

Private mergers and acquisitions in the Russian Federation: overview

Dr Alexander Ermolenko
FBK Legal

global.practicallaw.com/7-550-3587

CORPORATE ENTITIES AND ACQUISITION METHODS

1. What are the main corporate entities commonly involved in private acquisitions?

The main types of legal entity involved in M&A transactions are:

- Joint-stock companies.
- Limited liability companies (LLCs).

The Civil Code of the Russian Federation also describes business partnerships as a means by which to expand corporate business, but cases of their use are rather rare today.

The Russian Federation is currently undergoing a reform of civil and corporate legislation. From 1 September 2014 all companies carrying on business in Russia were classed as public or non-public. Only joint-stock companies whose shares are offered to the public, as a rule, via stock mechanisms, are recognised as public companies. Stricter rules apply to both circulation of their securities and disclosure of information relating to their activities.

All other companies, whether joint-stock companies and limited liability companies, are non-public companies. Regulation of their activities, including as regards relations between the shareholders/participants is freer and largely determined by the company charter and/or shareholders'/participants' agreement.

An LLC is usually the most straightforward legal entity in terms of its establishment and administration. The buyers and target companies in business purchase and sale transactions in Russia are usually LLCs.

The charter capital of joint-stock companies is divided into shares, and that of limited liability companies into equity interest.

2. Are there any restrictions under corporate law on the transfer of shares in a private company? Are there any restrictions on acquisitions by foreign buyers?

Restrictions on share transfer

There are practically no significant prohibitions on sale of shares/equity interests in corporate legislation, apart from the following:

- Shares that are not paid for by the shareholders/participants on their issue cannot be sold (until their complete payment).
- LLCs are restricted from selling interests to third parties who are not shareholders/participants in the LLC in question. In effect, this means that existing shareholders/participants and the company itself have a pre-emption right to purchase interests, and an interest can only be sold to a third party following their refusal.

In addition, a shareholders' agreement and the internal documents of the company can contain different restrictions on the disposal of

shares/interests by shareholders/participants. In the last several years these have become more widespread in business practice and private M&A transactions.

There are restrictions on acquisitions by foreigners on transactions with business entities of strategic importance for Russian national defence and state security, under federal law "On the order of execution of foreign investments into business companies, having strategic importance for assurance of the country's defence and safety of the state" No 57-FZ. This requires significant transactions in certain industries to be agreed by the government, including, for example, industries concerning:

- The production and turnover of arms.
- Nuclear materials.
- Encryption means.
- Production and development of aircraft equipment.
- Study of subsoil.
- Development of mineral resources and other spheres to the above industries.

This list is established by the law and is closed.

There are similar legal restrictions on the acquisition of a target company by foreigners in other spheres. For example, the direct or indirect participation of foreigners of over 20% in Russia's mass media is prohibited (*Law of the Russian Federation "On mass media" dated 27 December 1991 No 2124-1 with amendments dated 14 October 2014*).

Foreign ownership restrictions

There are restrictions on acquisitions by foreigners in certain industries (*see above, Restrictions on share transfer*). Otherwise, the law does not prohibit ownership of Russian companies and assets by foreigners and foreign organisations. The general regime of holding shareholding/ownership of companies, established by the Civil Code of the Russian Federation and corporate laws, applies.

3. What are the most common ways to acquire a private company? What are the main advantages and disadvantages of a share purchase (as opposed to an asset purchase)?

Share purchases: advantages/asset purchases: disadvantages

The advantages of acquisition of a target business via purchase of shares/interests in Russia, as in other jurisdictions, include the possibility of acquiring all assets, resources and business relationships required for the conduct of business in one transaction, including:

- Property.
- Intellectual property.



- Employees.
- Essential business contracts and obligations.
- Licences.

In addition, it is also possible to determine the transaction price of the business for tax purposes quite freely, within reasonable limits. There is more freedom under the legislation to establish the price than is the case with a specific asset or property (see below, *Share purchases: disadvantages/asset purchases: advantages*). However, it is impossible to ascertain that there are no hidden risks attached to the legal entity, such as tax arrears, issued and unpaid bills, and violations of the environmental or labour legislation, which can reduce the future business value or make otherwise make the acquisition worthless.

Share purchases: disadvantages/asset purchases: advantages

Acquiring a specific asset grants greater certainty over the assets acquired and the related risks. At the same time, it greatly removes the freedom of choosing the transaction structure and determining the price for taxation purposes (see above, *Share purchases: advantages/asset purchases: disadvantages*).

4. Are sales of companies by auction common? Briefly outline the procedure and regulations that apply.

Sale of companies by auction in private M&A transactions is rare, although it has been gaining momentum in recent years, because of the improvement of infrastructure (such as electronic trading floors and company organisers of trade), and now forms a separate area of legal practice. Bidding and auctions are used more widely in sale of insolvent businesses, for example big banks form special subdivisions for preparation for sale by auctioning companies which they obtained in settlement of loans. Also in accordance with the special law these procedures are used when privatising state and municipal property.

PRELIMINARY AGREEMENTS

5. What preliminary agreements are commonly made between the buyer and the seller before contract?

Letters of intent

Agreements of intent are made in practically every transaction, and they are often of different legal types, such as:

- Heads of agreement and safe agreements recorded on paper, which are not legally binding, are not subject to disclosure and act as a promise between two parties.
- Comprehensive binding preliminary or framework agreements, provided for under civil legislation. It is possible to require the sale of the business to be concluded under the conditions set out in these contracts.
- Option agreements and frameworks agreements. These have appeared in the Russian Civil Code since 2015. They can stipulate the rights and duties of the parties in a multi-stage transaction and provide that each stage is executed as a separate agreement. Such contracts can be enforced. These agreements simplify the structuring of transactions and are often used by lawyers, but the courts have only just begun to formulate an approach to the use of these agreements.

Exclusivity agreements

Exclusivity agreements are also used and, as a rule, provide that during a certain period the seller will not offer its business for sale to other companies and will provide the buyer with all required

information to evaluate risks and determine the adequate cost of assets. Usually under such agreements the buyer can refuse to purchase only in cases of evident discrepancies in the information, originally provided by the seller. Earnest money (a form of security deposit) is paid as a rule.

However, such agreements are legally very difficult to enforce. Where they are breached, an award for damages is not generally made because of an absence of stable court practice and the very high standard of proof required to establish that the breach had negative consequences for the buyer in Russian courts.

Non-disclosure agreements

Non-disclosure agreements are often used, but have the character of written promises, rather than legally protected contracts. Usually they provide for financial penalties in the event of disclosure of confidential information, but it is almost impossible to obtain those damages because of the difficulty in proving loss (see above, *Exclusivity agreements*).

ASSET SALES

6. Are any assets or liabilities automatically transferred in an asset sale that cannot be excluded from the purchase?

There are no assets or liabilities that are automatically transferred in an asset sale that cannot be excluded. The list of assets to be transferred is determined as specifically as possible. There are currently no legislative requirements on the need to transfer assets together with liabilities. Where a business is divided unfairly into different parts and the most valuable part is sold separately, liability only arises in the event of bankruptcy proceedings involving criminal prosecution where there is damage to the creditors of the divided business.

7. Do creditors have to be notified or their consent obtained to the transfer in an asset sale?

According to the applicable legislation creditors must be notified only in the case of a company's reorganization, for example, where part of a business is transferred before the business' sale. In that case, they can claim early fulfilment of their obligations.

Corporate approval is required when property is transferred to related parties or where certain thresholds of the balance sheet value of the property to be alienated are exceeded (which in the case of an LLC amounts to 25% of the company's assets). This transfer must also comply with competition law.

SHARE SALES

8. What common conditions precedent are typically included in a share sale agreement?

Condition precedents commonly include conditions relating to:

- Repayment of debts.
- Dismissal of certain employees.
- Confirmation of certain licences.
- Transfer of shares/equity interests of companies to be sold to the address of one target company (often located in an offshore jurisdiction).
- Obtaining the approval of the Federal Anti-Monopoly Service (FAS) for the transaction.

Unusual conditions are also possible, such as initiating a tax audit over the business to be sold to ensure there are no tax violations.

SELLER'S TITLE AND LIABILITY

9. Are there any terms implied by law as to the seller's title to the shares in a share sale? Is any specific wording necessary and do buyers normally impose a higher standard than is implied by law?

Implied terms as to the seller's title are not used in Russian law. Specific wording can be important when a transaction is governed by English law. In this case, the lawyers must be careful as this approach to wording is not used in the Russian civil law.

10. Can a seller and its advisers be liable for pre-contractual misrepresentation, misleading statements or similar matters?

Seller

Generally a seller cannot be liable in cases of pre-contractual misrepresentation. Criminal prosecution or a requirement to reimburse losses will only apply if a crime is committed or if the contract of sale provides for this.

Advisers

Generally advisers will not be liable, unless their actions are considered to constitute wilful misleading of the buyer in accordance with criminal law.

MAIN DOCUMENTS

11. What are the main documents in an acquisition and who generally prepares the first draft?

Usually the purchase and sale contract is the main document, both for transactions involving shares/equity interests and for property or asset transactions. The contract or contracts is made as a single document in writing. It is necessary to provide signed contracts concerning transactions over certain property, principally immovable property, to the state authorities for registration.

Transactions involving an LLC must have a notarial certification (see *Question 24*). The notary must send information on the transaction to the tax service, which keeps the Unified State Register of Legal Entities (USRLE). Transfer of rights to shares/equity interests occurs at the moment of notarial certification of the transaction.

Aside from basic documents, contracts guaranteeing execution are often signed including:

- Pledges.
- Sureties.
- Bank guarantees.
- Shareholders' agreements, ensuring business management after the transaction.

There is no absolute rule or generally accepted practice concerning which party must prepare the first draft documents or execution version for signing. This can be lawyers from both parties or even internal lawyers of the target company. Currently standard templates, accessible to the public on specialised sites, are often used.

ACQUISITION AGREEMENTS

12. What are the main substantive clauses in an acquisition agreement?

The wording of the subject is the main difference between agreements. It is necessary to identify shares/equity interests very clearly, including:

- To which person they belong.
- Their par value.
- Their issue number.
- The quantity to be sold.

It is also necessary to identify the property as clearly as possible, to avoid disputes when fulfilling the contract.

Guarantees and security mechanisms are often similar for shares/equity interests and asset transactions.

13. Can a share purchase agreement provide for a foreign governing law? If so, are there any provisions of national law that would still automatically apply?

According to the general rule, a contract for purchase and sale of shares/equity interests can be subject to foreign law, if a foreign element is present in the transaction, for instance if one of the participants to the transaction (a foreign company or property) is located abroad. The transaction or its separate terms and conditions must not be contradictory to the regulatory standards of Russian law. For example, the corporate, currency, tax, anti-monopoly and labour legislation of the Russian Federation contain a number of obligatory requirements, which must be observed irrespective of the law of the state governing the principal contracts in the transaction.

WARRANTIES AND INDEMNITIES

14. Are seller warranties/indemnities typically included in acquisition agreements and what main areas do they cover?

Warranties and representations have been used in Russian private M&A transactions for a long time, irrespective of whether contracts are subject to English law or Russian law. Despite the absence of any prohibition on using warranties and representations, there have been no significant court rulings for a long time in respect of the application and treatment of warranties and representations in Russian law. Due to the reform of the Civil Code of the Russian Federation special rules have appeared from 2015, allowing parties to make representations as to the essential circumstances for completion of the transaction in the contracts for the purchase and sale of business. Indemnities have also entered into Russian law. Acceptance by the courts on how these standards apply is in the early stages.

Usually representations cover all essential aspects of the business to be sold and depend on the character of the business. Certain standard warranties are used regardless of the nature of the business to be acquired, and adjusted depending on the specific features of the contract, for example:

- Acquisitions of plants: the plant observes environmental legislation and is subject to no outstanding claims from the regulatory authorities.
- Acquisitions of retail networks: that all contracts with basic suppliers are valid.

Generally, tax representations will be the same in both cases.

In a sale of property contract warranties and representations relate to:

- The lawfulness and legitimacy of its acquisition.
- Its use.
- The absence of defects.
- Whether the property is known to the seller.
- The rights and availability of all required powers to sell it.

What are the main limitations on warranties?

Limitations on warranties

There are no restrictions on the provision of guarantees.

Qualifying warranties by disclosure

The seller must reveal fully, and to the maximum extent, the defects of the business that are known to him. Otherwise any defect can give a rise to reimbursement of damages or direct compensation of losses.

15. What are the remedies for breach of a warranty? What are the time limits for bringing claims under warranties?

Remedies

Reimbursement of losses, which can be calculated and proved in each separate case or pre-evaluated by the parties, serves as a remedy for protection of interests. Also the parties can stipulate the conditions giving rise to payment of the penalty.

The party which relied on unreliable representations can terminate the contract.

Time limits for claims under warranties

The limitation period for starting a claim is three years from the moment when the person became aware of the potential violation of their right, but must not exceed ten years after the emergence of the obligation.

CONSIDERATION AND ACQUISITION FINANCING

16. What forms of consideration are commonly offered in a share sale?

Forms of consideration

In this case the parties to the transaction are free to use any form of consideration, beginning with direct purchase and sale to exchange of assets. The legislation does not prohibit and does not prescribe any specific methods. Due to the specific legal culture of the parties to such transactions rather simple methods of payment, excluding the possibility of different interpretation or abuse, often prevail.

Often offshore companies or bank accounts in special jurisdictions are used in the settlement of transactions. Cash settlements or payments with bills of big banks are practiced more and more rarely.

Factors in choice of consideration

Relevant factors include:

Assets which are not completely ready for sale, having some legal complexities, but sold at a lower price, are sometimes the subject of a transaction. There are concepts "to buy the situation" or even "to buy the problem". In this case the process of payment can be

complicated, taking into account the schedule of bringing the asset to a state suitable for use.

17. If a buyer listed in your jurisdiction raises cash to fund an acquisition by an issue of shares, how is the issue typically structured? What consents and regulatory approvals are likely to be required?

Structure

In most cases quite simple methods of financing are used: bank crediting, direct investment funds or pool of private investors.

Consents and approvals

According to the general rule no consents are required. In the case of settlement of transactions with enterprises in strategic industries the consent of the Government of the Russian Federation is required. Transactions with banks and credit organisations require the consent of the Bank of Russia, and in all cases of possible restriction of competition the consent of the anti-monopoly authority is required.

Requirements for a prospectus

According to the general rule, a prospectus is not required.

18. Can a company give financial assistance to a potential buyer of shares in that company?

Restrictions

There are no restrictions on financial assistance to potential buyers in Russian legislation. In reality, however, this financing is rarely used.

Exemptions

Exemptions on the sale of a private company are not provided for or used.

SIGNING AND CLOSING

19. What documents are commonly produced and executed at signing and closing meetings in a private company share sale?

Signing

Contracts of purchase and sale, containing conditions precedent, which must be fulfilled by the parties before the completion of the transaction, are usually signed (see Question 8). Framework agreements, providing for stage-by-stage fulfilment of the transaction, can also be signed (see Question 5, *Letters of intent*).

Closing

Where conditions precedent are fulfilled, the parties sign the documents, confirming transfer of the shares/equity interests from the seller to the buyer. For joint-stock companies a special transfer deed submitted to the registrar confirming the transfer of shares in the register from the seller's personal account to the buyer's account serves as this document. For LLCs the ownership right to interest transfers from the moment of notarial certification of the interest sale contract.

20. Do different types of document have different legal formalities? What are the formalities for the execution of documents by companies incorporated in your jurisdiction?

There are no special requirements for the contracts, except the requirement for notarial certification for an LLC. Contracts of purchase and sale of business are made in a free form, except for one essential condition, the description of the subject of the transaction, and should include the scope of the agreement between the parties at their discretion.

21. What are the formalities for the execution of documents by foreign companies?

There are no special formalities for the execution of documents by foreign companies.

22. Are digital signatures binding and enforceable as evidence of execution?

Digital signatures can be used and there is a special federal law, "On electronic digital signature", describing their particular requirements. However in reality digital signatures are used rarely. Generally a digital signature is used when the transaction is made in bidding in an electronic forum.

23. What formalities are required to transfer title to shares in a private limited company?

The following formalities apply:

- Joint-stock companies: the transaction must be recorded in the register, which is kept by the specialised licences registrar for joint-stock companies.
- Limited liability companies: the contract for the purchase and sale of an interest must be notarised and amendments registered with the tax service.

Usually the purchase and sale contract is the main document, both for transaction involving shares/equity interests, and for property or asset transactions. Such a contract or contracts are made as a single document in writing. For transactions involving an LLC the law provides for the obligatory notarial certification. The notary must send information on the transaction to the tax service, which keeps the register of legal entities (USRLE). Transfer of rights to shares/equity interests occurs at the moment of notarial certification of the transaction.

TAX

24. What transfer taxes are payable on a share sale and an asset sale? What are the applicable rates?

Share sale

A transfer tax is not payable on the sale of shares/equity interests. A seller that is a company must pay profit tax at 20% on the difference between the selling price and the price of acquisition. A seller that is an individual must pay individual income tax at the rate of 13% on the difference between income and expense.

Asset sale

Generally, VAT is payable on the transfer at the rate of 18%.

25. What are the main transfer tax exemptions and reliefs in a share sale and an asset sale? Are there any common ways used to mitigate tax liability?

Share sale

There is no special transaction tax. Transactions with shares and equity interests are not subject to VAT.

Asset sale

The transaction is subject to VAT (see *Question 25, Asset sale*). Expenses reduce the buyer's tax base, and for the seller income increases the tax base on the profit tax.

26. What corporate taxes are payable on a share sale and an asset sale? What are the applicable rates?

Share sale

Corporate tax is paid at the general tax rate of 20% on profit obtained on the sale of shares/equity interests (see *Question 25, Share sale*).

Asset sale

Corporate tax is payable on profit obtained from the sale of assets (see *above, Share sale*).

27. What are the main corporate tax exemptions and reliefs in a share sale and an asset sale? Are there any common ways used to mitigate tax liability?

Share sale

Exceptions are provided for companies on sale of shares/equity interests of Russian companies from corporate tax when they have held them for more than five years or they are related to a high-tech (innovative) sector of the economy.

Asset sale

See *above, Share sale*.

28. Are other taxes potentially payable on a share sale and an asset sale?

Not applicable.

29. Are companies in the same group able to surrender losses to each other for tax purposes? For example, can interest expenses incurred by a bid vehicle incorporated in your country be set off against profits of the target before tax?

Companies in a group cannot surrender losses to each other for tax purposes. Each company must individually calculate and pay its taxes.

EMPLOYEES

30. Are there obligations to inform or consult employees or their representatives or obtain employee consent to a share sale or asset sale?

Asset sale

There is no obligation to inform or consult employees or obtain employee consent to an asset sale in the labour legislation.

Share sale

There is no obligation to inform or consult or obtain consent in the labour legislation. Change of the company's owner can be a special ground justifying termination of the employment contract in a number of cases, expressly provided for by the Labour code of the Russian Federation.

31. What protection do employees have against dismissal in the context of a share or asset sale? Are employees automatically transferred to the buyer in a business sale?

Business sale

Employees retain their employment contracts with the company that has been sold. Automatic transfer of the employees is not provided for. They can be transferred to another company only with their written consent.

Share sale

Sale of shares/equity interests is not a ground for termination of the employment contract, and no special protection is established for this case by the labour legislation.

Transfer on a business sale

There is no automatic transfer of employees on a business sale (see above, *Business sale*).

PENSIONS

32. Do employees commonly participate in private pension schemes established by their employer? If an employee is transferred as part of a business acquisition, is the transferee obliged to honour existing pension rights or provide equivalent rights?

Private pension schemes

Private pension schemes are not often used in Russia, although they are used for employees in very large corporate groups. Employees conclude direct pension insurance contracts with the fund. In case of sale of business or dismissal of employees, such contracts remain in effect.

Pensions on a business transfer

Private pension schemes remain in effect post sale of a business or dismissal of an employee (see above, *Private pension schemes*).

COMPETITION/ANTI-TRUST ISSUES

33. Outline the regulatory competition law framework that can apply to private acquisitions.

Triggering events/thresholds

The consent of the Federal Anti-Monopoly Service (FAS) is required for transactions of purchase and sale of a business or essential assets where the following thresholds are met (*Law on protection of competition*):

- More than RUB7 billion in assets or RUB10 billion in total proceeds for the last year for the buyer's and the seller's groups aggregated together.
- At least RUB250 million in assets for the target company.

Notification and regulatory authorities

The FAS is the regulatory authority in the area of protection of competition, and the federal law "On protection of competition" is the main regulatory framework. It is necessary to notify the FAS for preliminary consent where the thresholds are met before completion of the acquisition (see above, *Triggering events/thresholds*). The duty to obtain consent lies with the buyer.

If consent is not obtained, the FAS may deem the transaction invalid, and fine the buyer RUB500,000.

Substantive test

The substantive test is whether the acquisition does or could lead to the restriction of competition.

ENVIRONMENT

34. Who is liable for clean-up of contaminated land? In what circumstances can a buyer inherit and a seller retain liability in an asset sale and a share sale?

The principle of "polluter pays" applies in cases of contaminated land. Liability lies with the company which polluted the environment.

ONLINE RESOURCES

Consultant plus

W www.consultant.ru

Description. Consultant plus is an assistance system to work with the legislation of Russia. Consultant's centralised database is updated daily. It is distributed via a network of partners. The full federal law database includes over three million documents; regional acts are distributed in a separate database with over four million documents.

Practical Law Contributor profile

Dr Alexander Ermolenko, Partner

FBK Legal

T +7 495 737 5353

F +7 495 737 5347

E Ermolenko@fbk.ru

W www.fbk-legal.com

Professional qualifications. Russian Federation, Lawyer; 2004 Kutafin Moscow State Academy of Law, PhD; 2000 Kutafin Moscow State Academy of Law (summa cum laude)

Areas of practice. Corporate law; mergers and acquisitions; restructuring; reorganization; bankruptcy; dispute resolution.

Recent transactions

- Structuring and conducting transactions of the largest Russian importer of fish on the acquisition of over a dozen Far Eastern fishing companies with preliminary due diligence of each target company.
- Successful representation of the client's interests in the dispute with the Moscow Committee for Architecture and Urban Development.
- Providing legal support on a project implemented by Russian Helicopters and Augusta Westland aimed at construction of the first Russian plant producing civil helicopters.
- Challenging RUB2.5 billion claims filed against Gazprom's subsidiary by its creditors.
- Legal support of a unique international project on the foundation of a joint venture between the Russian Federation and Kazakhstan aimed at development and exploitation of rich oil and gas resources at the bottom of the Caspian Sea.

Languages. Russian, English

Professional associations/memberships. Member of International Bar Association (IBA); Member of Expert council of JSC Transneft; Member of the Management Board of the Russia-China Law Society.