Transfer pricing conflict hinders investment

Russia needs to resolve the conflict between corporations carrying out transfer pricing deals and disgruntled minority shareholders if it wants to attract investors says Dmitry Davydenko of Monastyrsky Zyuba Stepanov & Partners

Transfer pricing, that is, pricing between related or affiliated entities, is an exception to the general principles of civil law and market regularities. Firstly, commercial companies usually transact to make profit. This is not the case with transfer pricing deals, which make no or limited profit (in comparison with market priced deals). Secondly participants of civil turnover are legally independent. Conversely, transfer pricing is used between parties that are not independent – either one (the principal or, sometimes, holding company) controls the other (subordinate) or both parties are controlled by the same third party or by different third parties, one of which is subordinate to the other. Thirdly, freedom of contract, including freedom of establishing the price, is one of the most essential and sacred principles of civil law in a market-oriented economy. And yet, in reality the law impedes transactions with transfer prices that are considerably lower than market ones, through the possibility of their rescission by certain third parties, as interested-party transactions, and through tax correction mechanisms, as well as by other legal means.

The precondition of transfer pricing is the existence of related or affiliated business entities. They can be either different legal persons, or branches or other divisions of the same legal person. In both cases the transfer price is used between parts of a structure controlled from one centre. These structures are vertically integrated. They use transfer prices that are considerably lower than the market prices for the following reasons:

- to ensure control over the single production and sale mechanism (in particular, to facilitate the exchange of component parts and assembly units);
- to avoid market risks, such as dealing with monopolist suppliers or traders;
- to minimize tax (mostly by sending profit to controlled offshore companies);
- to stimulate integration between the related companies and attract new members.

Vertical integration provides flexibility and mobility in the structure management and helps to concentrate capital and resources on the most promising avenues. Vertically integrated structures prefer to transfer assets within their divisions without increasing their costs. As a result, the vertically integrated structure often includes a number of subordinate companies that are not designed to make profit. Instead, they exist to support the whole structure, and their own profit, if any, is several times smaller than the profit the companies would gain if they sold their products at market prices.

The problem arises where subordinate companies (under Russian law, the company is deemed subordinate if another (principal) company can determine its decisions, either through a dominating participatory share in its charter capital or under an agreement concluded between them, or otherwise) have minority participants (shareholders). Minority shareholders are obviously interested in maximizing the company's profit, but the structure owners, through the competent bodies of the company, transfer all, or almost all, of the profit and assets to the principal company or to an entity under their control.

The conflicting interests of the subordinates' minority shareholders and the principal companies have lead to confrontation and the so-called corporate wars, where the principal companies deprive the subordinates' minority shareholders of their profit share. This confrontation has been widely covered by Russian and foreign media. The exclusion of minority shareholders from participation in profit distribution is hindering Russia's efforts to attract investors. This problem (combined with tax evasion through offshore companies) has become so acute in Russia in recent years that it has been expressly mentioned in the Government Decree dated July 10 2001, N 910 (as amended by the Government Decree dated June 6 2002, N 388) "On the social and economic development of the Russian Federation middle term programme (2002 – 2004)". The Decree reads: "The problems of assets withdrawal and transfer pricing to the detriment to the issuer, the shareholders, the creditors and the state will be resolved through the federal law on the joint-stock companies as well as through the Criminal Code of the Russian Federation (art 165, 201, 204), tax law improvement and restricting the control over large-scale and interested-party transactions".

The problem's roots lie in the privatization that took place in the 1990s in Russia. Many large state enterprises (including oil producers and processors) have been transformed into holdings, with a principal company whose only activity is to control the subordinate companies, which in turn conduct production and processing. Individuals and entities that bought small shares in capital of many of these subordinate companies have become minority shareholders.

The Russian corporate law reform has provided minority shareholders with a number of remedies. As confirmed by the Plenum of the High Arbitration Court of Russian Federation (Resolution N 19 dated November 18 2003, point 37), the shareholder may only file suits in a limited number of cases, expressly provided by the law. The first option, provided by art 71.5 of the federal law "On the joint-stock companies" dated June 13 1996, No 65-FZ (the Joint-stock Companies Law) is to claim damages from a company's supervisory and executive bodies, such as a member of the directors board or the director-general, resulting from their culpable actions or omissions. However, only shareholder(s) that own more than 1% of the placed ordinary shares have this right to sue. Also, a subordinate company's bodies often do

not have enough money and property to compensate the losses caused to the company, so filing claims is often impracticable.

The profit is usually transferred to the principal company, so suing it sounds more promising. The second option is challenging the validity of the interested-party transaction on the grounds that it was not approved by competent company management bodies as prescribed by the law.

The Joint-stock Companies Law (art 81.1) defines an interested-party transaction as a transaction (including a loan, credit, pledge or suretyship) that creates a conflict of interests for a board of directors member, the director-general/executive body member, a shareholder that has, together with its affiliated persons, 20% or more of voting shares, or a person/entity empowered to give obligatory orders to the company. These persons have a conflict of interests in concluding the transaction if they, their spouses, parents, issue, brothers or sisters (including those of half blood), adoptive parents or children and/or their affiliated persons:

- is a party to or the beneficiary, intermediary or representative in the transaction;
- own (each one separately or jointly) 20% or more of shares (participatory interests) of the legal person which is a party to or the beneficiary, intermediary or representative in the transaction;
- hold office in the management bodies of the legal person which is a party to or the beneficiary, intermediary or representative in the transaction or hold office in the management bodies of the managing company of the legal person; and
- in other cases specified in the company's articles of incorporation.

The Joint-stock Companies Law (art 82) requires such persons to inform the board of directors and the board of auditors of:

- legal persons of which they own, individually or together with their affiliated persons, 20% or more of voting shares (participatory interest);
- any positions of office they hold in the managing bodies of legal persons;
- transactions known to them that are being concluded or contemplated and in which they can be recognized as having conflict of interest.

If the subject of an interested-party transaction is property worth more than 2% of the value of the company's assets, it must be approved in advance by the majority of the company's board of directors members or, if the established quorum is not complied with or there are more than 1000 voting shareholders, the general meeting of shareholders. In both cases, only individuals that are not qualified as interested in the transaction by the law may vote.

The minority shareholders' right would be merely declarative if they were not endowed with the right to be informed about the affiliates of their company. Under the Joint-stock Companies Law (art 93), the company is obligated to keep record of its affiliates. The affiliates must inform the company of the number and type of shares they own not later than 10 days from the date of their purchase. If the affiliate fails to timely provide this information and causes losses to the company, it is liable to indemnify the company for these losses.

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If a court declares the transaction invalid, the minority shareholders (the plaintiffs) may claim the consequences of its invalidity, that is, restitution and recovery of the damages, from the interested party (this party can be the principal company).

The Joint-stock Companies Law also provides for a special order to be followed when concluding major transactions, that is, transaction(s) whereby the company acquires, alienates, or provides grounds for alienating in future, the property worth at least 25% of book value of the company assets (according to the most recent balance sheet), excluding the transactions effected in the course of ordinary business activity. The shareholders may challenge the validity of these transactions if they were not approved by competent company bodies. However, the efficiency of this remedy should not be overestimated. In one case the Arbitration Court of Moscow invalidated the oil-supply contract between Rosneft, a well-known state-dominated oil company, and its producing subordinate Rosneft-Krasnodarneftegaz (NG). Five offshore companies, which owned 45% of KNG shares and belonged to OAO Sovlink, filed the suit. The claimants alleged that about 1 million tons of oil was sold under the contract at a reduced transfer price, which caused $32 million lost profit to the subordinate company.

The invalidated contract provided for the supply of 1.2 million tons of oil to be produced by KNG in 2001. It also set up the framework for concluding further oil supply contracts. The invalidated court all 19 contracts concluded by the parties in 2001, which determined practically all of KNG's commercial activity. However, the appellate court reversed the decision. The cassation court acknowledged the disputed contracts valid on the ground that "the order of effecting major transactions established in the Joint-stock Companies Law does not apply to transactions effected in the course of ordinary business activity, regardless of the value of the assets alienated or acquired under such transaction" (Ruling of the Federal Arbitration Court of Moscow circuit, September 18 2002, 40/6201-02).

Another remedy is provided by art 6.3 of the Joint-stock Companies Law: the subordinate company shareholders may sue on behalf of the subordinate company (which is called the indirect suit, given that the plaintiffs claim damages not to themselves but to their company and so protects their interests in the profit share indirectly) and claim damages from the principal company for losses it causes to the subordinate company. The losses are deemed the fault of the principal company only if the company exercised its right and/or opportunity to make the subordinate company commit actions knowing that it would be detrimental to the subordinate company. This option is

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attractive because the transaction does not need to be unlawful, it only needs to be disadvantageous for the company. The difficulty is proving the amount of damages, which is, clearly, the lost profit rather than the actual loss. Also, there must be evidence that the principal company exercised its opportunity to determine the decision to effect this particular transaction. However, the doctrine says that the mere fact the transaction is obviously advantageous for the principal company (or another of its subordinate) and disadvantageous for the subordinate is enough to prove that the principal exercised such opportunity.

The judicial practice of claiming damages from the principal company by the shareholders of the subordinate company in Russia has not developed. This does not mean, however, that such disputes don't exist. One merely needs to mention the claims of minority shareholders of Purneftegaz (subordinates to OAO Rosneft); the minority shareholders of companies subordinate to Sidanko and Tumen oil companies; and the minority shareholders of the Bulgarian company Lukoil Neftokhim subordinate to Lukoil, to name but a few big cases.

As regards protecting the minority shareholders' interests by employing criminal law provisions, the Russian Criminal Code articles mentioned in the quoted Government Decree specify the following crimes: causing pecuniary loss to the property owner or possessor by fraud or abuse of confidence; abuse of powers; and commercial bribing. They can in certain cases be used against the subordinate management but not against the principal company. It is considered the management's task under statutory rules and company by-laws to serve the interests of the company itself rather that the interests of its particular shareholder(s).

The opposition between the subordinates' minority shareholders and the owners of vertically integrated structures and similar corporations or groups of companies is detrimental to all parties involved. Progressively, the existence of minority shareholders in the subordinate companies has become grossly inconvenient for many business owners, and such business owners have undertaken various measures to make these shareholders sell their shares to the company and its majority shareholders. However, either the minority shareholders resist the sale or the parties cannot agree upon the price of the shares. Many large corporations have employed the shares consolidation mechanism, which compels the shareholders to sell the resulting fractional shares to the company (the law in force before 2002 did not allow the existence of fractional shares); some organized mergers and acquisitions allowing corporations to get rid of subordinates and transform them into mere branches. Subordinate shareholders often vigorously resist this consolidation if it does not meet their interests. In practice, sometimes the subordinate companies' assets have been transferred to the principal company whereas the liabilities have stayed with the subordinate company.

Apparently, the minority shareholders problem could be resolved if the related companies reject, or are compelled to reject, non-market transfer prices.

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However, they are unlikely to do this voluntarily because they would lose all benefits resulting from using the privileged regime of assets transfer between affiliates.

According to the Ministry of Finance of the Russian Federation, a law restricting the control over transfer pricing is likely to enter into force in late 2005 or early 2006. The appropriate project of law was approved by the state Duma in the 1st reading in 2000. The main purpose of the law is to reduce the budget losses from transfer pricing.

The budget losses from using reduced transfer prices have been high and are likely to remain high given that the Russian government is in favour of internal offshore zones. However, enhancing an unfavourable legal regime of vertically integrated structures (including pursuit by tax authorities) might be detrimental to Russian economy as such structures are necessary in many industries, including oil and gas.

Outlining the approaches to resolve the transfer prices and minority shareholders problem, it should be mentioned that the solution might consist in:

- consolidation of vertically integrated companies with transition to single share, transformation of subordinate companies into branches; and
- providing the minority shareholders with an option: to sell their shares at fair market value or to exchange them into the principal company shares at fair rate.

Besides, many legal systems provide for the minority shareholders' statutory right to demand conversion of their subordinate shares into the principal company shares at fair rate. It sounds reasonable to endow them with this right under Russian law. This, however, requires working out mechanisms of conversion.

The simplification and consolidation of large vertically integrated corporations structures in Russia is objectively determined by global and national economic development. What is pertinent is how the interests of all parties involved could be met.