

New debt restructuring opportunities: debt-for-equity swap in Russia

Client Newsletter

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On 31 December 2009, a new law took effect lifting the principal restriction with respect to forming charter capitals of business companies, namely, the mandatory prohibition to set off monetary claims to the company for the purpose of increasing its charter capital. The requirement prohibiting issuers from increasing their charter capital to cover for the losses they incur was excluded specifically with respect to Russian joint-stock companies.

This means that a new legal instrument known as debt-for-equity swap and abbreviated to D4E in the progressive foreign states has arrived in Russia. No such swap is contemplated for equity securities, other than shares; other securities are payable only with money.

The prohibition to form charter capital by setting off claims remains effective only for credit institutions.

Potential Opportunities:

- (i) a less costly and risky direct method of restructuring a business company's debt towards its creditors;
- (ii) an effective instrument for restoring signs of solvency prior to bankruptcy procedures without borrowings or litigation;
- (iii) a tool for additional motivation of executives (with no option arrangements involved) providing for a partial compensation in the form of ownership interest in the employer's business under an employment contract;
- (iv) no more risk of "illegal" indirect offset of claims in exchange for ownership interest in the capital of Russian joint stock companies (JSCs) and limited liability companies (LLCs) known to the national financial practice;
- (v) added clarity regarding the application of bankruptcy laws providing for a private opportunity to swap debt for equity. These rules were interpreted ambiguously by the courts resolving certain disputes.

Previously, this mechanism was already used in Russia through the evasion of regulatory prohibitions and involvement of a variety of arrangements (for example, by exchanging promissory notes, using the release-money instruments, by a formal transfer of money from creditor to the debtor for a share of capital obliging the latter to repay it immediately to the creditor to redeem the debt), including for debt restructuring purposes. This, however, involved serious risks of these operations (in particular, additional share issue) being recognized as invalid, and additional financial and time costs.

Restrictions on Use:

- who can/cannot use it: credit institutions may not use debt-for-equity swaps. As to the persons, to whom a company owes certain funds, no direct restrictions are placed: it may be used by creditors for civil obligations, who do or do not hold shares (interest) in the companies, employees of debtor companies, etc.
- debt nature: the claims to be set-off against the payment for shares (interest) should be monetary claims (for example, obligations to repay loans and credits, to pay for products under a sales contract or services under a contractor agreement, to pay commission or agency fees, etc.). Please note that partial payments (up to 20%) with shares (interest) are not prohibited under labour laws.
- procedure: only by private offering of additional shares for Russian JSCs. It should be noted that a private offering may be restricted by a JSC's charter;
- no set-off is permitted if a monetary claim expected to be swapped for shares (interest) is an expired claim, i.e. the statute of limitations for recovering this debt through litigations has already expired (natural obligation);
- set-off of monetary claims is null and void if related to the compensation of physical or health injury, as well as permanent alimony;
- other inadmissible or special procedure set-off envisaged in laws and/or case law.

The companies willing to swap debt for equity and their creditors should keep in mind that a set-off, as a unilateral transaction, may be declared invalid by a court on the grounds contemplated in civil laws. This invalidation, in turn, may cause more severe consequences that involve challenging or denying legitimacy of the increase of the charter capital of Russian JSCs or LLCs. To avoid these significant risks, a thorough legal assessment is required to review legality of such a "swap", including analysis of the monetary claims set off against the payment for shares (interest).

Set-Off Mechanism Activation:

To swap debt for equity, companies will require:

- (1) amending the charters of Open Joint Stock Companies, if they restrict private offering opportunities;
- (2) creditor consent for having the monetary claims to the company redeemed by swapping debt for equity;
- (3) legal due diligence on the set-off admissibility and further restrictions subject to the general and special rules of the current legislation, recommendations of the Federal Financial Markets Service of Russia and the existing judicial practice;
- (4) consent of the required number of company shareholders (participants) expressed in the form of a general meeting's resolution.

The number of votes required for JSCs (subject to quorum) is 75% of votes cast by the holders of voting shares taking part in the general meeting of shareholders, unless more votes are required by the company's charter for adopting this resolution. In this case, the shareholders are voting for the increase of capital by a private offering.

For LLCs, a special resolution needs to be adopted regarding the participants and/or third parties' right to set off monetary claims to the company against their additional capital contributions. This resolution will be legitimate for the purpose of debt-for-equity swap only if adopted by all the company's participants unanimously.



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