

LEGAL UPDATE

# Survival guidelines for Transaction Practitioners

ISSUE 1: ENFORCEMENT OF A SHARE PLEDGE VS SHAREHOLDERS' PREEMPTION RIGHT  
UNDER RUSSIAN LAW

07 OCTOBER 2021

## Introduction

The security of obligations, ie a pledge, is commonplace on the Russian market due to the benefits it provides to creditors. Various assets may be made subject to pledge, including shares in a *non-public joint-stock company* ("**NPJSC**"), which is widely used in practice in financial transactions. However, the enforcement of such pledge during the levy of execution may be hindered by preemption rights held by other NPJSC shareholders to acquire such shares.

## Share Pledge vs Preemption right

### *By way of a reminder:*

- Under Russian law, there are currently two types of joint stock companies: *public* and *non-public*.<sup>1</sup> The pledge of shares in a public joint stock company ("PJSC") may not be restricted by the provisions of such company's charter, nor does it require the consent of other shareholders;<sup>2</sup>
- Unlike with a PJSC, the charter of an NPJSC may provide for restrictions on the disposal of shares to third parties. For instance, shareholders in an NPJSC and the NPJSC itself may have a preemption right to acquire the shares to be disposed of to third parties under transactions for a consideration, *if* such right is provided under the company's charter.<sup>3</sup> For NPJSCs, the existence of such preemption right is a market standard.

***What does such preemption right mean in relation to NPJSC shares?*** The preemption right is the right of the NPJSC shareholders to acquire such NPJSC's shares to be disposed of to a third party, at the price offered to such third party or on such other terms, as set out in the company's charter. By default, shareholders enjoy a preemption right to acquire the shares to be disposed of in proportion to the number of shares held by each shareholder. The preemption right applies where it is provided under the NPJSC charter.

***Does this mean that the preemption right is optional for the NPJSC and can be excluded?*** This is correct. This right is optional, ie the question as to whether preemption rights exist is regulated in the company's charter and therefore depends solely on the will of the shareholders of such company.

***What does the preemption right have to do with the pledge of shares in an NPJSC?*** The law provides that shareholders may become entitled to the preemption right when shares are disposed of to third parties under transactions for a consideration.<sup>6</sup> Examples of transactions for a consideration include sale and purchase, exchange, compensation, etc.

At the time a share pledge is created, no "disposal" occurs, but when the share pledged is enforced, the NPJSC shareholders may have a preemption right (as noted above, if so provided under the charter).

### *We note that:*

- *The existing regulatory framework for preemption rights for NPJSC shares was enacted on 1 July 2015;*<sup>4</sup>
- *Previously, the preemption right to acquire shares available to shareholders in a closed joint-stock company was **mandatory**, ie it was provided under the law and could not be cancelled in the company's charter;*
- *In addition, the preemption right only arose when shares were sold to a third party; other disposals of shares did not give shareholders any extraordinary rights.*<sup>5</sup>

<sup>1</sup> Federal Law No. 208-FZ "On Joint-Stock Companies" of 26 December 1995 ("JSC Law"), article 7, clause 1.

<sup>2</sup> Russian Civil Code, article 97, clause 5.

<sup>3</sup> JSC Law, article 7, clause 3.

<sup>4</sup> Federal Law No. 210-FZ "On making amendments to certain legislative acts of the Russian Federation and recognising certain provisions of legislative acts of the Russian Federation to be no longer in force" of 29 June 2015, article 3, clause 5.

<sup>5</sup> JSC Law, article 7, clause 3 as amended by Federal Law No. 120-FZ "On making amendments and additions to the Federal Law "On Joint-Stock Companies" of 7 August 2001, and section 9 of Resolution of the Plenum of the Higher Arbitrazh Court of the Russian Federation of 18 November 2003 No. 19 "On certain issues of the application of the Federal Law "On Joint Stock Companies"

<sup>6</sup> JSC Law, article 7, clause 3.

<p><b>What are the consequences of a breach of the preemption right?</b> If the pledge of the other shareholders' NPJSC shares is enforced and the shares are disposed of in breach of preemption rights, the following risks will arise:</p>	
<p><b>for the pledgee (secured creditor)</b></p> <ul style="list-style-type: none"> <li>• <i>A delay in the pledge enforcement process and discharge of the overdue debt.</i> Shareholders and/or the company itself whose preemption rights have been breached can challenge the share pledge enforcement process. An out-of-court enforcement process may therefore turn into lengthy court proceedings, and the enforcement of the pledge in court may become even more burdensome;</li> </ul>	<p><b>We note that:</b></p> <ul style="list-style-type: none"> <li>• <i>By default, the period for exercising preemption rights is <b>two months</b>,<sup>7</sup> which is significantly longer than the statutory time limit for enforcing a pledge.</i></li> </ul>
<ul style="list-style-type: none"> <li>• <i>(potential) sanctions risks.</i> If sanctions are imposed on the company or its shareholders (for example, where enforcement is triggered by a sanctions event (a sanctions event of default/prepayment event occurs)), depending on the particular circumstances and requirements of the applicable sanctions, the pledgee may be restricted from selling the shares to the shareholders or the company entitled to the preemption right by virtue of the sanctions since this may result in a breach by the pledgee of the sanctions regime;</li> </ul>	
<p><b>for the acquirer of shares</b></p> <ul style="list-style-type: none"> <li>• <i>risk of forfeiting the shares.</i> The acquirer of shares risks forfeiting them. Shareholders and/or the company itself whose preemption rights have been violated are entitled to demand that the shares being disposed of are transferred to them.<sup>8</sup></li> </ul>	<p><b>We note that:</b></p> <ul style="list-style-type: none"> <li>• <i>This right can be exercised by shareholders/company within <b>three months</b> of the date on which they learned or should have learned of the violation of their right.</i></li> </ul>
<p>Therefore, the existence of a preemption right will at least result in an extension of the time limit for enforcing the pledge on the NPJSC shares to the time limit for exercising such right (<i>which amounts to no more than <b>two months</b></i>).</p>	
<p><b>What is the most effective way to eliminate the preemption right for a NPJSC?</b> This issue may be dealt with in one of the following ways.</p>	

<sup>7</sup> JSC Law, article 7, clause 4.

<sup>8</sup> JSC Law, article 7, clause 4.

<ul style="list-style-type: none"> <li>• <b>Option 1: excluding the preemption right</b></li> </ul> <p>In order to be able to efficiently enforce the share pledge, the preemption rights must be excluded. To effect this, we recommend that, prior to entering into a pledge agreement, <i>the charter of the NPJSC whose shares are subject to pledge be amended to exclude the preemption rights of both the company and its shareholders.</i></p> <p><b>We recommend:</b> using this method. It is the most robust solution, since it completely removes the effect of preemption rights.</p> <p>However, it may not always be available.</p> <ul style="list-style-type: none"> <li>• <i>Firstly</i>, the removal of the relevant provisions from the charter must be approved by the general meeting of shareholders unanimously by all shareholders of the company.<sup>9</sup></li> </ul>	<p><b>We note that:</b></p> <ul style="list-style-type: none"> <li>• <i>amendments to the charter are recorded in the Unified State Register of Legal Entities, and a copy of the charter may always be obtained from the registration authority;</i></li> <li>• <i>therefore, the pledgee will be able to monitor whether this exception is stated in the charter.</i></li> </ul>
<ul style="list-style-type: none"> <li>• <i>Secondly</i>, the process of amending the charter is a rather time consuming process: it would necessitate the convocation of a general meeting of shareholders and the registration of the amendments to the charter in the Unified State Register of Legal Entities. We estimate that in practice such procedure may take approximately <b>a month and a half</b> to implement.</li> </ul>	<p><b>We note that:</b></p> <ul style="list-style-type: none"> <li>• <i>Such period includes the period for calling the general meeting of shareholders (normally 40 days) and the period for registering amendments to the charter (normally five business days)</i></li> </ul>
<ul style="list-style-type: none"> <li>• <b>Option 2: waiver of the preemption right</b></li> </ul> <p>If the abovementioned method is unacceptable to the parties (eg, due to time limitations or because it is not feasible to obtain the approval of all shareholders), we recommend that <i>prior to entering into the pledge agreement, a written waiver of the preemption rights in respect of the pledged shares be obtained from the shareholders and the company.</i> The waiver may be granted for the benefit of:</p> <ul style="list-style-type: none"> <li>• a particular person, such as the pledgee (which may be relevant where the pledgee uses property acquisition as a method of disposal); or</li> <li>• an unlimited number of acquirers (eg including the future purchaser of the shares).</li> </ul> <p>Although there are cases in practice of a prior waiver of the pre-emptive right being obtained to acquire shares, this method is sub-optimal in view of the following:</p> <ul style="list-style-type: none"> <li>• The scope of the application and the validity of such waiver <i>are not supported by law or court practice.</i> The key risk in this case is that, at the time of granting such waiver, the terms of disposing of the shares (including the share price and other material terms of the transaction) may not be definitively known;</li> </ul>	<p><b>We note that:</b></p> <ul style="list-style-type: none"> <li>• <i>a waiver for the benefit of a particular person, ie pledgee, where the pledge agreement stipulates that the pledgee has the right to appropriate the shares appears to be a more secure measure than the grant of a waiver for the benefit of an unlimited number of acquirers; and</i></li> <li>• <i>if the creditor wishes to receive cash compensation and is not interested in the NPJSC shares as such, such subsequent sale would require a second waiver of the preemption right from the shareholders.</i></li> </ul>

<sup>9</sup> JSC Law, article 7, clause 3.

- we also cannot rule out the possibility that such prior waiver of the preemption right may be revoked, as the law and court practices do not directly address this issue.

**We note that:**

- unlike amendments to the charter (as discussed above), as a practical matter, the pledgee will not be able to monitor the revocation of such waiver.

## Contacts

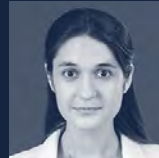


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