

## New Regulation of Major Transactions and Interested Party Transactions

Newsletter

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On January 1, 2017, the new provisions on the procedure of conclusion of interested party transactions and major transactions by legal entities will enter into effect. The changes have been introduced by Federal Law No. 343-FZ dated July 3, 2016 and significantly altered the usual approach of the legislators to the regulation of these categories of transactions. Thus, the amendments:

- ▶ have abolished the loss criterion for contesting major transactions;
- ▶ have specified the procedure for determining the value of the subject matter of a major transaction;
- ▶ have replaced the notion of affiliation underlying the concept of an interested party transaction by the concept of a controlling person;
- ▶ have replaced the approval of interested party transactions by notice thereof, etc.

Read more about these and other changes, as well as about how the provisions of the company's Charter will be affected by the new version of the law in the Mosgo & Partners newsletter.

### 1. CRITERIA OF MAJOR TRANSACTIONS AND CHANGE OF GROUNDS FOR CHALLENGING THEM

The new versions of the Federal Laws "On Joint-stock Companies" (the "JSC Law") and "On Limited Liability Companies" (the "LLC Law") envisage the concept of **ordinary business activities**. Thus, the laws have formalized the positions previously established in the court practice and clarifications of the supreme courts.<sup>1</sup>

It should be noted that major transactions are understood to mean not only contracts aimed at the acquisition or alienation of property, but also agreements on **the transfer of property for temporary use** (lease agreements) and agreements for assignment **of intellectual property rights** to third parties (license agreements).



**Challenging the transaction does not require proof of losses incurred through it.**

Simultaneously, the legislators have now excluded from the text of the abovementioned laws the **loss** criterion previously required for invalidation of major transactions – that criterion required proving that the transaction has entailed or may entail losses to the company or the shareholder filing the action. According to one of the authors of the amendments – A. Kuznetsov,<sup>2</sup> a major transaction does

not necessarily entail losses, but its consequences may endanger the continued existence of the legal entity. For example, disposal of the plant and equipment of the enterprise will not necessarily result in losses for the company, although at the same time such a transaction may frustrate the company's main activity.

## 2. DETERMINING THE VALUE OF THE SUBJECT MATTER OF THE TRANSACTION (FOR MAJOR TRANSACTIONS)

The law has retained the quantitative criterion for qualifying transactions as major transactions: the value of property involved must be over 25 percent of the balance sheet value of the company's assets. However, starting from January 1, 2017, depending on whether the company is disposing of its assets or purchasing them, different systems for evaluation of the subject matter of the transaction will apply.

- ▶ For **alienation of property**, either the balance sheet value of such property, or the price at which it is to be disposed of will apply, depending on which amount is bigger.
- ▶ For **acquisition of assets**, the acquisition price of the property will be still used.
- ▶ For **transfers of property for temporary possession** to third parties, the balance sheet value of the transferred property will be compared to the balance sheet value of the company's assets.

## 3. THE DECISION TO AUTHORIZE A MAJOR TRANSACTION: FLEXIBLE REGULATIONS

The company's management bodies will be able to include provisions allowing to formulate the terms and conditions of a transaction in a more flexible manner, into their decision to approve a major transaction. Such terms may include:

- ▶ The upper cap for the acquisition or the lower cap for the sales of the property or the procedure for the determination of the price ("The sale price shall not be less than RUB 1 million.");
- ▶ Authorization of a number of similar transactions ("To enter into transactions on the same terms and conditions with 15 Sellers.");
- ▶ Alternative terms and conditions of the transaction ("The property price shall amount to RUB 10 million, provided the Contract is concluded before December 1, 2016; or RUB 12 million, in case the Contract is concluded on a later date.");
- ▶ Authorization of a major transaction subject to the execution of several transactions at the same time ("The consent shall be valid subject to simultaneous execution of the Cooperation Agreement and the Supply Agreement by the parties thereto.");
- ▶ The period during which the decision is valid ("This consent shall be valid during three months from the execution of the Minutes of the General Meeting of Shareholders.").

The law provides that a major transaction may be concluded under the **condition precedent of obtaining the respective approval** (subsequent ratification), that is, that the contract may incorporate a provision according to which it shall enter into full force and effect only upon approval.

For joint-stock companies, the law provides for mandatory **preliminary assessment** of major transactions by the Board of Directors. The Board of Directors shall submit its opinion containing information on the potential effect of the major transaction on the activities of the company and the expediency of its conclusion to the General Meeting of Shareholders, seized of the issue of

authorizing the respective transaction.

#### 4. INTERESTED PARTY TRANSACTIONS: THE CONTROLLING PERSON CRITERION

At present, the interest of a shareholder in the transaction is defined through affiliation, as well as the related concept of a group of persons. In interpreting this test, the courts have developed an approach that the list of affiliated persons in the JSC Law and the LLC Law is not exhaustive.<sup>3</sup> In new versions of the aforementioned laws, these tests have been replaced by the criterion of the **controlling person** and the list of persons falling under this criterion will be exhaustive.



**Instead of affiliation, interest will be determined by the degree of control over the company, and an exhaustive list of controlling persons will be introduced into the law.**

The controlling person shall mean a person who:

- ▶ by virtue of direct or indirect participation, or any agreement (including a shareholders' agreement) is entitled, directly or through intermediaries, to exercise **more than 50% of votes** in the supreme management body of the company; or
- ▶ has the right to **appoint** the sole executive body; or
- ▶ has the right to **elect more than 50%** of the members of the collegial executive body.

It should be noted that transactions between legal entities or their corporate bodies within one group of persons will most likely continue to fall under the category of interested party transactions. Exceptions are made for transactions of **individuals with the second or third degree relatives**, which previously fell under the group criterion. Such contracts will not be recognized as interested party transactions.

#### 5. THE PROCEDURE FOR THE CONCLUSION OF INTERESTED PARTY TRANSACTIONS

The new provisions have reversed the former procedure for approval of interested party transactions. Instead of it, a **notice** of the transaction to the disinterested shareholders of a LLC, or the members of the Board of Directors, or collegial executive body, and, in some cases, the shareholders of a JSC, will suffice.

The notice shall be made **no later than 15 days prior to the date** of the transaction. At the annual General Meetings of Shareholders, the company shall submit a **report** on the interested party transactions entered into within the past year.



**Prior consent to the conclusion of interested party transactions is generally not required.**

**Prior consent** of the Board of Directors or the General Meeting of Shareholders of the company for the transaction is not required. However, it **may be required** by the General Director, a member of the collegial executive body or a shareholder owning shares (voting shares) of not less than 1% of the

total number of such shares.

If the transaction is made in the absence of prior consent, the member of the Board of Directors or the participants (shareholders) of the company are entitled to **demand that the company provide information** confirming that such a **transaction does not violate the interests of the company**.

It should be noted that the personal notice procedure will not be successful in all cases, because it cancels collective decision-making, which in some cases may be problematic. For example, that would be the case when the Board of Directors is formed out of persons with niche specialization in completely different areas of the company's business. The most optimal solution for such a situation is to provide for a mandatory initiation of prior approval of the transaction within the company.

## 6. CHALLENGING MAJOR TRANSACTIONS AND INTERESTED PARTY TRANSACTIONS

Interested party transactions and major transactions that the authorized body of the legal entity refused to authorize can be **invalidated** in court. The criteria of invalidity for both major and interested party transactions have changed significantly.

The main criterion for declaring a major transaction invalid is the **absence of subsequent approval (ratification)** of the transaction.

For interested party transactions, it is **the damage to the interests of the company** (presumed where the authorization of transaction or subsequent approval is absent or the information confirming that the transaction does not violate the company's interests was not provided).

To invalidate both major transactions and interested party transactions it will also be necessary to prove that the other party **knew or should have known** that the transaction in question was an interested party transaction or a major transaction for the company, and/or that the authorization of this transaction **was absent**.

Another development new for the Russian legislation is the shift of the burden of proof of the counterparty's bad faith to the plaintiff. Previously, contractors had to prove that they did not know that the transaction was a major or an interested party transaction for the other party. This resulted in numerous requests from contractors fearing the risks of invalidation of transactions to provide large volumes of internal information of the company. According to the idea of the authors of the reform, the new rules will allow to get rid of this kind of bureaucracy in executing transactions.

## 7. ARE THE AMENDMENTS MANDATORY FOR ALL COMPANIES?

The rules on **major transactions** currently provide for an opportunity to reject their application in the charter of a limited liability company, or to provide for other types or amounts of transactions, which will be subject to approval as major transactions. Starting from January 1, 2017 this option will be excluded from the law: limited liability companies will be required to follow the procedure for approval of major transactions and their criteria prescribed by the law.

As regards the rules on **interested party transactions**, which are now mandatory for all types of companies, from January 1, 2017 the relevant provisions will cease to be mandatory for limited liability companies and private joint stock companies: they will be able to reject the application of the rules on interested party transactions or provide for a procedure different from the one stipulated in the law, in their charters.



**Starting from January 1, 2017, non-public JSCs and LLCs will be able to reject the application of the provisions on interested party transactions, or to provide for another procedure for their conclusion/approval in their charters.**

In fact, the legislator has switched the dispositive and the imperative nature of the statutory provisions for major transactions and interested party transactions, making the former provisions imperative, and the latter – dispositive (except where they apply to public JSCs).

## **8. THE NEW PROVISIONS OF THE LAW OR THE CHARTER: WHAT SHALL APPLY FROM JANUARY 1, 2017?**

In general, the charters of most companies already contain provisions on the procedure for concluding major transactions and interested party transactions, and they often copy the current version of the JSC and LLC Laws. With the entry into effect of the amendments, these charters will no longer correspond to the provisions on interested party transactions and major transactions enshrined in the laws.

For public joint stock companies, statutory rules both on major transactions and interested party transactions will be mandatory. In this regard, it is recommended that public JSCs update their charters subject to the new version of the JSC Law.

For LLCs and non-public JSCs, the provisions on **interested party transactions** enshrined in their charters will continue to apply, as the regulation of these transactions will become dispositive. If necessary, these companies can revise the procedure prescribed by the charter and provide for a new one, or accept the one proposed by the legislator in the new version of the JSC and LLC Laws.



**It is advisable to check the company charters for compliance with the new legislation and, if necessary, to amend the rules on approval of transactions.**

Due to the fact that the new version of the law does not provide for possible derogation from the provisions on **major transactions**, starting from January 1, 2017, the existing provisions of the charters of LLCs on major transactions will apparently continue to apply only to the extent in which they conform to the legislation. The question will be resolved similarly as regards charters of JSCs, which contain the rules on major transactions similar to the current wording of the JSC Law. In this regard, it is expedient for LLCs and, in particular, non-public JSCs to revise their existing charter provisions on major transactions and, if necessary, to make appropriate changes.

In addition, when making transactions with counterparties from January 1, 2017, companies should note that the outdated provisions of their charters may contradict the imperative norms of the

legislation, which will create additional grounds for challenging the respective transactions.



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<sup>1</sup> See, e.g., Resolution of the Presidium of the Supreme Commercial Court of the Russian Federation No. 722/11 dated July 12, 2011, Resolution of the Presidium of the Supreme Commercial Court of the Russian Federation No. 9597/12 dated January 15, 2013, and p. 6 of Resolution of the Plenum of the Supreme Commercial Court of the Russian Federation No. 28 dated May 16, 2014 “On Certain Issues Related to Challenging Major Transactions and Interested Party Transactions”.

<sup>2</sup> The opinion expressed at the round table of the Research Centre for Private Law named after S.S. Alekseyev under the Russian President dated September 7, 2016.

<sup>3</sup> See Resolution of the Presidium of the Supreme Commercial Court of the Russian Federation dated March 22, 2012 in case No. 14613/11, Ruling of the Constitutional Court of the Russian Federation No. 1486-O-O dated November 2, 2011 “On the Complaint of Citizen Sattarov Shavkat Concerning a Violation of His Constitutional Rights by Paragraph 1 of Article 81 and Paragraph 1 of Article 84 of the Federal law “On Joint Stock Companies””.