of persons (names and/or categories of persons such as the company's employees, shareholders, credit institutions, etc.) to whom the company intends to issue additional shares if the issue takes place through closed subscription			✓

Depending on the method of placement, the decision to place shares can include optional information, as presented in Table 5.²⁹⁵

Table 5: Optional Information Included in the Decision to Place Shares			
Optional Information	Method of Placement		
	Conversion	Distribution	Subscription (Open or Close)
The date, or the procedure to determine the date, of placement (the dates of the beginning and end of the period of placement)	✓	✓	✓
The sources from which the increase in charter capital will be paid	✓	✓	

²⁹⁵ FCSM Regulation No. 03-30/ps, Sections 4.1.3, 5.1.1 and 6.1.1.

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Optional Information	Method of Placement		
	Conversion	Distribution	Subscription (Open or Close)
The procedure and the period for making the payment for additional shares			✓
The procedure for concluding contracts during the placement of additional shares			✓
The number of additionally issued shares that is necessary for the issue to be recognized as completed, and the procedure for returning payments that have been made for additionally issued shares ²⁹⁶			✓

d) Issue of Shares for In-Kind Contributions

If the decision to place shares allows shareholders to pay for additional shares with other securities, or with other assets having monetary value, such a decision must also include the:²⁹⁷

- List of assets that can be used to pay for shares; and
- Name of the Independent Appraiser(s) who will be used to determine the market value of the assets.

C. Protecting the Charter Capital

One of the purposes of the charter capital is to provide a minimum guarantee that the company will fulfill its obligations toward creditors. However, this function will only exist in theory if it is not linked to preserving a minimum level of company assets. The Company Law provides that the value of a company's net assets at the end of the second and any subsequent year cannot be lower than the stated

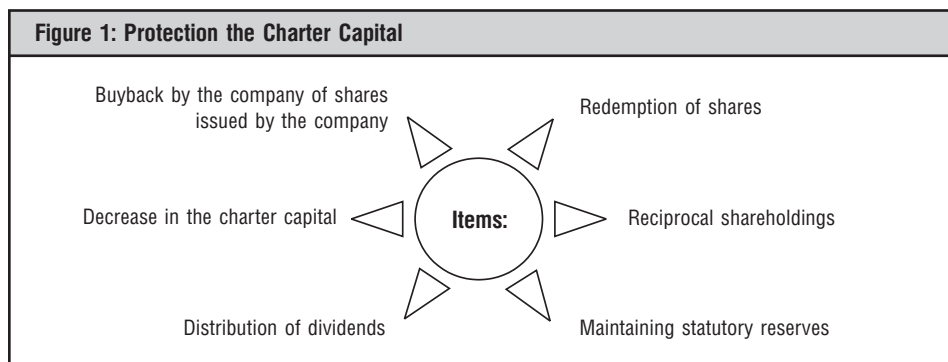
²⁹⁶ FCSM Regulation No. 03-30/ps, Section 6.1.11. The volume of additionally issued shares that is necessary for the issue to be recognized as having taken place cannot be less than 75% of the additionally issued shares.

²⁹⁷ FCSM Regulation No. 03-30/ps, Section 6.1.12.

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charter capital of the company.²⁹⁸ Should this occur, the company must decrease its charter capital, but not to a level lower than the minimum amount set forth in legislation.²⁹⁹ Moreover, the company must liquidate if the value of its net assets at the end of the second year, or any subsequent year thereafter, falls below the minimum amount of the charter capital.³⁰⁰ This is yet another safeguard for providing protection for creditors. If the company does not make the decision to either decrease the charter capital or liquidate within a reasonable period of time, creditors may request either the early performance, or the early termination of obligations toward them. In both cases, creditors can also request compensation for losses. Finally, state oversight bodies have the right to ask the court to liquidate the company.³⁰¹

There are other actions that may, in one way or another, affect the charter capital and net assets. Such actions and mechanisms, which protect against the distribution of the company's assets to shareholders or other parties to the detriment of creditors, are listed in Figure 1.



Source: IFC, August 2003

²⁹⁸ LJC, Article 35, Clause 4.

²⁹⁹ LJC, Article 29, Clause 1, Paragraph 4. The company cannot decrease its charter capital below the minimum specified by legislation, which is currently set at RUR 100,000 as of 1 January 2004. The minimum charter capital is determined as of the date of submission of the documents for the state registration of charter amendments related to the decrease of the charter capital. However, when the decrease is required by the Company Law, the minimum charter capital must be determined as of the date of the company's state registration.

³⁰⁰ LJC, Article 35, Clause 5.

³⁰¹ LJC, Article 35, Clause 6. The Constitutional Court of Russia has recently upheld the legality of these rules (Decision No. 14-P, the Constitutional Court of the Russian Federation, 18 July 2003).

1. Overview of Decreasing the Charter Capital

A decrease in the company's charter capital is generally used as a tool to create returns for shareholders without paying dividends. Decreases in charter capital — more specifically, share buybacks — do however have the potential for abuse. A decrease in the charter capital can favor some shareholders at the expense of others. If a decrease in the charter capital involves a share buyback, it is essential to ensure the equitable treatment of all shareholders. This holds particularly true if the company has several classes of shareholders with different rights or holders of other securities. At the same time, a decrease in the charter capital reduces the level of shareholders' liability and the minimum amount of assets intended to serve as a guarantee that the company will fulfill its obligations toward creditors.

Thus, any decrease in the charter capital can be:

- **Real** when it involves a share buyback from shareholders; or
- **Nominal** when the charter capital is decreased by writing off losses, intended to either reorganize the company's financial position or create reserves that can be used for future distribution.

a) Methods of Decreasing the Charter Capital

The charter capital can be decreased in three different ways as summarized in Table 6.³⁰²

Table 6: Methods of Decreasing the Charter Capital			
	Decrease the Nominal Value of Issued Shares	Retire Treasury Shares	Buyback Outstanding Shares and Retire These
Type of Decrease	Nominal	Nominal	Real
Legal Stipulation	Mandatory and/or voluntary	Mandatory and/or voluntary	Voluntary
Charter Stipulation	Always permitted	Always permitted	Only if permitted by the charter

³⁰² LJSC, Article 29, Clause 1, Paragraph 2.

Table 6: Methods of Decreasing the Charter Capital			
	Decrease the Nominal Value of Issued Shares	Retire Treasury Shares	Buyback Outstanding Shares and Retire These
Who Can Propose the Decrease	Shareholders or the Supervisory Board	Shareholders or the Supervisory Board	The Supervisory Board, unless the charter provides otherwise
Approving Governing Body	The GMS	The GMS	The GMS
Class by Class Voting	Yes, if the rights of preferred shareholders can be limited as a result of decreasing the charter capital	No	No
Implementation of the Decrease	Conversion of shares with a higher nominal value into shares with a lower nominal value	Retiring treasury shares	Purchasing and retiring shares

b) Mandatory and Voluntary Decreases of the Charter Capital

A decrease in the charter capital is required by legislation, if:³⁰³

- At the end of the second and every subsequent financial year the value of the net assets of the company is less than the charter capital; and
- Treasury shares are not replaced within one year after the company has purchased them.

Decreasing the charter capital by retiring treasury shares is only possible if permitted by the charter.³⁰⁴

c) Procedures for Decreasing the Charter Capital

Regardless of which method is chosen, the decision to decrease the charter capital must be taken by a simple majority vote of shareholders participating in the GMS.³⁰⁵

³⁰³ LJC, Article 35, Clause 4; Article 34, Clause 1, Paragraph 5; Article 72, Clause 3, Paragraph 2; Article 76, Clause 6, Paragraph 2.

³⁰⁴ LJC, Article 29, Clause 1, Paragraph 3.

³⁰⁵ LJC, Article 29, Clause 2; Article 49, Clause 2.

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The proposal to decrease the charter capital by decreasing the nominal value of issued shares, or by retiring treasury shares, can be placed on the agenda of the GMS either by shareholder proposal or at the initiative of the Supervisory Board. If shares are repurchased for retirement, the right to put this resolution on the agenda of the GMS rests exclusively with the Supervisory Board, unless the charter provides otherwise.³⁰⁶

If the proposal to decrease the charter capital is submitted by the Supervisory Board, a simple majority vote of its members participating in the Supervisory Board meeting is required, unless the charter or by-laws require a higher percentage of votes.³⁰⁷

Best Practices: The quorum for the Supervisory Board meeting proposing to decrease the charter capital should be defined as $\frac{2}{3}$ of all directors.³⁰⁸

d) Information Included in the Decision to Place Shares

To decrease the charter capital by reducing the nominal value of issued shares, new shares with a lower nominal value must be issued, and the existing shares have to be converted into these newly issued shares. In this case, the decision to decrease the charter capital is also called the decision to place shares and must include information on:³⁰⁹

- The types and classes of shares, the nominal value of which will be decreased;
- The nominal value of shares for each type and class after the decrease has taken place; and
- The method of placing shares (in this case, the conversion of shares with a higher nominal value into shares with a lower nominal value).

The decision to place shares can also include information on the date, or the procedure to determine such date, when shares must be converted.³¹⁰

³⁰⁶ LJSC, Article 49, Clause 3.

³⁰⁷ LJSC, Article 68, Clause 3.

³⁰⁸ FCSM Code, Chapter 3, Section 4.15.

³⁰⁹ FCSM Regulation No. 03-30/ps, Section 5.1.2.

³¹⁰ FCSM Regulation No. 03-30/ps, Section 5.1.2.

e) Decreases in the Charter Capital and Creditor Protection

The decrease of the charter capital typically affects creditor rights since it decreases the minimum amount of the company's assets serving as a guarantee that the company can meet its obligations toward creditors. The company must then notify creditors in writing of a reduction in the charter capital. It must further publish an announcement in the print media that publishes information on the state registration of legal entities regarding the decrease in its charter capital within 30 days after the decision is taken.³¹¹ This falls under the authority of the General Director who will commonly assign this task to the Corporate Secretary or another person.

The company is required to present evidence to the state registration authority of the timely notification of all creditors regarding the decrease in the charter capital before the respective charter amendments can be registered.³¹²

Within 30 days after the submission of the notification to creditors, or after the publication of the announcement, a creditor has the right to demand in writing:³¹³

- Early termination of the company's obligations and the reimbursement of losses caused by early termination; or
- Early fulfillment of obligations by the company and the reimbursement of losses related to early fulfillment.

2. Share Buybacks

Under certain circumstances and conditions, companies have the right to repurchase their own shares. This is called a share buyback. Share buybacks may have a number of corporate governance implications. First, there may be a financial planning concern: since cash is used to purchase shares, fewer funds may be available for further business development. Second, shareholder rights can be abused if the company does not provide equal opportunity to all shareholders to sell their shares back to the company. Third, the company distributes cash directly to selling shareholders and may therefore diminish the company's ability to service its debts or otherwise meet its obligations to creditors.

³¹¹ LJSC, Article 30, Clause 1.

³¹² LJSC, Article 30, Clause 2.

³¹³ LJSC, Article 30, Clause 1.

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Certain rules specify how to conduct a share buyback and are summarized in Table 7. They differ depending on whether the buyback is to decrease the charter capital (specific buyback) or for any other reason (general buyback).

Specific³¹⁴	General³¹⁵
The shares issued by the company are repurchased and retired to decrease the charter capital	The shares issued by the company are repurchased for any reason
The repurchase is carried out by decision of the GMS to decrease the charter capital	The purchase is carried out by decision of the GMS, unless the charter delegates this right to the Supervisory Board
The share buyback is only permitted if allowed by the charter	The share buyback is only permitted if allowed by the charter
Shares must be retired upon buyback	Purchased shares must be re-placed or retired within one year

a) Buyback Procedures

To repurchase its own shares, a company must follow steps, as summarized in Table 8.

	Specific	General
Initiation	On the basis of the decision to decrease the charter capital	At the discretion of the Supervisory Board or a shareholder proposal
Decision-making	The GMS	The GMS, unless delegated to the Supervisory Board
Purchase price	Market value	Market value
Limitations	The charter capital may not become less than the legal minimum	The nominal value of the outstanding shares must not be less than 90% of the charter capital after the shares have been repurchased ³¹⁶

³¹⁴ LJSC, Article 72, Clause 1, Paragraph 1.

³¹⁵ LJSC, Article 72, Clause 2, Paragraph 1.

³¹⁶ LJSC, Article 72, Clause 2, Paragraph 2.

Table 8: Buyback Procedures		
	Specific	General
Share retiring	Must be retired upon purchase	Must be retired within one year or re-placed

The decision to buyback shares issued by the company must be approved by either:³¹⁷

- A $\frac{3}{4}$ -supermajority of shareholders participating in the GMS, upon the proposal of the Supervisory Board, unless the charter provides otherwise; or
- A simple majority vote of directors participating in the Supervisory Board meeting, if the charter delegates this authority to the Supervisory Board.

The Supervisory Board must set the purchase price of shares for each type and class, which is always the market value of shares.³¹⁸

The Supervisory Board must also define the form of payment for the shares. As a rule, a company must pay in cash unless the charter provides otherwise.³¹⁹

In addition, the Supervisory Board must set the period within which the share buyback must take place. This period cannot be less than 30 days.³²⁰

b) Information Included in the Buyback Decision

The decision to buyback shares must include information on:³²¹

- The type and class of shares to be repurchased;
- The number of shares of each type and class;
- The purchase price;
- The form of payment;
- The period for making payments to shareholders; and
- The period within which the buyback will take place.

³¹⁷ LJSC, Article 49, Clause 3; Article 49, Clause 4; Article 68, Clause 3.

³¹⁸ LJSC, Article 72, Clause 4, Paragraph 2; Article 77.

³¹⁹ LJSC, Article 72, Clause 4, Paragraph 2.

³²⁰ LJSC, Article 72, Clause 4, Paragraph 2.

³²¹ LJSC, Article 72, Clause 4, Paragraph 1.

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c) Limitations on Share Buybacks

Several limitations are placed on the repurchase of shares as summarized in Table 9.

The Company Cannot Repurchase if:	Common Shares³²²	Preferred Shares³²³
The nominal value of the outstanding shares will be reduced to less than 90% of the charter capital after repurchase ³²⁴	✓	✓
The charter capital is not fully paid	✓	✓
The company is bankrupt	✓	✓
The company would be bankrupt as the result of a buyback	✓	✓
The company had not redeemed the shares upon the demand of shareholders ³²⁵	✓	✓
The value of the company's net assets is less than the sum of the charter capital, the reserve fund, and the positive difference between the liquidation value of preferred shares of all classes and their nominal value	✓	
The value of the company's net assets will become less than the sum of the charter capital, the reserve fund, and the positive difference between the liquidation value of preferred shares of all classes and their nominal value specified by the charter as a result of the repurchase by the company of common shares	✓	
The value of the company's net assets is less than the sum of the charter capital, the reserve fund, and the positive difference between the liquidation value of preferred shares of a specified class, the owners of which have priority in receiving the liquidation value of their shares in relation to the preferred shares of the specified class that must be purchased by the company, and their nominal value		✓

³²² LJSC, Article 73, Clause 1.

³²³ LJSC, Article 73, Clause 2.

³²⁴ LJSC, Article 72, Clause 2, Paragraph 2.

³²⁵ LJSC, Article 73, Clause 3.

Table 9: Limitations on Share Buybacks		
The Company Cannot Repurchase if:	Common Shares ³²²	Preferred Shares ³²³
The value of the company's net assets will become less than the sum of the charter capital, the reserve fund, and the positive difference between the liquidation value of preferred shares of a specified class, the owners of which have priority in receiving the liquidation value of their shares in relation to the preferred shares of the specified class that shall be purchased by the company, and their nominal value specified by the charter as the result of the repurchase by the company of preferred shares		✓

d) Implementing a Share Buyback

A company must notify shareholders 30 days before the beginning of the period during which a buyback will take place. The shareholder notification must contain the same information as required for the decision on the buyback.³²⁶

Any shareholder who owns shares of the type and class that shall be repurchased by the company has the right to sell shares to the company within the specified period. The company must pay for these shares within the period that has been specified in the decision and communicated to shareholders in the notice.³²⁷

If shareholders offer more shares for sale than the company intends to buy according to the decision on the repurchase, the company must purchase shares from all shareholders in a number that is proportionate to the number of shares that have been offered by shareholders for sale (see Mini-Case 1).³²⁸

3. Redemption of Shares

The redemption of issued shares is another transaction that may affect the charter capital, and consequently, the rights of shareholders and creditors. Shares redeemed by a company are commonly retired so as to reduce the charter capital. During a reorganization, repurchased shares must be retired upon re-

³²⁶ LJSC, Article 72, Clause 5.

³²⁷ LJSC provides no statutory period for such payment.

³²⁸ LJSC, Article 72, Clause 4, Paragraph 3.

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Mini-Case 1		
Charter capital = RUR 300,000 (10,000 common shares with a nominal value of RUR 30 each).		
The company has decided to purchase 1,000 of its own shares.		
Five shareholders offer to sell 2,000 shares.		
The company must purchase shares in proportion to the shares offered by shareholders for sale.		
Shareholders	Number of shares offered to the company:	Number of shares the company must purchase:
Shareholder 1	400	200
Shareholder 2	200	100
Shareholder 3	600	300
Shareholder 4	300	150
Shareholder 5	500	250
Total:	2.000	1.000

Source: IFC, March 2004

demption.³²⁹ The Company Law provides for certain procedures to protect the rights of creditors; in particular, a company cannot use more than 10% of its net assets to redeem shares.³³⁰ If shareholders request the redemption of shares with a total value of more than 10% of the company's net assets, the company must redeem shares from all shareholders pro rata to the number of shares offered for redemption.

→ For more information on redemption rights, see Chapter 7, Section B.6.

4. Reciprocal Shareholdings

Reciprocal or cross-shareholdings are quite common between different companies and may be set up to establish mutual influence or diversify portfolios. Such shareholding structures between two or more companies often cause governance problems. For example:

- If companies increase their charter capital by means of reciprocal subscriptions to shares, the same initial contribution serves to cause two capital increases;

³²⁹ LJSC, Article 76, Clause 6, Paragraph 1.

³³⁰ LJSC, Article 76, Clause 5.

- When two companies create a reciprocal shareholding by acquiring issued shares of each other, they are causing, at least partially, an indirect distribution or repayment to shareholders whose shares are purchased; or
- Reciprocal shareholdings can decrease the normal influence of independent directors in both companies, and replace the normal control exercised by the shareholders over directors and officers, with a self-controlling system.

Russian legislation, however, does not provide any specific rules regarding reciprocal shareholdings, unless the relationship of dominance and subordination in groups of companies appears.

→ *For more information on groups of companies, see Part V, Chapter 15.*

D. Statutory Reserves

Protecting the charter capital to safeguard creditor rights is further extended by the requirement and possibility of creating certain additional reserves. As with the charter capital, such reserves only exist in accounting terms.

1. The Reserve Fund

Every company must have a reserve fund.³³¹ This fund is used to cover (a portion of) the company's losses, and covers the costs of redeeming shares and bonds when company profits are insufficient for such payment. A company may also establish other funds and additional paid-in capital. The decision as to whether and when to use the reserve fund and the additional paid-in capital is made by the Supervisory Board.

The amount of the reserve fund must be specified by the charter, and cannot be less than 5% of the charter capital. Its main purpose is to protect creditors by ensuring that part of the company's assets, in addition to the charter capital, cannot be distributed among shareholders.

The reserve fund must be funded by annual deductions from the company's net profits. The amount of such annual deductions must be specified in the charter, and cannot be less than 5% of its net profits.³³²

³³¹ LJSC, Article 35, Clause 1, Paragraph 1.

³³² LJSC, Article 35, Clause 1, Paragraph 2

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Only if, and to the extent that the company does not have other resources, the reserve fund may be used to:³³³

- Write off/cover losses of the company;
- Redeem bonds; and/or
- Redeem shares from shareholders.

The reserve fund may only be used upon a decision by the Supervisory Board.³³⁴ The GMS has no authority in this regard.

2. Other Funds

a) Employees' Fund

The GMS can establish a special fund from its net profits for company employees.³³⁵ The Company Law does not require or define specific requirements for such a fund. Its establishment is therefore optional, and all provisions governing such a fund must be specified in the charter.

This fund can only be used for acquiring shares, provided that such shares are to be transferred to the company's employees. Accordingly, the Company Law provides for one specific source for replenishing the employees' fund: if a company has transferred shares purchased by using the employees' fund to its employees, the funds collected must be re-directed to the employees' fund.³³⁶

b) Other Funds of a Company

The charter or a decision of the GMS may establish other internal funds, such as for stock option plans or dividend payments. Such internal funds are financed through a deduction from the company's net profits. An example of such funds is the special fund for the payment of dividends on preferred shares.³³⁷ Such funds can only be used upon a decision of the Supervisory Board.³³⁸

³³³ LJSC, Article 35, Clause 1, Paragraph 3.

³³⁴ LJSC, Article 65, Clause 1, Paragraph 3, Section 12.

³³⁵ LJSC, Article 35, Clause 2, Paragraph 1.

³³⁶ LJSC, Article 35, Clause 2, Paragraph 2.

³³⁷ LJSC, Article 42, Clause 2.

³³⁸ LJSC, Article 65, Clause 1, Paragraph 3, Section 12.

3. Additional Paid-In Capital

Additional paid-in capital is part of the company's equity and is typically composed of the following sources:

- Any increase resulting from the re-valuation of non-current assets; and
- The positive difference between the nominal value and the placement value of the company's shares.

Additional paid-in capital has an accounting meaning only, and there is no actual accumulation of funds. Additional paid-in capital can be used, for example, to:

- Offset the losses as the result of re-valuating non-current assets; and
- Increase the charter capital from internal resources of the company.