For the purposes of further analysis recipients of direct investments can be divided into two large groups. First - mature companies in need of additional investment for their future growth (Growth Capital). The second - young companies that, as a rule, do not generate cash flows working in high technology areas (Venture Capital). Legal issues of their work have both general and specific questions for each group.

Common problem of Private Equity: shareholder agreements

The institute of shareholder agreements works effectively in case of its subjection to the English law (national legal systems, which have adapted the principles of relations regulation similarly to the English law). Unfortunately, the short-term experience of applying shareholder agreement rules (agreements of participants) fixed in the Russian law on joint stock companies and limited liability companies indicate very narrow possibilities of using this institute which is new for the Russian law.

The ineffectiveness of the Russian shareholder agreement is due to the fact that the Russian legislation when introducing the concept of shareholder agreement failed to ensure its effectiveness by reforming some of the legal institutions that are used in the mechanism of the shareholder agreement, in other words, in order to make a shareholder agreement work in the Russian law it is not enough just to name such an agreement in law, complex reform of the civil law is needed. What are the very legal problems?

First, you can not effectively put in place the financial responsibility for the violation of the agreement’s provisions while the right to reduce the size of a contractual penalty by court discretion is enshrined in the art. 333 of the Civil Code of the Russian Federation. Despite the fact that § 7 of Art. 32.1 of the law on joint stock companies introduced a new kind of liability for breach of obligations under the shareholder agreement in a form of compensation (which is a fixed monetary amount or amount determined in the manner specified in the shareholder agreement), the absence of a clear distinction of penalty terms enshrined in the law (according to § 1 of Art. 330 of the Civil Code, it’s an amount of money which the debtor must pay the lender in case of nonperformance or improper performance of obligations) and compensation, as well as the complete absence of any relevant judicial practice with regard to this institution do not allow its use in structuring shareholder agreements.

Secondly, it is impossible to be sure that many standard mechanisms of shareholder agreement providing the obligation of the party of the agreement to sell the shares (share) upon the occurrence of some circumstances described in the agreement (e.g. tag alone, drag alone, dead-locks provisions, including Russian roulette, options etc.) will be workable, while exists the art. 157 of the Civil Code “Conditional deals”, for application of which the absence of subjective influence on the circumstances is needed, which – on its turn - is the trigger for the application of these essential tools of shareholder agreement. Opportunities of inclusion in the shareholder agreement of the parties obligation to sell (buy) shares at a fixed price in certain circumstances (similar in para 3 of Art. 8 of the Federal Law of 08.02.1998 No. 14-FZ “On Limited Liability Companies”) while stating the importance of this tool, unfortunately does not solve the problem of its operation, since the former requires revision of the provisions of the Civil Code on conditional deals.

In this context, it is still necessary using the English shareholder agreement for structuring main commitments of the parties of the deal. This in turn implies the need to incorporate a legal entity that is subject to regulation of the shareholder agreement (target) outside of Russia.

As mentioned above, in order to make the Russian institute of shareholder agreement become effective revision of the Russian Civil Code is required.

It is encouraging that in terms of difficult mediation procedures among the Ministry of Justice of the Russian Federation, Council of the President of the Russian Federation on codification, Ministry of Economic Development of the Russian Federation and Working Group for Establishment an International Financial Center in the Russian Federation under the Council of the President of the Russian Federation for Development of Financial Markets a draft of new version of the First Part of the Civil Code containing improved regulation of these institutions has been agreed.

With regard to the penalty the art. 333 of the Civil Code will be supplemented by the following rule: “The reduction of contractual penalties payable by an entrepreneur is permitted in exceptional cases when it is proved that the collection of penalties in the amount specified in the contract may result in unreasonable benefit for the creditor.” The significance of this nouvelle will be that in contrast to the compensatory nature of the penalty worked out by court practice the possibility of its subjection to the English law (national legal systems, which have adapted the principles of relations regulation similarly to the English law).
of obtaining the benefit from its collection is provided by law.

With regard to conditional deals the draft of the Civil Code provides the introduction of a new type of contract - the option contract (Article 429.2) - providing the unconditional right of the option's party to enter a contract on terms set by this option; the clause on option may be included in another contract. Thus, without changing the concept of regulation of conditional deals, the new edition of the Civil Code would create the opportunity to execute the concerned task of the shareholder-agreement through the use of alternative type of commitment.

Despite the fact that this edition of the Code has not been considered by the State Duma, the consensus on the content of the document achieved among government agencies involved gives the hope that it can become the law before the end of this year.

**Specific problems of Venture Capital**

It seems that generally the legal conditions of Growth Capital companies in the Russian Federation have been created and correspond to the international practice (e.g. mutual fund industry, institute of qualified investors, IPO tools and so on.)

However, the described conditions of investment and exit for Growth Capital companies does not work for Venture Capital companies. High risk of default investments in start-ups does not allow spending money on costly structuring of legal relationships between investors and investment recipients under the foreign law (by virtue of the high cost of the services), as well as getting help in raising funds from professional investment managers (difficult for execution complex regulatory conditions for activities of investment funds (e.g. licensing, standards of investment on the structure and composition of assets, constant supervision by the regulator) are forcing them to limit their investment interest by objects with a fairly high level of capitalization).

Fortunately, the experience in the field of Venture Capital accumulated by the state investment vehicles (e.g. RUSNANO, Skolkovo Foundation) over the past few years led the legislator to understand the realities of venture capital financing that resulted in the adoption of two important laws designed to promote the development of venture financing in Russia. It's about the Federal Law of 28.11.2011 No. 335-FZ "On Investment Partnership" (hereinafter - the Law on Investment Partnership) and the Federal Law of 03.12.2011 No.380-FZ "On Commercial Partnership" (hereinafter - the Law on Commercial Partnership).

In terms of Russian law the investment partnership is an intermediate form between the Simple Partnership (which is not a legal entity) and Limited Partnership (division of partners into general partners and partners with limited liability) and the commercial partnership is an intermediate form between the Limited Company (ability to limit liability) and Unlimited Partnership (optionality in management structure) as described in the Civil Code. The refusal of legislative “tuning” of these institutions for the needs of venture business and creation of new civil forms instead (Investment Partnership and Commercial Partnership) are most likely caused by the complex reform of the Civil Code being in course and thus inability of fast change of its part only with regard to the concerned legal institutions.

Due to the unprecedented importance of these laws for the entire industry of venture projects this article provides their detailed analysis with an assessment of the prospects of their application.

**Law on Investment Partnership (entered into on January 1, 2012)**

The Investment Partnership is a subspecies of a simple partnership contract and a form of collective investments into investment activity objects without creating a legal entity. Above mentioned investment activity objects can be not traded on stock exchanges shares of joint-stock companies and limited liability companies, bonds, financial instruments of futures transactions, as well as shares of commercial partnerships.

This form is the closest analogue of the English limited partnership the distinguishing features of which are:

- participation of general partners, being as a rule a private equity firm, carrying out the acquisition of assets in innovation sphere and management until they are sold, and limited partners, whose responsibility and right to participate in the management of the partnership are limited;
- limited partner has no right to exit from the contract and refuse to execute the schedule of financing (investment commitments);
- simultaneous participation of general and limited partners in several partnerships is allowed.

Russian investment partnership meets all the characteristics described. Additionally the following details on the legal status of this new legal form of business can be given:

Term: the term of the partnership is limited to 15 years (similar to Russian mutual funds) or achievement of investment goal.

Subject's structure: in addition to individuals, non-profit entities, in form of which state development institutions (e.g. state corporations) and pension funds could exist, can be the partners of the partnership.

Optionality is a basic principle of regulating the relations between the partners. The ability to define in the Contract of investment partnership of various rights and obligations of general, managing and limited partners, conditions of new partners admission, resignation of the working ones, various terms of profit distribution and voices in decision-making regarding the implementation of joint investment, and other conditions adequate to different conditions of investment projects in business innovation is provided by law.

Stability of legal relations: the restriction of exit of a partner from the Contract on his initiative.

Stages (schedule) of funding: unlike other forms of business investment partnership model provides the opportunity to invest on a phased basis (investment commitments) and provides a tough financial liability for failure to comply with the schedule of financing. The existing in Russian law forms of legal entities prescribe formation of bound charter (share) capital during first year of existence, the possibility of further capital injections are conditional to achievement of a new consensus among the participants of the business.

Legal status of Partners: partners are divided into managing (general) and non-managing (limited) partners. Limited partners may contribute only in the form of money while general partners can do it in any form, including professional experience. The responsibility of limited partners for commitments of the partnership towards entrepreneurs is limited to the size of their contribution while a general partner is liable for such obligations in a subsidiary form with limited partners in full.

The absence of double taxation: it is encouraging that the legislator alongside with the reform of the civil law to the scope of which an investment partnership relates, has provided economic conditions of its use: almost simultaneously with the mentioned law new amendments to the Tax Code were accepted. They are to provide the investment partnership with the same tax regime as for the Russian mutual funds, namely the distribution of income from investments is made without deduction of tax on profit (income) on the source.

**The Law on Commercial Partnership (coming into force from July 1st, 2012)**

The commercial partnership is a commercial organization with legal status being managed by partners.

Liability of partners is limited by the size of their contributions to the share capital.

The partnership is regulated by the Articles containing the minimum of information and being an object of state registration and the Contract on the management of the partnership being deposited with the notary.

This Contract allows to adjust the relationship among the partners on the most convenient conditions, relevant to particular business project terms (i.e. the principle of discretionary maximum): the possibility of establishing different rights and responsibilities of different actors of partnership, different order and conditions of new participants admission, resignation of the working ones, various conditions concerning distribution of profits and votes in the decision-making in respect of business, priority of the rights of some members over others, and so on.
Along with partners the partnership itself as well as third parties such as employees and external consultants can be parties to the Contract.

As in the investment partnership there is the opportunity of phased financing (investment commitments): in this case this possibility is realized through description not in the Articles but in the Contract of the size, composition, timing and procedure of making contributions to the share capital, as well as the procedure for changing shares of partners in the capital; there is a possibility of extrajudicial exclusion of a participant from the partnership in case of its default on completion of financial obligations under the Contract.

The division of share capital into shares, which by default are freely circulated, is an important feature of the status of the partnership; moreover there may be not only the right to purchase shares by the a partnership, but even the duty of it to purchase shares at request of the partner (similar to an open and interval mutual funds).

Allowed by law possibility to limit the rights of exit of a partner from partnership and of disposal of partner’s share in joint capital for a certain period of time as well as the right of partners to demand from other partners the fulfillment of obligations taken under the Contract in kind make relationship of partners in the business project stable.

Prospects

As the described laws have been prepared on the initiative and with direct participation of the government institutions of development and innovation, especially Rosnano, it appears that in the near future these forms of innovation will be very intensively tested in practice.

It’s no secret that during the passage of the stages of the legislative process the original draft of law is undergoing some adjustments resulting from compromises between various participants of the legislative process. Therefore, these laws are a priori not an exact replica of the Western analogs.

On the other hand, a significant role in the practical application of the new law is the opinion of legal practitioners: as the law becomes reality its text is interpreted by them in a manner more conservative than by the authors of the bill. For example, the para 4 of Art. 11 of the Law on Investment Partnership has provided an opportunity to include to Investment Partnership contract of the investment criteria “... to determine the limits of court discretion to reduce the penalty depending on the extent and consequences of a breach of such obligations, including those based on a complete or partial non-fulfillment of such obligations, amount of broken or unfulfilled obligations, duration of the infringement, eliminating the possibility of these disorders ... “ On the one hand, the obvious purpose of this rule is limiting the discretion of the court to reduce the penalty under the Art. 333 of the Civil Code, on the other hand - these criteria are already applied in judicial practice before, but it is unclear whether the specific values of these criteria set out in the contract will be mandatory for the court in deciding whether to reduce the penalty. If the text of the law were worded more clearly, the goal would be achieved.

Thus, only practical enforcement, including judiciary practice, can answer this and other similar questions, but now there is no doubt that the new laws create new opportunities for structuring venture capital projects that were not available prior to their adoption.

*You can find more information on the new forms of investment - investment partnerships and economic partnership - in a special legislative review prepared by the lawyers of Law Firm Liniya Prava: http://www.lp.ru/analytics/specialalerts/specobzor-zakonodatelistva-ot-161211/*