

VERBA / LEGAL

# Reform of Corporate Contracts

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The Ministry of Economic Development of the Russian Federation has prepared several draft laws aimed at further development of legislative regulation of the institution of corporate contracts in Russia:

- Draft Federal Law “On Amendments to Part One of the Civil Code of the Russian Federation” (Draft ID: 122129);
- Draft Federal Law “On Amendments to Article 32.1 of the Federal Law “On Joint-Stock Companies” and the Federal Law “On Limited Liability Companies” (Draft ID: 122141).

## Current Regulation of Corporate Contract Institution in Russia

Currently, Russian legislation has the following system of regulation of the corporate contract institution:

- Article 67.2 of the Civil Code of the Russian Federation (‘CC RF’) sets forth general provisions on the corporate contract applicable to corporate contracts both in relation to joint-stock companies and limited liability companies. Nevertheless, Article 67.2 of the CC RF stipulates that the concept of corporate contract is generic, which includes both a shareholder agreement (applicable to joint-stock companies) and a participation agreement (applicable to limited liability companies);
- shareholder agreements have additional regulation, which is separately described in Article 32.1 of Federal Law No 208-FZ of 26 December 1995 “On Joint-Stock Companies” (‘JSC Law’);
- Participation agreements, unlike shareholder agreements, do not have similar regulation and are only partially mentioned in Federal Law No 14-FZ of 8 February 1998 “On Limited Liability Companies” (‘LLC Law’) (for example, in Article 8 of the LLC Law).

## Objectives of Reform of Corporate Contracts

The proposed laws are drafted to:

- unify the legal regulation of shareholder agreements and participation agreements;
- legislatively regulate individual corporate procedures included in corporate contracts (for example, provisions on drag-along rights and tag-along rights);
- clarify provisions on penalty abatement under corporate contracts;
- enable 'will substitution decisions' of court if one of the parties to a corporate contract violates its voting obligations.

## Unification of Legal Regulation of Shareholder Agreements and Participation Agreements

In order to unify the legal regulation of corporate contracts in respect to different business entities, it is proposed to introduce a new article into the LLC Law – Article 8.1, whose structure and contents are similar to those of Article 32.1 of the JSC Law.

The introduction of this article into the LLC Law will lead to each law on business entities (i.e. LLC Law and JSC Law) containing special rules for regulating corporate contracts in respect to such business entities, and the CC RF containing general provisions applicable to all corporate contracts.

## Inclusion of Option or Option Agreement in Corporate Contract

The draft law stipulates that a corporate contract may contain elements of:

- an option agreement on alienation/acquisition of shares/interests; or
- an option / an option provision agreement to conclude an agreement on alienation/acquisition of shares/interests.

However, the proposed amendments are not some kind of innovation, since the inclusion of elements of various other agreements (including options / option agreements) in a corporate contract is widespread in practice and is based on the freedom-of-contract doctrine.

In addition, the draft law provides that:

- the fact of occurrence of conditions (entailing occurrence of certain rights under options / option agreements) may be confirmed by a third person;
- the terms of the corporate contract may provide for the procedure for confirming the occurrence of such conditions.

These provisions have already been widely used in practice and included in various options. Option exercisability often depends on the company's financial performance (EDITDA, etc.). In this case, to confirm the fact of the company's achievement or non-achievement of certain financial indicators, the parties shall nominate appraisers, whose appraisal reports must confirm the fact of the company's achievement or non-achievement of such indicators.



## Tag-Along and Drag-Along

The draft law provides for the possibility of structuring the tag-along right and the drag-along right in a corporate contract.

### Tag-Along Right

The tag-along right is usually provided to minority shareholders (for example, investors), and is one of the ways to protect the rights of minority shareholders from an unauthorized change of control in the company. In addition, the tag-along right enables the minority shareholder to receive a proportionate part of the premium for control, as well as to enjoy liquidation preference.

The draft law proposes the following model for structuring the tag-along right:

- Shareholders enter into a put option (based on the option agreement or put option model), which stipulates that, if one shareholder (transferor) transfers its shares/interests to a third person (transferee), the other shareholder (the one joining the transfer) has the right to demand that the transferor purchase the shares/interests held by the joining shareholder.
- The transferor either:
  - purchases the shares/interests from the person joining the transfer under a put option and then resells such shares/interests to the transferee; or
  - assigns to the transferee the rights to receive shares/interests arising from the transfer agreement in respect of such shares/interests, which was concluded as a result of the exercise of the put option.

## Tag-Along and Drag-Along

### Drag-Along Right

The drag-along right is generally provided so that a party to a corporate contract (usually majority shareholders or founders) who has found a strategic investor willing to purchase the company at a high price could ensure that all 100% of the shares/interests of the company are sold (i.e. eliminate the risk of refusal of one or more minority shareholders to sell their shares/interests, which will lead to disruption of the company sale to a strategic investor).

**The draft law proposes the following model for structuring the drag-along right:**

- Shareholders enter into a call option (based on the option agreement or put option model), whereunder the transferor has the right to demand that the person forced to join in sell its shares/interests.
- The transferor either:
  - purchases the shares/interests from the person forced to join in under a call option and then resells such shares/interests to the transferee; or
  - assigns the rights under a call option to the transferee; or
  - assigns to the transferee the rights to receive shares/interests arising from the transfer agreement in respect of such shares/interests, which was concluded as a result of the exercise of the call option.

## Tag-Along and Drag-Along

### Consequences of Non-Compliance with Tag-Along and Drag-Along

The current legislative regulation does not directly provide for the consequences of a breach by any party to a corporate contract of its obligations to further resell or assign as part of exercising the drag-along right or tag-along right.

Therefore, it is fundamentally important that the draft law proposes to establish special consequences for failure to comply with the procedures described above:

- if the transferor has not notified the other party to the corporate contract of its intention to sell shares/interests or has not notified the transferee of the right of other shareholders to join in the sale, then the transferee has the right to unilaterally terminate the agreement on transfer of shares/ interests concluded with the transferor;
- if the transferor violates its obligations to further resell or assign the rights as described above, then the other party to the corporate contract has the right to 'disrupt' the entire deal, i.e.:
  - to demand that the shares (interests) transferred by it are returned; and
  - to invalidate the transfer agreement between the transferor and the transferee.

Such regulation will substantially eliminate the risks of the unenforceability of one's rights if any party to the corporate contract violates its obligations under the corporate contract.

## Disclosure of Corporate Contract

The draft law establishes the confidentiality of the terms and conditions contained in a corporate contract. The parties to a corporate contract may agree upon a non-disclosure clause.

This provision is not new as well, since in practice the parties to a corporate contract have included confidentiality provisions therein. However, if these draft laws are adopted, the issue will be legislatively prescribed.

## Penalty Abatement under Corporate Contract

Draft laws prepared by the Ministry of Economic Development of the Russian Federation provide for special regulation of the issue of penalty abatement under a corporate contract.

The obligations of the parties to a corporate contract (both 'negative obligations', i.e. obligations not to do something, and 'positive obligations', e.g. obligations to vote) are often secured by penalties with significant fines.

In such a case, the obligations are secured by the fact that the party obligated under a corporate contract refrains from violating its obligations under the threat of incurring significant property losses. However, such penalties are often the only effective remedy of shareholders.

Meanwhile, the Russian legal order demonstrates a generally negative attitude towards excessive penalties, which leads to a default risk for the parties to a corporate contract, and liability for such default will be significantly limited by the court, which makes the institution of penalties no longer disciplinary in relations between the parties to a corporate contract.



To solve this problem, the following amendments to the legislation are proposed:

- to include a general rule in the CC RF stipulating that the specifics of penalty abatement under a corporate contract are established by laws on business entities;
- to establish a prohibition on penalty abatement as a general rule in the JSC Law and the LLC Law, as well as a special procedure for proving the need to abate the penalty.

It would be necessary to prove that:

- the collection of a penalty in the amount stipulated by the corporate contract may result in a greater benefit for the other party than it could have received if the party to the corporate contract requesting penalty abatement had not violated the corporate contract;
- the violation of the corporate contract occurred through no fault of the party requesting penalty abatement (if the party to the corporate contract requesting penalty abatement is a business entity).

## Challenging of Resolutions of General Meetings Adopted in Violation of Corporate Contract not all Company Members are Parties to

A key problem with the institution of corporate contracts is the enforcement of members' rights if other parties to the corporate contract violate their voting obligations (as stipulated in the corporate contract).

Currently, resolutions of the company's management bodies can be challenged due to a violation of the corporate contract only if, at the time of the resolution, all company members are parties to the corporate contract.

Furthermore, it is proposed to grant the right to challenge resolutions of the general meeting adopted in violation of the corporate contract not all members of the company are parties to, subject to the following conditions:

- such possibility shall be provided for by the company's charter;
- all members of the company knew or should have known about the content of the corporate contract prior to the adoption of the resolution of the general meeting, specifically due to the fact that information about the content of such contract was disclosed or otherwise brought to the attention of such members;
- the violation of the corporate contract affected the quorum or the number of votes required to adopt the challenged resolution.

## Will Substitution Decisions' of Court

Russian law does not recognise 'will substitution decisions' at the moment. This means that if one of the parties to a corporate contract violates its obligations to exercise its right to vote in a certain way, the other parties cannot apply to the court to recognise the resolution adopted. In order to protect their rights, the parties usually provide for various penalty options, penalties, etc. for default of voting obligations.

The proposed law sets forth that the default of a party to a corporate contract to exercise its right to vote in a certain way may be grounds for an arbitration court to:

- invalidate the vote of such party: in this case, the resolution of the general meeting may be deemed void if the above conditions are met; or
- recognise that such party has voted in a certain way in accordance with the corporate contract (if all members of the company are parties to the corporate contract): in this case, the resolution of the general meeting adopted basing on the results of the previous vote is deemed void with the simultaneous recognition of the resolution of the general meeting as adopted or not adopted basing on the amended voting results from the moment the decision of the arbitration court comes into force.

The claim may be filed no later than three (3) months (for JSC) or two (2) months (for LLC) from the date of drawing up the minutes of the general meeting.

In these circumstances, the parties to the corporate contract have the right to request from the company information about the voting of the other party to make sure that the terms of the corporate contract are complied with. Such information shall be provided within seven (7) business days from the date of receipt of the request.

## Retroactive Law

The amendments are expected to also apply to corporate contracts concluded before the effective date of the proposed laws.



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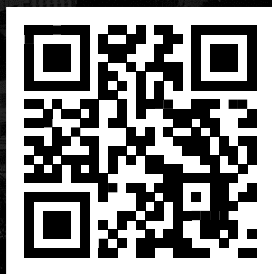


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