



# Private Equity

Fund formation and transactions  
in 42 jurisdictions worldwide

# 2009

Contributing editor: Casey Cogut



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# Russia

## Anton Klyachin and Igor Kuznets

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### 1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction?

Although there have been appropriate reforms in corporate governance, there is still a lack of special regulation aimed at private equity transactions and investments generally. Effective laws regulating investments are outdated and practically of no use, and even the effective legal definition of a private equity transaction is far from the accepted standards. This makes it harder to implement deals that have complex structures, limiting the vast majority of investors to the simplest types of private equity transactions.

Considering this, the most widespread private equity transactions in Russia are acquisitions of controlling or blocking shares (or participation interests, depending on the company) to achieve control over the target company and secure its development, and direct asset acquisition, when the object of investment is not a company itself, but some of its valuable assets or real estate. Other types of equity transactions such as leveraged buyouts, management buyouts, etc, are also available and performed from time to time, for example, in October 2008 a major leveraged buyout of a company producing consumer goods took place; however, the number of such complex transactions is still insignificant, though it may increase in future.

### 2 Corporate governance rules

What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or become public companies?

Due to lack of special regulation, investors follow the same general corporate governance rules while making private equity transactions as all other business entities operating in Russia, with no special preferences for any type of private equity transactions. All advantages and disadvantages of each type of private equity transaction therefore arise from general legislation regulating companies, the stock market, competition, currency control, etc. Regarding the two main types of the said transactions that have become common in Russia, this means that the acquisition of shares, participatory interests and assets of Russian companies by a private investor is subject to the same governance as any other respective acquisition, and since the law grants foreign individuals and companies the same legal status as Russian ones, foreign private investors shall have almost the same rights as local private investors (excluding several limitations mentioned below). If referring to public companies, it is important to note that current Russian legislation does not formally divide public and private companies. In Russia a joint-stock company that has performed a public offer of shares is understood as a public company. Corporate governance of such public companies does not substan-

tially differ from the governance of private joint-stock companies whose shares are not publicly traded.

### 3 Issues facing public company boards

What are the issues facing boards of directors of public companies considering entering into a going-private or private equity transaction? What is the role of a special committee in such a transaction where management members of the board are participating in the transaction?

The management structure of Russian companies differs from Anglo-American standards. The role of the board of directors in a Russian public company is less important, while shareholders tend to control the company's activities. Thus boards of directors of public companies are not competent to make any important resolutions regarding going-private and private equity transactions; their role is to determine tactics of the company, provide the shareholders with certain recommendations (for example, if when the company receives a voluntary or mandatory offer of one of the shareholders to buy out all other shares) and make necessary disclosures connected with private equity transactions when required by the law. In several cases, individual members of the board may participate in transaction, although in these cases the law does not provide for the organisation of any special committee. Provisions regulating related party transactions, however, shall become applicable.

### 4 Disclosure issues

Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

Due to the order of the state Federal Service for Financial Markets (FSFM) related to the disclosure of information by public companies, a company becomes obliged to disclose certain information on its substantial facts and information that may significantly affect the price of company's issued securities. Such information includes, for example, any acquisition by one shareholder of 5, 10, 15 per cent and so on up to 75 per cent of shares of the company. Although there are no specific disclosure requirements connected with going-private transactions or other private equity transactions, the deal would most probably lead to necessary relevant disclosure, if it involves a listed company.

Another potentially necessary disclosure is to antimonopoly bodies, which is required if a transaction involving the purchase of shares or assets exceeds certain thresholds provided by antimonopoly bodies in normative acts regulating limitation of monopoly activities. In this case, the transacting parties shall, depending on the value of the deal and the assets of the parties involved, either inform the competent authorities of the deal, or apply for the permit to enter into the deal, and within the framework of such notification

or application the purchaser will have to disclose certain information regarding both the target company and itself.

#### 5 Timing considerations

What are the timing considerations for a going-private or other private equity transaction?

Russian legislation does not provide any limitations or requirements in respect of timing of a private equity transaction, so the parties are free to take as much time as they think satisfactory. As in other jurisdictions, the most time-consuming matters are adjustment of transfer conditions between the parties and complex due diligence of the target company or assets by the purchaser. Sometimes the companies involved in the transaction perform one or several corporate actions, approve the transaction, etc. If the transaction involves large companies, prior permission from antimonopoly bodies may be required, and this inevitably takes at least another one-and-a-half to two months. If the transaction involves the transfer of real estate located in Russia, or if participatory interest in a Russian LLC is purchased, it will be necessary to apply for state registration of the results of the transaction, which might also prove time consuming. Usually, therefore, private equity transactions take several months from the beginning to the moment of closing of the deal.

#### 6 Purchase agreements

What purchase agreement issues are specific to private equity transactions?

There are some important issues to be noted in respect of share or asset purchase agreements according to Russian law. Generally, this instrument has very limited use, since it is almost impossible to include in the agreement any conditions other than those related to sale and purchase. For example, representations and warranties as they are known in the common law are not accepted in Russia at all, and the courts would most likely acknowledge this part of agreement as void. This turns many investors to seek mechanisms allowing them to regulate the transaction under foreign law. Though it is theoretically possible to include some provisions regarding further financing in the purchase agreement, the parties to the private equity transaction usually have additional and detailed shareholders' agreements, often also regulated by foreign law. The purchase agreement shall basically contain provisions defining the subject matter of the agreement, price of the agreement (consideration), mutual rights and obligations of the parties (including completion mechanics) and an arbitration clause if the parties to the agreement wish to submit their disputes to arbitration.

#### 7 Participation of target company's management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues?

Classical management buyouts still are quite rare in Russia. They mostly take place when rather small companies are going private. However, the management of larger companies may still participate in going-private transactions in several ways, including bonuses, stock options and profit-sharing schemes. For example, a large Russian telecoms operator was purchased last year by a strategic investor jointly with the management of the company, which had received from the former sole shareholder an option to purchase the whole equity stock in the company. Such cases are not common, but do occur. Generally, practice shows that investors are interested in the preservation and motivation of competent management of a promising company; such motivation may include different means such as

stock options, including phantom stock options, or bonuses connected to certain times, achievement of financial results, etc.

#### 8 Tax issues

What are the basic tax issues involved in private equity transactions? Can share acquisitions be classified as asset acquisitions for tax purposes?

Since the modern Russian tax system is relatively young and immature, the parties to a private equity transaction may face some difficulties when implementing complex structures for the transaction, connected not only to present and future taxation, but also to historic tax risks of the target companies, which could have implemented tax schemes in order to avoid paying VAT, profit tax and payroll taxes. VAT and withholding tax issues often require complex solutions, often with the participation of local consultants and auditors.

Currently, there are not many options provided to the parties to private equity transactions, but at the same time the tax system is constantly developing and there have been recent attempts by the legislator to provide advantages to investors, for example recent exemptions for dividends on strategic investments. Applicable taxes and tax issues differ slightly depending on the type of deal (acquisition of shares or assets), and so the methods of tax optimisation and decreasing tax risks differ. In the case of a share transaction the parties may decide to bring the transaction to a foreign jurisdiction, often offshore. This may provide the possibility not only to enjoy the advantages of a shareholders' agreement governed in accordance with western legal principles, but also to decrease taxation connected directly with the transaction, primarily profit tax, and to further use Russia's network of double tax treaties. In the case of an asset deal, it is not possible to use an offshore deal structure, so the overall taxation shall be comparatively higher and include 18 per cent VAT, and 24 per cent profit tax for the seller. However, sometimes, to escape historic tax risks of the old company, the asset deal may be preferable.

All money income received by executives is subject to individual income tax, which is currently at a flat rate of 13 per cent.

Generally, since the wording of the Russian Tax Code is often vague, which enables the tax bodies to impose sometimes doubtful claims, the Tax Code itself is constantly changing, and target companies in Russia, especially those with a long history, shall most likely have significant tax risks, it is strongly recommended to perform a detailed tax analysis in respect of each private equity transaction.

#### 9 Existing indebtedness

What issues are raised by existing indebtedness at a potential target of a private equity transaction? How are these issues resolved?

Existing indebtedness of a target company generally does not restrict or limit the possibility of a private equity transaction involving its shares or assets. However, it is something that the parties to the transaction must be aware of. Existing indebtedness is usually handled in two ways, depending on its nature. Third-party debts (commercial indebtedness to suppliers and financial indebtedness to banks and other lenders) usually stays after a private equity transaction until repaid by the target company, being considered as a part of the enterprise value of target company. In the case of indebtedness to selling shareholders, such debt, usually upon agreement of the parties to the transaction, shall be assigned by the old shareholder to a new one or otherwise redeemed before the completion of the transaction.

**10 Debt financing structures**

What types of debt are used to finance going-private or private equity transactions? Do margin loan restrictions affect the debt financing structure of these transactions?

Russian legislation recognises only two types of debt – credits provided by banking institutions and loans provided by any company or other entity. There may, therefore, be separate debt financing using banking credits and debt financing using loans, although both types would have very similar consequences for the target company. The concept of margin loan is not known in Russian law as a separate type of debt; therefore, no specific restrictions are applicable to such arrangements.

**11 Debt and equity financing provisions**

What provisions relating to debt and equity financing are typically found in a going-private transaction? What other documents set out the expected financing?

A typical private equity transaction in Russia combines debt and equity financing, where debt usually precedes equity. Debt financing is usually provided through loan or credit agreements. Equity financing is possible through the initial subscription of the investor for the issued shares of the target company, and also through the purchase of shares from the other shareholder. If the target company is a Russian-based LLC, the law also provides its shareholder with a possibility to invest funds directly into the company's assets without further compensation, which sometimes proves to be a rather useful financial instrument. A new possibility in 2009 is a convertible debt arrangement, which can now be structured through the creation of a pledge over shares or participatory interests, which is converted directly into the equity at some point in time; such structure was not available before.

**12 Fraudulent conveyance issues**

Do private equity transactions involving leverage raise 'fraudulent conveyance' issues? How are these issues typically handled in a going-private transaction?

Apart from the bankruptcy context, the concept of 'fraudulent conveyance' is not recognised by Russian law. However, to protect the company and its creditors throughout the private equity transaction, especially connected with the change of shareholders in the target company, the parties usually perform actions aimed to increase control over the target company's activities throughout the deal. This may include limitation of powers of executive bodies to the lowest level possible and economically reasonable scope and close control over the company's operations and bank accounts.

**13 Shareholders' agreements**

What are the key provisions in shareholders' agreements covering minority investments or investments made by two or more private equity firms?

One of the most noticeable problems that private equity firms may face in Russia is the current practical unavailability of shareholders' agreements regulated by Russian law. In some recent cases, parties to the transactions tried to prepare and execute such agreements based on the concept of freedom of agreement provided by Russian civil legislation; however as court practice shows the court system is not ready to accept and protect such agreements. The necessity of legal regulation of shareholders' agreements has been evident for a long time and noticed by many domestic lawyers, but a law that will govern all the basic aspects of shareholders' agreements has not yet been

enacted and at the moment exists as a bill. Currently, the parties to a private equity transaction, even if both parties are Russian, in most cases are forced to bring the deal outside Russian borders by using special purpose vehicles, usually offshore ones, in order to be able to execute a comprehensive and effective shareholders' agreement providing all the obligations of parties in respect of further financing and operation of the target company, as well as mutual representations and warranties, and to submit this agreement to the foreign law, usually one of the common law systems. This reason, combined with tax optimisation considerations, are the main reasons leading to a major part of private equity transactions targeted at Russian companies being concluded abroad. Therefore, to structure the deal and to execute a valid shareholders' agreement, the parties often engage foreign advisers specialised in such matters, and it usually means that the key provisions of shareholders' agreements intended to operate a target company in Russia are in all essential aspects the same as in shareholders' agreements usually concluded all over the world.

However, recent changes to the law regulating limited liability companies, effective from 1 July 2009 provide for the right of LLC participants to enter into participants' agreements, which may, among other things, regulate voting issues, pre-emption and first refusal rights and other matters of cooperation among the participants. At the same time, there is still no analogous regulation for joint-stock companies.

**14 Limitations on transaction size**

Do private equity firms have limitations on the size of transactions they may engage in?

Russian law does not limit the size of transactions of private equity firms. However, depending on the size, certain obligations may arise for such companies, related to antimonopoly and similar provisions. These obligations may include disclosure of certain information in respect of the transaction, receiving of permission of antimonopoly bodies to effect a transaction (which cannot be withheld unless the transaction violates antimonopoly regulations and limits competition). In the case of Russian-based mutual investment funds and incorporated investment funds, there are limitations on the maximum part of assets that may be invested in instruments issued by the same issuer and similar limitations, but they refer to proportions of assets of the said funds and not directly to the size of the transactions they may engage in.

**15 Exit strategies and investment horizons**

How do the exit strategies and investment horizons of private equity firms affect the structuring and negotiation of leveraged buyout transactions?

As noted above, leveraged buyout transactions are not common in Russian investment practice. At this time there have been solitary examples of leveraged buyout transactions and it is impossible to estimate the influence of the exit strategies and investment horizons of private equity firms on the structuring of leveraged buyout transactions. As for exit strategies of investors operating in Russia in general, the main strategy in the past and in the foreseeable future is a sale to a strategic investor or to the state (including state banks or state-owned companies). IPOs were not common practice until 2007/2008, and considering the present condition of the stock market, we assume that almost no IPOs of Russian companies shall take place in 2009.

### Update and trends

In Russia, the beginning of the financial crisis coincided with the start of a large state programme of support for private equity and the venture capital sectors. Many investors have received leverage from state corporations and funds of funds to apply to venture set-ups, nanotechnology businesses and other companies. At the end of 2008 and in the beginning of 2009, these funds are basically the only active investors out there. The state has developed a substantial body of new legislation on the matter, which relates mainly to the process of getting access to state funds. We expect this legislative body to be further refined and expanded by inclusion of norms regulating state

control over the investments, etc.

Russian corporate law is also undergoing substantial changes aimed at providing more flexibility to private companies' governance rules, which potentially should attract investors and decrease their willingness to use foreign law for transactions. We do not expect, however, a quick shift to Russian law-governed documentation among investors, since the law should be first tested in the courts. Considering the general conservativeness of the Russian court system, we believe English law will for the time being remain dominant on the Russian private equity scene.

### 16 Principal accounting considerations

What are some of the principal accounting considerations for private equity transactions?

The principal consideration is to be very cautious when dealing with accounting information. IFRS is not widespread in Russian companies and official financial statements shall be provided in the form set by Russian accounting standards. This is the reason why, sometimes, it is hard for an investor, especially a foreign one, to receive accurate information on the financial condition of the target company. There may be two solutions to this problem, complementing each other. The first is to demand accounting information composed in accordance with IFRS from the target company or seller. This may take additional time and delay the transaction, but it is, in our view, a fair exchange for accurate and proper information. The second way is to engage experienced local advisers who can estimate the accuracy of the provided information and possible financial risks.

### 17 Target companies and industries

What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in focus in recent years?

Traditionally, the scope of investment activities in Russia was more or less limited to real estate, retail and production of consumer goods as the most profitable spheres. Recently, other spheres such as IT and telecommunications have also begun to provide vast opportunities for investors operating in Russia, while retail, real estate and consumer goods have kept their role as the leading investment areas. However, in recent months the focus has significantly changed. The debt-ridden real estate and retail businesses are out of favour. Investors are looking mostly for infrastructure projects, the high-tech

sector and high-margin natural resources companies, such as those providing timber, oil and gas, precious metals and stones or even peat. Some sections of the real estate market still attract investors, such as the hotel business.

### 18 Industry-specific regulatory schemes

Do industry-specific regulatory schemes limit the potential targets of private equity firms?

In accordance with the Federal Law of the Russian Federation 'On order of investments in business companies having strategic importance for country defence and state safety', the participation of foreign investors (and investment groups that include foreign entities) in companies acting in several spheres of industry is limited. Among these areas are aviation equipment development and production and TV and radio broadcasting. Participation of a foreign investor in a company with a dominant position on the market and included in a special register of dominant companies is also limited. The Land Code of the Russian Federation provides limitations on foreign entities' ownership of agricultural land. As for other sectors and companies, there are no legal limitations on the participation of foreign private investors.

### 19 Cross-border transactions

What are the issues unique to structuring and financing a cross-border going-private or private equity transaction?

As noted above, due to lack of regulation and the cautious position of the Russian courts in respect to shareholders' agreements, in practice most significant private equity transactions are indeed cross-border. This fact, in combination with the absence of special regulation of



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private equity transactions, causes the parties to combine within the framework of the single transaction the laws of several jurisdictions, including general rules and more specific rules covering activities of the parties to the transaction and the target company. All issues related to international treaties, double taxation and dispute resolution shall be closely examined and coordinated by the parties. A positive aspect is that, unlike in the past, currency control has become unnecessary due to general liberalisation of the currency legislation, so currency control shall not notably affect private equity transactions.

#### 20 Club and group deals

What are the special considerations when more than one private equity firm (or one or more private equity firms and a strategic partner) is participating in a club or group deal?

Since Russian law does not provide special regulation for private equity transaction as a concept, it does not provide any special considerations related to club or group deals. Such deals are treated like all other private equity transactions. Since in this case the agreement between shareholders is inevitable, such transactions shall most likely involve foreign law with all subsequent issues arising on account of the cross-border nature of such transactions.

#### 21 Recent credit market disruptions

How have disruptions in the credit markets affected dealmaking?

What specific changes to transaction terms have you seen and do you expect in the future?

Due to recent drastic disruptions, private investors have become very prudent in respect of new investment projects and transactions and their primary concern is not to lose large sums. Current deal making is concentrated in two main directions – investment of monies provided by the state through venture, nanotech and other funds; and investments in distressed assets where the price is sometimes much lower than the asset value. The second direction may turn out to be profitable in the long term; however, investments in distressed assets have significant risks and make demands of the investor and its team; precise and elaborate steps are necessary to keep the assets from dilution and to convince creditors not to initiate insolvency procedures for a substantial time. Therefore, the current trend in the market can be characterised as the ‘rule of creditor’.

