

IMPACT OF NEW RUSSIAN LAW ON LIMITED LIABILITY COMPANIES IN M&A TRANSACTIONS WHERE THE TARGET IS A RUSSIAN LLC

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A Limited Liability Company (“LLC”) is an often used form of Russian legal entity. In 2009, the Federal Law “On Limited Liability Companies” (“LLC Law”) was significantly changed, with the majority of amendments coming into force on 1 July 2009. While there are many important changes to the regulation of an LLC (including with respect to its formation, corporate governance and exit by its members), this article will focus on the new legal requirements for the transfer of a participating interest. While the announced goal of the lawmakers was to prevent the widespread practice of criminal and fraudulent transactions with participating interests in an LLC, made possible because of the simplicity of title transfer, the new requirements present additional difficulties for bona fide sellers and purchasers.

Recording Title to Participating interests and Transfer of Title

Before the recent legislative amendments, the title to a participating interest was recorded only in the Unified State Register of Legal Entities (the “State Register”) and in the foundation documents of the LLC, registered with the State Register. According to the amended LLC Law, the information on participants in an LLC is not reflected in the foundation documents. Instead, the new rules introduce the list (register) of participants. Such register must be kept by the LLC and contains information on each participant, its participating interest in the charter capital and payment for that interest, as well as on the participating interest owned by the LLC and the dates of transfer of such participating interest to the LLC. If the information contained in the register contradicts the information contained in the State Register, the right to the participating interest is to be determined based on the information contained in the State Register. In case of a dispute regarding authenticity of the information contained in the State Register, the right to the participating interest is to be determined based on an agreement or other document evidencing the right of the founder or participant to the participating interest.

Previously, a sale and purchase agreement with respect to a participating interest could be executed in a simple written form. The title transferred to the buyer from the moment of notification of the LLC of the transfer. The amended LLC Law requires that, as a general rule, a transaction aimed at transfer of a participating interest in an LLC must be notarised (a few exceptions relate to a transfer of participating interests to the LLC itself, distribution of participating interest among the company’s participants and purchase of a participating interest by the LLC’s participants through the exercise of a preemptive right), and title now transfers to the buyer from the moment of notarisation.

Form and Governing Law of SPA

Foreign sellers and buyers of a participating interest in a Russian LLC who enter into typical sale and purchase agreements (“SPAs”) governed by non-Russian law should be prepared for resistance by Russian notaries to notarise such SPAs. Russian notaries rely heavily on interpretation of the amended LLC Law by the Federal Notary Chamber and the regional notary chambers. While the common practice in each region and even from notary to notary may vary, the predominant position of notaries currently appears to be that they will not notarise a transaction governed by a non-Russian law (in fact, the explicit position of the Federal Notary Chamber is that such agreements must be governed by Russian law, as stated in the Federal Notary Chamber’s recommendations published in *Notarialny Vestnik*, 12.2009).

The notary chambers’ recommendations also suggest certain provisions which the notaries are advised to include into an SPA and even provide a recommended form SPA. The form SPA is a simple three-page document in Russian lacking all provisions usually found in SPAs typically used by sophisticated international investors. As a practical matter, notaries may insist on adding certain provisions (most likely, disclaimer of the notary’s liabilities), deleting others and otherwise changing the wording of an SPA prepared by the parties, or even insist on using a simple form SPA.

Authority Verification

Although the LLC Law (clause 13 of Article 21) requires the notary to verify only the authority of the transferring person to dispose of the participating interest, the notaries are required by the Notary Chambers and existing legislation on notaries to perform much more extensive checks, including the following:

- if a party is a legal entity – verify compliance with the rules for approval of major transactions or interested party transactions;
- if a party is an individual – require a notarised consent of the spouse to the transaction;
- verify compliance with the Russian law rule pursuant to which a limited liability company cannot have a single participant which, in turn, has a single participant or shareholder;
- verify that the participating interest has been fully paid for by the disposing participant;
- verify that consent of the other participants or the company has been obtained or that the preemptive right of other participants or the company has been complied with; and
- verify compliance with the approval procedure for transactions with participating interests of strategic companies.

As a result, depending on the notary's approach, the notary may require an almost indefinite number of documents in order to notarise a transaction.

Location of Execution of SPA

According to the amended LLC Law, a notary who has notarised a transaction must, within 3 days, file with the local tax authority where the LLC is registered an application signed by the transferring participant on the registration of the new participant with the State Register. This can be done by the notary either personally or by registered mail, or by fax or email if such method is approved by the authorised government body (as of writing, the procedure for sending application by fax or email has not been approved). In practice, however, parties will try to persuade the notary to file the application personally because the use of mail can result in an unpredictably long registration. Such service will also inevitably involve an additional fee.

Considering that pursuant to the notaries' regulations, notaries can act only within the territory of the relevant region, parties will have to execute and notarise an SPA in the same region where the target is registered, which will involve additional travel arrangements and costs.

Conditions Precedent

Many SPAs include conditions precedent to the closing of a transaction and the transfer of the participating interest (such as receipt of the payment by the seller or obtaining a prior approval of the transaction from the Federal Antimonopoly Service). However, under the amended LLC Law, transfer of the right to a share passes to the buyer from the moment of the SPA notarisation. To address this issue, on 19 July 2010 further amendments to the LLC Law were introduced. A new paragraph 3 of clause 11 of article 21 allows a participant to enter into an agreement under which the participant undertakes to execute a transaction aimed at transfer of the participating interest to another person under certain conditions or upon performance by the other party of a counter-obligation. The law does not specifically exempt such agreement from the notarisation requirement and currently a common understanding by the legal community (including, predictably, the majority of notaries) is that both an agreement providing for a future transfer of a participating interest and the "title transfer" agreement must be notarised.

Suggested Practical Approaches

If the target in an M&A transaction is not a Russian LLC but a non-Russian company holding a participating interest in a Russian LLC, the rules described above do not apply. Avoiding dealing

directly with participating interests in an LLC appears to be the best approach for the moment. The existing participant of a Russian LLC, in preparation for a complex M&A transaction, could transfer its participating interest to an offshore holding company, which would become the target of the transaction. Such pre-sale transfer could be made in accordance with the recommended simple Russian form SPA.

If the above approach is undesirable, non-Russian parties to a transaction on sale and purchase of participating interest in an LLC could, under Russian conflict of law rules, provide for non-Russian law to govern the SPA. However, as a matter of Russian law, notarisation of such SPA would still be required for the transfer of the title and registration of the new participant. (Another imperative requirement is that an SPA must be a single document). A possible solution would be to provide in the SPA governed by non-Russian law that at the closing the parties will execute in front of a Russian notary a separate agreement on transfer of the title as required by Russian law.

The problem with this approach is that Russian courts may deem such SPA invalid without its notarisation by a Russian notary and, therefore, a party to such SPA will not be able to obtain specific performance by the defaulting party to the SPA and register its title to the participating interest by reverting to a Russian (or any other jurisdiction) court. Therefore, the law of the relevant jurisdiction should be analysed to determine efficient remedies available to the parties in case the seller fails to execute a separate agreement on the transfer of the participating interest.

Considering the many ambiguities of the new law and unpredictable requirements of Russian notaries to the contents of an SPA (including the documents he or she will ask for to notarise the SPA), it is imperative to work closely with the notary well before the closing to get his or her “blessing” of the transaction.

Conclusion

While the goal of the amendments is to be applauded, the implementation of the new requirements has, so far, been very poor. In addition to ambiguity in the drafting of the new law, the Russian notary system may not be ready for the challenge. Verifying the seller’s authority and notarising an SPA in a complex M&A transaction will require high legal qualification of notaries. So far, contradicting commentaries and recommendations by different members of the notary community do not inspire optimism. One can only hope that the court practice and commentaries by the higher courts will help shape a clear and predictable practice of transferring a participating interest in a Russian LLC.

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