corporate law practice

Control through compulsory sale of shares

Compulsory sale of shares, or in other words, squeeze-out, is the right of a shareholder owning almost all of the company's shares (majority shareholder) to oblige the remaining shareholders (minority shareholders) to sell their shares for a fair price.

The concept of compulsory sale is not unique. Relevant provisions can be found in the legislation of such countries as the United States, Germany, United Kingdom, which differ just in figures and procedure specifics. In Russia, compulsory sale appeared in 2006.

Rules applied in Russia

Compulsory sale may be initiated solely by joint-stock companies. Although joint-stock companies and limited liability companies are broadly similar, the shares of members of the latter may not be bought out in such a way.

The key value for majority shareholders is 95 % plus; this is the stake a shareholder (together with its affiliates) must consolidate in order to buy out the remaining shares from minority shareholders. However, there are additional conditions for initiating the procedure, including, *inter alia*, the following:

- ✓ The company must be publicly held, the special aspects with regard to recognizing this status in practice will be considered below,
- ✓ At least 10 % of the company's shares owned by the majority shareholder must be acquired thereby as a result of either voluntary or mandatory offer, i.e. in the event when minority shareholders have already started withdrawing from the company's capital and selling their shares.

It should be borne in mind that minority shareholders are entitled to request that their shares be bought, if the majority shareholder has already become the owner of more than 95 % as a result of either voluntary or mandatory offer.

Purpose of squeeze-out

Squeeze-outs are often initiated for one particular purpose – centralization of control over the company. For example, such need often arises in companies established as a result of privatization of the 1990s. At

that time, many state-owned enterprises were transformed into companies whose shareholders were the employees of such enterprises. Then their small stakes were concentrated in the hands of one or more majority shareholders for the purpose of obtaining control over the company itself and, most importantly, over its property: equipment, immovables, and other valuable assets. However, 100 % consolidation of shares was rarely achieved, since the majority shareholders were satisfied with their dominant participation in the capital. Even today such companies may still have thousands of minority shareholders.

Naturally, the existence of minority shareholders, especially in large quantities, poses a number of risks associated with possible hostile actions on the part of both the minority shareholders and those who can buy their stakes at any time. It is necessary to point out the difficulties in conducting corporate procedures: minority shareholders shall be notified about each general meeting of shareholders, and such meetings should be organized in such a way so as to take into account possible participation of a large number of people whose votes produce actually no effect and are not required for proper operation of the company.

There are also other cases when compulsory sale of shares is aimed at solving existing problems. For example, in case of a corporate conflict, it is sometimes required to "squeeze out" a hostile shareholder from the company so that he/she/it does not interfere with normal conduct of business through unscrupulous actions.

First and foremost, when planning a compulsory sale procedure, one needs to pay attention to the status of the company and the current size of the stake owned by the majority shareholder.

Company's status

As mentioned above, a compulsory sale procedure may only be initiated by publicly held companies. It should be noted that in fact the question whether to consider any company a publicly held company could be answered differently, especially with regard to companies established under privatization process.

Legally[1], a publicly held company is a joint-stock company whose shares (or securities that may be converted into shares) are placed through public offering or are publicly traded on the market (for example, stock exchange). This provision is also cited by the Bank of Russia (Central Bank) when evaluating the attributes of a company's public dimension – such opinion was expressed by the Central Bank in its official letter[2].

Speaking of the companies established in the course of privatization, one may notice that the Central Bank often recognizes such companies as publicly held relying on the fact that in the process of privatization their shares were offered to the general public. Obviously, in this case, the owners may have difficulties in

changing the status for a non-public company, which, consequently, poses a question as to compliance with the requirements of the law governing the disclosure of information by publicly held companies (sometimes such information is not disclosed at all, which constitutes a violation of the law), as well as other questions related to the public status and relevant particular features of such companies. On the contrary, in terms of compulsory sale, such situation is convenient for the majority shareholders of privatized companies, since in many cases it provides an opportunity for conducting compulsory sale procedure and gaining entire control over the assets. Thereafter, one can initiate the change of the company's status or, for example, carry out reorganization.

Size of majority shareholder's stake

Before initiating buyout procedures, we may often observe two main trends concerning the stake of the majority shareholder:

- ✓ In the first instance, the majority shareholder holds less than 95 % of shares, and needs to somehow increase his/her/its stake prior to compulsory sale,
- ✓ In the second instance, the problem of achieving 95 % has been already solved, but the requirement of acquiring 10 % of shares under voluntary or mandatory offer is not met.

In each case, the decision depends on a combination of factors, but, generally, we can see that the problem of increasing the stake may often be solved either by buying up shares, or through additional issue.

The problem of the manner of purchasing 10 % of shares can be solved either naturally – when in the course of voluntary or mandatory offer the number of shares bought from minority shareholders amounts to the required 10 % or more, or artificially – in the course of either voluntary or mandatory offer controlled by the majority shareholder, when the procedures conducted are aimed at formal observance of legal requirements.

Litigation risks

The proper procedure of compulsory sale helps minimize the risks of litigation initiated by state authorities, but there are still risks relating to litigations on the ground of minority shareholders' claims. There are two common reasons for dissatisfaction of minority shareholders:

- ✓ Minority shareholders deem the buyout procedure itself to be unfair or illegal,
- ✓ Minority shareholders realize that the buyout procedure is completely legal, but are unhappy with the price of their shares.

With regard to fairness and validity, it stands to mention that since the appearance of compulsory sale procedure in Russia there have been repeated (however unsuccessful) attempts to prove that the procedure is unconstitutional. The Constitutional Court of the Russian Federation, which deals with such cases, has repeatedly claimed[3] that the procedure of compulsory sale complies with the Constitution, and is intended to ensure a balance between the interests of majority shareholders, who actually determine a company's development strategy, and those of minority shareholders whose property rights are affected by such buyouts. Mindful that the compulsory sale is expressly provided by law, and its legitimacy is confirmed by the contemplation of the Constitutional Court, the litigation risks in terms of the fairness and validity of buyouts can be considered null.

More importantly, we may observe a great number of litigations initiated as a result of minority share underpricing. The outcome of such litigations largely depends on the observance of the legislation governing the valuation activities, the quality of evaluation itself and the report drafted on the basis thereof. Thus, in order to minimize litigation risks, it is recommended to carry out this part of compulsory sale procedure with due care.

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[1] Article 66.3 of the Civil Code of the Russian Federation.

[2] Letter of the Bank of Russia dated 25.11.2015 No. 06-52/10054.

[3] Decisions of the Constitutional Court of the Russian Federation No. 681-O-P, 713-O-P, 714-O-P dated 03.07.2007, No. 334-O-O dated 23.03.2010.