

Involuntary Dilution of Shareholdings

By Daniel J. Rothstein, Esq.

(Editor's Note: Daniel Rothstein is a partner in the law firm Rothstein & Shaw.)

EXECUTIVE SUMMARY: Dilution of stock, in secret meetings, and often to the injury of foreign stock purchasers, has brought cries of foul from foreign investors. The problem has arisen as the old managers and employees try to retain their former positions even in the face of declining equity positions. Solutions by regulatory agencies, instead of the courts, has contributed to the difficulties.

Introduction

Since early this year, one of the major sources of investor caution toward the Russian securities market has been alleged improper action by several major privatized companies that have caused dilution of the shareholdings of outside investors, both foreign and domestic. These cases are the latest round in the struggle for control of attractive Russian companies that began with their privatization. This article examines some of the legal problems underlying these cases.

The facts described below are from reports in the Russian business press. Legislation discussed is taken from publicly available sources, and a copy of one private ruling was provided by a shareholder in the respective company discussed.

Komineft

The first dilution case that attracted public attention involved Komineft, a large oil company. On May 6, 1994, the company's meeting of shareholders made two decisions concerning an increase of the charter capital. The increase in charter capital was a result of the appreciation of the company's fixed assets due to inflation. The first decision was to increase the par value of the shares by a factor of ten. Second, it was decided to increase the

number of shares outstanding by fifty percent. Also, the shareholders' meeting decided that the new shares would be sold for par value to shareholders whose holdings were reflected in the shareholder register at the time of the May 6, 1994 meeting.

Dilution Kept Secret

The prospectus of the new share issue was registered eight months later, and the new shares were added to the accounts of the original shareholders. In the meantime, many shares of the company had been traded, and their new owners were not entitled to participate in the new

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share issue. These shareholders claim that their holdings were improperly diluted, because they were not informed of the decision to issue additional shares, nor given an opportunity to participate in the new issue.

Company Justification

The company has justified its actions on the basis of Section 4.4 of Letter No. 14 of the Ministry of Finance, which provides that sums connected with the revaluation of charter capital shall be distributed pro rata to shareholders according to their shareholdings as reflected in the shareholder register as of the date of the shareholders' meeting that made the decision on the increase in charter capital.

The shareholders with diluted stock have pursued their case through negotiations with Komineft's management, the press, and by attempting to apply pressure on the management through the government. The Ministry of Finance issued a ruling on April 19, 1995 addressed to a number of major brokerage and financial companies that are Komineft shareholders. The ruling provides the

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following interpretation of Section 4.4 of Letter No. 14: "[The rule of proportional distribution] extends only to shareholders whose proportional holding did not change from the time that the shareholders' meeting made the decision to increase the charter capital until the registration of the issue. In other cases, the amount of reevaluation of the charter capital shall be distributed among the shareholders *pro rata* according to their holdings ... at the time of registration of the issue." Negotiations between the diluted shareholders and the company management were continuing as of this writing.

Primorsky Sea Shipping

On June 30, 1993, the shareholders of Primorsky Sea Shipping (PSS) decided that there would be an additional issue of shares, but delegated to the board of directors the decision of the amount and conditions of the share issue. Seventeen months later, on November 9, 1994, the board of directors exercised the powers that had been

Dilution often occurred when management and employees were granted disproportionately large amounts of shares during privatization.

delegated to it by the meeting of shareholders. By that time, as with Komineft, Primorsky's shares were actively trading on the secondary market.

The board of directors decided that the additional issue would be in approximately the amount of the existing capital, *i.e.*, the charter capital would be doubled. The board also decided to place the issue through an underwriter, a subsidiary of PSS. The price of the new issue was approximately 400-500 times lower than the value based on the market price of shares at that time. The "underwriter" bought most of the new shares.

The injured shareholders have taken their case to the main governmental bodies responsible for privatization and securities: the Commission for Securities and the Capital Market, the Ministry of Finance, and the Committee for Management of State Property. There are no reports of an expected resolution of the case, nor are there reports of planned court action by the diluted shareholders.

Sakhalin Sea Shipping

The meeting of shareholders of Sakhalin Sea Shipping (SSS) decided to increase its charter capital by a factor of eleven, and to distribute half the new shares as dividends for 1993 to those who were shareholders at the time of the decision of the shareholders' meeting. The exact time of the dividend distribution was left open, presumably to be fixed by the board of directors. Because new buyers of shares may

not be able to participate in the dividend, the company's shares have become virtually illiquid. In January 1995, a subsequent buyer challenged the company's decision in court, but the case was dismissed on the grounds that the plaintiff was not a shareholder before the contested decision and therefore did not have standing to sue.

Privatization: The Roots of the Contest for Control

The companies' actions described above are a continuation of the corporate control battle waged by workers and management (hereafter employees) of Russian privatized companies, which began in 1991-1992 when the legislation for Russia's mass privatization campaign was being developed. The debate over control centered on two issues: (a) the rightful ownership of Russia's industrial wealth, and (b) the best procedure to ensure that companies would become controlled by the most economically effective owners. The debate produced, roughly, two camps: (1) an industrial lobby which argued that the employees of each company were both rightful and effective owners, and (2) the proponents of voucher privatization, who argued that all citizens should have an equal share in the total industrial wealth, and that selling companies to the highest bidders would put companies in the hands of the most effective owners.

Employees Awarded Large Blocks of Shares

The privatization legislation that was adopted was a compromise between the two views. State-owned enterprises were converted to open joint stock companies. The first block of voting shares—at least one-third, and sometimes over fifty percent—were sold to the employees in a closed subscription at prices far below the eventual market prices. An additional block of voting shares—typically 29 percent to 40 percent, and in some cases all of the

Some recent dilution cases involve clear violations of Russia's securities laws.

voting shares remaining after the closed subscription—were sold at public auction for privatization vouchers, bearer instruments that were issued to every citizen.

In companies considered valuable, the employees amassed vouchers in order to maximize their acquisition of auctioned shares. Despite the government's efforts to require wide access to voucher auctions, the massive scale and fast pace of the campaign often led to organizational problems that gave the employees informational and procedural advantages over outsiders in voucher auctions. The employees usually succeeded in using the voucher auctions to consolidate their control over the company.

Dilutions Kept Secret from New Buyers

In many privatized companies, it took several months after the voucher auctions to enter the new shareholders

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in the shareholder register, and few or none of the outsider shareholders were informed of the first shareholder meeting.

In the cases involving Komineft, PSS, and SSS described above, the actions were taken at the first shareholders' meeting held after privatization. In PSS, moreover, that meeting took place after the closed subscription of shares to the employees but before any shares were auctioned to the public for vouchers. Thus, at that time there were no outside shareholders, although the decision of the shareholders' meeting was to affect future outside shareholders.

Actions Were Clear Violations of Law

The Komineft, PSS, and SSS cases involve clear violations of Russia's securities laws. Although that body of legislation is young, certain fundamental norms were established before the mass privatization program. Thus, under rules in force since 1992, an issuer of securities must "provide full and equal information to all potential buyers of the securities of the given issue." (Ministry of Finance Instruction on Issue and Registration of Securities, No. 2, dated March 3, 1992.) In the Komineft and PSS cases, there was no public information about the additional share issue at the time of the respective shareholders' meetings. In the SSS case, the decision not to distribute share dividends to future shareholders can be seen as an illegal limitation on the original shareholders' rights to sell their shares, or a violation of their property rights guaranteed in the Civil Code.

More Faith in Regulators Than Courts

Instead of going to court to assert these rights, the Komineft and PSS shareholders have gone to the governmental regulators with an array of procedural arguments. The public discussion of the SSS case has also centered around a procedural issue: under various contradictory regulations, the increase in charter capital can be considered to be effective (i) as of the shareholders' meeting in which the decision was taken, (ii) after the prospectus has been issued and the new shares have been entered in the shareholder register in the company's name, or (iii) after the additional shares have been placed with shareholders.

The focus on narrow procedural issues is understandable in the Russian context. There is little faith in the court system, and parties seeking the help of administrative bodies must focus on areas in their competence, for example, whether to register an issue of shares or refuse the registration.

Disadvantages to Agency Remedies

There are, however, problems with the reliance on administrative bodies and narrow procedural issues that are in their competence. First, there are contradictions in the regulations and legislation, and the administrative bodies often add to the confusion with new regulations. Second, the administrative bodies are limited in the relief they can provide.

The Komineft case is a good example of these problems. A court could hold that in order to increase the capital to reflect appreciation of fixed assets, an increase in the par value of the existing shares would have been sufficient; that the issue of new shares was designed to benefit existing shareholders at the expense of future shareholders; and that all shareholders were not given an equal opportunity to purchase the new shares. The court would order relief under the particular circumstances of the case. For example, the court could declare the issue void and give holders of the canceled shares a remedy against the company. Because the case was brought to the Ministry of Finance, however, relief took the form of reinterpretation of the regulation to fit the circumstances of the case. Regulators cannot do this in every case.

More Rules, Less Coherence

A common complaint about the Russian legal system is that there is not enough legislation governing modern commercial transactions. This is true, and encouraging efforts are underway to produce a more coherent body of securities regulations. But a more serious problem is that there are no respected institutions to interpret and implement the laws that do exist—prosecutors, regu-

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latory enforcement bodies, and courts. In the absence of such institutions, regulators are forever trying to catch up with reality by adding more and more rules to address highly specific situations. In this game, the incentives give the law-breakers the upper hand.

The investment and securities professional community is looking to the Commission on Securities and the Capital Market, which was constituted in November of 1994 with significant enforcement powers, to break the cycle of "violate-regulate-violate." In order to justify these hopes, the Commission must not only set an example but will also need support from other legal institutions.

Conclusion

In the share dilution cases discussed here, the companies' actions against outside control were made possible because of specific circumstances existing immedi-

Regulators are trying to catch up with reality by adding more and more rules to address highly specific situations.

ately after the mass privatization campaign of 1993-1994. In most Russian privatized companies, insiders remain in control and will use legal and illegal means to make investment from outsiders difficult, at least until share prices rise enough for them to receive a higher premium for their shares, or until minority shareholders have effective legal protections. The particular legal maneuvers of the insiders will change over time, and in the absence of working legal institutions, new regulations will be insufficient to protect shareholders' rights. □