

New Rules in the Corporate Playground: Authorized Capital, Creditors, Bonds

Client Newsletter
Corporate Law

February 2010

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 on the changes outlined herein
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INTRODUCTION

On 31 December 2009, a law revamping the corporate and securities legislation took effect. Amendments were introduced to Part 1 of the RF Civil Code, the Federal Law on Joint-Stock Companies, the Federal Law on Limited-Liability Companies, the Federal Law on the Securities Market, the Federal Law on Banks and Banking, and the Federal Law on the State Registration of Legal Entities and Individual Entrepreneurs.

The main thrust of changes is to improve norm-setting rules governing issues related to the formation of the authorized capital of companies, to restrictions on bond issuance, to creditors' rights in cases of authorized capital reduction, and also to requirements to companies in the event of discrepancy between authorized capital and the net asset value (**NAV**).

The main objectives of this revision are: to provide new possibilities for economic entities when forming authorized capital; to establish a more flexible and balanced system of interaction between companies and their creditors when increasing and reducing authorized capital; to upgrade the institution of bond guarantee and bond issuance of joint-stock and limited-liability companies.

The above changes:

- (i) make it possible to increase the authorized capital of a joint-stock company in order to cover its losses;
- (ii) reform the procedure of reduction of the authorized capital of a joint-stock company and set forth measures of the company management's response to the reduction of the company's NAV;
- (iii) revise the existing methods of protection of creditors' rights in cases of reduction of the authorized capital of a joint-stock company;
- (iv) introduce new requirements to guarantors of bond loans and further detail the issuance of bonds by economic entities;
- (v) include in the Unified State Register of Legal Entities (USRLE) additional information about joint-stock companies, which must be promptly updated and be accessible to interested parties.

Below is our detailed overview of the most significant changes.

AUTHORIZED CAPITAL

Authorized capital reduction. Authorized capital to net asset value ratio

The change of rules concerning the reduction of the authorized capital of a joint-stock company is attributed to a reform of the institution of protection of a company's creditors when that decision is made at a shareholders' meeting (see the next section below) and the authorized capital/NAV ratio requirement.

The reduction of a company's NAV, including the negative value of assets, most probably does not mean that the company is insolvent. The practice of business in Russia shows: a company may have negative assets for several years but continue to do business, stay solvent and earn real benefits for its owners and the economy. The absolute obligation of authorized capital reduction in this case, let alone liquidation, would be an overkill rather than a productive solution of the problem.

In this context, a new regulation has been introduced: a provision was made for mandatory measures of reaction by a company to the discrepancy between the authorized capital amount and NAV. For example, if at the end of the second financial year or each subsequent year, NAV is below the authorized capital, the JSC board of directors, preparing for an annual shareholders meeting, is obligated to include a section on the status of the company's net assets in the annual report.

This section will:

- reflect the dynamics of NAV and the authorized capital of JSC in the past three full financial years;
- analyze the causes and factors underlying such state of affairs;
- list measures to bring NAV in line with the authorized capital size.

In the same situation before, a company had to announce immediately the reduction of its authorized capital to an amount not exceeding NAV.

If a company's NAV is still below its authorized capital after the next financial year following the second or each subsequent financial year after which NAV was below the authorized capital, the company, not later than six months after the end of the relevant financial year, must take one of the following decisions:

- (1) on the reduction of its authorized capital to an amount not exceeding NAV; or
- (2) on company liquidation.

If in that case NAV is below the minimum permissible authorized capital of a CJSC/OJSC, the company will not have that alternative but will have to decide on liquidation.

In order to enforce the aforementioned rules in the event a company dodges relevant decisions, the law empowers the tax authorities (and provides for giving other bodies of public authority the same competence through a federal law) to take legal action on JSC liquidation. Clear-cut time periods are set for a company to meet the obligation of deciding to reduce the authorized capital or go into liquidation. Failure to meet them clears the way for the tax authority to go to court. Before the amendments, that time period was defined as "reasonable".

Previously, the law empowered such authorities to file a lawsuit demanding that a company reduce its authorized capital. At present, they do not have this right.

It is noteworthy that the new rules in regard of the authorized capital to NAV ratio do not apply to lending organizations set up in the form of joint-stock companies. The procedure for matching the authorized capital amount of such organization with NAV (equity) is established by the Federal Law on the Insolvency (Bankruptcy) of Lending Organizations.

Consequences: the changes will allow companies to deal with the authorized capital to NAV ratio problems in a more structured and flexible fashion, to examine related problems, and to propose and implement solutions instead of the past practice of automatic authorized capital reduction.

CREDITORS

The legislators made drastic changes in the regulation of methods of protection of the rights of JSC creditors in the event a company decides on authorized capital reduction.

Earlier, Russian legislation provided for the sole method of creditors' protection – the right to early annulment or termination of a JSC's obligations and reimbursement of losses by the company. This situation was responsible for the company becoming a hostage to its relations with creditors because before reducing authorized capital, it had to pay off its creditors. The absence or shortage of resources made it impossible for a company to reduce its authorized capital. This resulted in a serious imbalance in observing the interests of creditors and the company, as well as its shareholders.

Although in practice the amount of authorized capital rarely performs as a guarantor of creditors' interests (who resort to other methods to evaluate debtor solvency and enforce obligations), in cases of authorized capital reduction creditors used a formal pretext in order to earn even greater benefits as compared with the normal course of events.

To provide creditors with free access to important information, the new rules make it incumbent on JSCs to inform the tax authority within three days about a decision to reduce the authorized capital. This information shall be reflected in USRLE. Moreover, the company is duty-bound to report this fact by publishing an announcement (twice a month) in the State Registration Herald.

Within 30 days at most (preclusive term) from the date of the second publication, creditors have the right to demand an early fulfillment of obligations by a JSC and, only in case of inability to meet them, the termination of the obligations and reimbursement of the related losses. To promote the stability of civil law relations, a shorter time limit for filing such claims has been set for creditors – six months from the date of the second publication.

Therefore, if a creditor demands an early fulfillment or termination of obligations by a JSC outside of the prescribed 30 days, the company (or court) has the

right to reject such demand. If a creditor met the deadline, but brought action after 6 months, the company may plead a statute of limitations and the court may refuse to protect the creditor rights.

Court also has the right to refuse to satisfy the demands of a creditor who has not missed any of the above time limits if the JSC proves that:

- the reduction of the authorized capital does not infringe on the creditor's rights;
- the security provided is sufficient for the proper execution of relevant obligations.

The same obligations of a company to publish announcements, creditors' rights to demand an early fulfillment or termination of obligations, preclusive terms and statutes of limitation, and also a court's option to refuse to satisfy such claims of creditors are envisaged for cases when NAV is below the authorized capital of a JSC by over 25% at the end of 3, 6, 9 and 12 months of the financial year following the second and each subsequent financial year after which NAV was less than the authorized capital.

Consequences: the legislators provided a more flexible system of guarantees of the rights of JSC creditors, which strikes a balance between the interests of creditors and those of debtor-companies (their shareholders), which will eventually help reduce the number of unjustified bankruptcies and creditors' abuse of their rights. Consequently, this will ensure a greater stability of civil transactions.

BONDS

Guarantee

Article 27.4 of the Federal Law on the Securities Market, dealing with bonds secured by a guarantee, has been reworded.

The main additions are (i) the imposition of imperative demands on the guarantor of bond obligations, and (ii) the introduction of a new material term in the contract of bond loan guarantee.

Previously, neither the laws regulating securities issuance nor the Issuance Standards of the Federal Financial Markets Service (FFMS) (Federal Commission for the Securities Market (FCSM)) stipulated who may act as a guarantor of a bond

loan. Consequently, the legislation did not prohibit a situation in which any legal entity, including one without sufficient assets to guarantee a loan obligation, could become such a guarantor. Such situations were fraught with high risks and problems for bond holders.

At present, the guarantors of bond loans may be:

- (1) *commercial organizations* whose NAV is not less than the sum total (amount) of a guarantee; or
- (2) *government corporations* or a *state company* if the provision of guarantees by them is allowed by the Federal Law; or
- (3) *international financial organizations*.

As a new material term of the bond guarantee contract, the law makes it incumbent to indicate the term of the guarantee, which must exceed the term of fulfillment of these obligations by at least one year.

When applying the new norms, it is necessary to take into account the regulator's official position on the issue set forth in the FFMS Information Letter, dated 13 January 2010, "On Enactment of New Requirements Related to the Provision of Guarantee for Bonds" (**Information Letter**).

According to the Information Letter, the new guarantee requirements, pursuant to Article 4 and Article 422 of the RF Civil Code, apply to all issues of bonds secured by a guarantee which will be placed after 31 December 2009, regardless of whether the state registration of these issues occurred before or after that date. This is due to the fact that the bond guarantee contract is deemed made as of the moment of the origin of the first holder's right to such bonds.

If there is a placement of bonds whose guarantee does not comply with the new requirements, then, according to the Information Letter, this constitutes grounds for suspending the issuance of securities and pronouncing their issue null and void.

In the Information Letter, the regulator proposes a solution by amending the registered decisions on the issue of bonds with a guarantee and prospectuses of such bonds to include the requisite changes removing discrepancy with the new requirements. Specifically, such changes may provide for:

- replacing the guarantor who does not comply with the new requirements with another guarantor, one conforming with them;
- replacing the inappropriate guarantee with another type (method) of securing compliance with the bond obligations, for example, a pledge or a bank, government or municipal guarantee;
- excluding the guarantee that does not confirm with the reworded legislation on securities if the issuer has the right to issue bonds without security.

Following the appearance of imperative demands to bond loan guarantors, the Information Letter recommends that an application for the registration of an issue of bonds secured with a guarantee be accompanied with a document testifying to compliance with these requirements. If such document (a regulatory legal act is pending) is absent, the letter hints that this may cause the state registration of the issue to be denied.

The necessary document, according to FFMS Russia, may be a document containing the NAV calculation of the guarantor commercial organization according to the requirements of the RF legislation; such calculation is based on accounting reports for the last quarter (full reporting period) preceding the date of submission of documents for the registration of the guaranteed issue of bonds, provided the submission date for such reports under the rules of federal laws has expired.

Consequences: the possibility of arbitrary guarantee of bond loan by any organization to the detriment of the interests of creditors or with the aim of abusing this opportunity has been removed. Bond holders also received an additional guarantee in the form of the minimum mandatory guarantee period.

Specifics of Bond Issuance

The Federal Law on the Securities Market was supplemented with new Article 27.5-4 detailing the issuance of bonds specifically for limited-liability and joint-stock companies. The general rule of inadmissibility of issuance of bonds until the full payment of a company's authorized capital remains in force. A provision has been made for the nominal value of bonds not to exceed the amount of its authorized capital and/or the amount of security

provided by third parties for these purposes. In the absence of such security, a bond issue is permitted only in the third year of a company's existence and on condition of properly approved annual financial statements for two full financial years.

At the same time, the law provides for significant exceptions in regard of provisions on the nominal value and the moment of issuance of unsecured bonds, based on the graduation of bond issuers and/or type (status) of bonds (primarily depending on the extent of issuers' reliability). The above general rules do not apply to:

- (1) mortgage-backed bonds;
- (2) companies whose issued securities have been listed at a stock exchange;
- (3) companies and/or bonds that have a credit rating from a rating agency (the approved list is pending), accredited by a federal executive agency, authorized by the Russian Government, which rating is not below the level set by FFMS Russia;
- (4) bonds targeted at qualified investors.

Besides, in regard of bonds targeted at qualified investors, special restrictions were put in place to specify (i) assets which they may be included in (open-ended PIFs and also AIFs not targeted at qualified investors and (ii) funds that cannot be placed in such securities (pension reserves, pension accumulations of NPFs, insurance reserves of insurance organizations).

Consequences: the provision of the above exclusions from the general rules must have a positive impact on the development of the Russian corporate bonds market and significantly raise the possibilities of Russian issuers to solicit financing through securitization of their assets, specifically, mortgage loans. The regulating role of stock exchanges has been raised as they may now exclude the need to provide security (guarantee) on bond issuance by listing issuers' securities.

At the same time, the new restrictions in regard of bonds for qualified investors may significantly narrow the potential audience for the allocation of such bonds, thus affecting the cost of borrowing.

USRLE

Two new sections were added to the Register for joint-stock companies to provide information to interested parties (i) that a JSC is in the process of reduction of its authorized capital and (ii) about a company's NAV on the date of completion of the last full reporting period. This data must be submitted by a company to the relevant tax authority within 3 days after changes thereof. There is a proviso that any changes to USRLE (with some exceptions) should be reported within working and not calendar days, as before.

In this context, it is noteworthy that the period of preparation of minutes of voting results and minutes of a shareholders' general meeting has now been reduced from 15 to 3 *working days* after the meeting closure.

When announcing the beginning of a capital reduction process, a company affixes the relevant decision of the general shareholders' meeting for the registrar. The three-day period for the submission of data to USRLE is counted in this case *from the moment of decision making* and not the compilation of the minutes.

Information about NAV is submitted to USRLE by a company on a quarterly basis (within the time period for the submission of annual or quarterly financial statements).

Consequences: JSC creditors and shareholders interested in tracking the events of the company's corporate life received faster and better access to authentic USRLE information about processes such as the reduction of a JSC's authorized capital and NAV quarterly dynamics.

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We hope that the practical application of said changes will boost the financial standing of your companies, broaden your business opportunities, enable you to raise additional capital through bond issuance and, consequently, improve conditions for investment in your business, i.e., have a positive impact on the investment climate in the Russian Federation.



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