

## **RF Constitutional Court Declares Previous Practice of Share Consolidation and Redemption Constitutional, but Opens the Door for Possible Procedural Challenges**

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Previously it had been a relatively common practice in Russia for majority shareholders of joint stock companies to squeeze out minority shareholders through a consolidation of shares which would create fractional shares which were then subject to mandatory redemption by the company. Pursuant to the amendments to the Law "On Joint Stock Companies" (as so amended, the "Amended JSC Law") adopted on August 7, 2001, the ability to squeeze out minority shareholders through the creation of fractional shares was eliminated. The Amended JSC Law provides that while a joint stock company can consolidate stock and create fractional shares through a consolidation, these fractional shares are not subject to mandatory redemption by the company. Shareholders may hold and vote the fractional shares that have arisen as a result of the consolidation. Even prior to the Amended JSC Law, shareholders holding fractional shares as a result of a consolidation sought to challenge the provisions of the JSC Law with respect to the consolidation and redemption of such shares as unconstitutional.

In its ruling on February 24, 2004, the RF Constitutional Court (the "Court") eliminated all doubts with respect to the constitutionality of joint stock companies consolidating shares and subsequently forcing the redemption of the resulting fractional shares; there is now no question that this practice was constitutional prior to the Amended JSC Law, and that the practice in and of itself did not violate shareholder rights. Although the Court acknowledged the constitutionality of this former practice, the Court opened the door for former minority shareholders to challenge a consolidation and forced redemption of shares if any aspect of the transaction was carried out in violation of otherwise applicable law.

The Court stated that in carrying out a consolidation of shares, a company is required to respect the rights and interests of minority shareholders and protect the welfare of the joint stock company as a whole, rather than focus merely on the interests of the majority shareholder(s). The Court further stated that, based on principles of equity, the procedures governing a redemption of shares at the shareholders' initiative should govern a redemption of fractional shares created by a consolidation, i.e. a redemption of shares at the initiative of a joint stock company.

The Court indicated that a joint stock company is obligated to prepare a list of all shareholders potentially affected by a consolidation of shares and to provide those shareholders full information with respect to the market price of the shares to be consolidated and the conversion ratio. In addition, the company is required to provide all potentially affected shareholders with a decision by the board of directors whereby a consolidation of shares is put to a vote at the general shareholders' meeting. The Court noted that, although the owner of a fractional share in the past could no longer be considered a shareholder after a consolidation of shares and the State registration of the share issuance with a new par value, the owner could still seek court protection of its property rights and challenge the decision of the general shareholders' meeting, as well as the legality of the procedures used by a joint stock company during the consolidation and redemption, so long as the right is exercised within the applicable statute of limitations. The Court further stated that a decision of a general shareholders' meeting to consolidate shares results in a redistribution of property among shareholders through a forced seizure of shares, which is effectively a deprivation of property. Since the Russian Constitution does not permit

an individual to be deprived of property without a court judgment, the legality of a consolidation could be adjudicated by a court if challenged by a shareholder.

While the Court eliminated one potential source of litigation, i.e. former shareholders challenging as unconstitutional the redemption of fractional shares created by a share consolidation prior to the Amended JSC Law, the Court nonetheless left open the door for plaintiff-former shareholders to challenge the procedures used in such consolidations and redemptions.

In addition, the Court ruling increased the risk that other types of conversion which are currently used for eliminating minority shareholders may also be challenged in court, since the procedures used in these other forms of conversion are not specified by the law and are thus untested.

Overall, the Court recognized that that it is the nature of business that a company's majority share-

holders, minority shareholders, creditors, and others may have conflicting interests.

The Court acknowledged that the exercise of rights granted to any one of the above interested parties must be balanced in relation to the other parties involved. In particular, the need to protect the property rights of minority shareholders must be balanced against the ability of companies and majority shareholders to undertake corporate reorganizations.

Such a balance must be achieved by following lawful procedures, through judicial review, and through fair compensation for minority shareholders. The Court also seems to establish a certain boundary of judicial review of corporate actions somewhat similar to the business judgment rule. The decision states that courts should ensure the protection of shareholders' rights, and not rule as to whether corporate actions made by the board of directors or the general meeting of shareholders are economically sound. □