

## **SOME ISSUES RELATED TO REDEMPTION OF FRACTIONAL SHARES**

### **Redemption of fractional shares: why this issue is of present interest?**

The redemption of fractional shares by a joint-stock company is regulated by Kyrgyz law (the “Law”) in a rather fragmented way. A direct reference to it is contained only in Article 68 of the Joint-Stock Companies Act of the Kyrgyz Republic of March 27, 2003 No. 64 (the “Companies Act”).

According to Article 68 of the Companies Act, by decision of the general meeting of shareholders, the company may consolidate its outstanding shares so that two or more shares of the company could be converted into one new share of the same class. In this case, the charter of the company should be amended to reflect the new number of authorized shares of the company. If a consolidation results in **fractional shares, these shares should be redeemed by the company at a market price** determined in accordance with Article 71 of the Companies Act. Since Article 68 of the Companies Act is an imperative sentence, the redemption of fractional shares is mandatory for the company.

The Law does not specify any particular rights of shareholders with respect to redemption of fractional shares. The primary right of a shareholder is to receive the market value of fractional shares from a joint stock company initiating their redemption.

It should be noted that there is no solid case law in respect of redemption of fractional shares in Kyrgyzstan, nor is there any public information on court decisions incidental thereto. It is not excluded that there were no cases of consolidation of shares and consequently, the need to redeem resulting fractional shares never arose. This, on the one hand, complicates research, in view of the lack of case studies, but, on the other hand, prevents analysis confined to prevailing case law, which means that there is still an opportunity to influence its development. This is why, in particular, this issue seems relevant.

### **Status of fractional shareholders: still shareholders or not?**

The Companies Act requires that fractional shares arising from the share consolidation must be redeemed by the joint-stock company and the shareholder may not refuse to sell (Article 68). At the same time, the Companies Act allows the shareholder to sell to other individuals or legal entities or otherwise dispose of the shares or part thereof subject to the requirements for closed joint stock companies (Article 25.2).

The Companies Act defines a shareholder as an individual or legal entity **holding at least one share of a company** entitling him to have claim to the assets of the joint-stock company and conferring on him the rights and obligations provided by the Law (Article 2). Since a fractional

share is less than one full share of equity ownership and the shareholder is no longer fitting a definition of a shareholder, it is obvious that the scope of his rights cannot be identical to that of the shareholder of the company. Formally, until an entry is made in the shareholder register, such a person remains a shareholder, although he has less than one full share, but in fact his rights are limited since he has no shares and, as a result, for example, cannot vote at general meetings of shareholders, since voting is subject to a *one-share-one-vote* rule.

Also, the Law does not specifically regulate the process of sale or disposal of fractional shares, and in view of this gap, it is most likely that the rights of holders of fractional shares, including the right to sell fractional shares, may be unenforceable in practice and, ultimately, such fractional shares will be anyway redeemed by the joint-stock company initiating consolidation. Moreover, it will be technically impossible to sell fractional shares, since under Section 32 of the Regulation on maintaining security holder register in the Kyrgyz Republic, approved by the Resolution of the Government of the Kyrgyz Republic of September 7, 2011 No. 536, from the moment of registration of changes related to share consolidation with the State Service for Financial Market Regulation and Supervision under the Government of the Kyrgyz Republic (the “FSA”), the registrar must suspend shareholder account operations until registration of results of consolidation with the FSA.

Thus, until registration of results of issuance of new shares with the FSA, in fact, the rights of shareholders will be limited and share transactions will not be allowed. This also confirms that the holder of fractional shares will have to agree on redemption of his shares by the company, as required by the Companies Act (Article 68), as he will not be able to sell them independently due to suspension of personal account operations. But nevertheless, *de jure*, the holder of fractional shares remains the shareholder of the company until fractional shares are redeemed by the joint-stock company and the share registrar makes an entry in the shareholder register about the new shareholders.

### **What are the risks associated with redemption of fractional shares?**

In order to illustrate potential risks and considering the lack of public information on Kyrgyz court decisions incidental to redemption of fractional shares, we provide below an overview of the Russian case study, in particular, the Russian Constitutional Court’s Decision of February 24, 2004.

In 2004, the Russian Constitutional Court considered a case challenging the constitutionality of Articles 74-75 of the Federal Companies Act. The claimants bringing the case alleged the violation of their constitutional rights and requested the court to declare unconstitutional the provisions of the Companies Act on the consolidation of outstanding shares and determination of their market value. Since under the Russian Constitution, someone’s property can be taken only by a court decision, the provisions requiring mandatory redemption of fractional shares by the company at a market value determined by the board of directors without the consent of

shareholders must be deemed to have violated the constitutional rights of shareholders to private property and judicial protection conferred thereon by Article 35 (1, 2 and 3) of the Constitution.<sup>1</sup>

The Constitutional Court ruled to dismiss the case and thereby upheld the constitutionality of Articles 74-75 of the Companies Act. In support of its ruling, the Constitutional Court noted the following: *“Considering the specific nature of a joint-stock company as a business organization, some shareholders may be deprived of their property, if it is in the general interest of the joint-stock company to the extent that it contributes to the general good. That said it should be borne in mind that as a result of consolidation carried out in the general interest of the joint-stock company, majority shareholders find themselves in better position than minority shareholders who generally face the negative effects of consolidation. The existence of conflicting interests among groups of shareholders in the process of consolidation objectively enhances the role of legal requirements for economic decision making and effective, rather than formal judicial review, serving as a guarantee of minority shareholder rights”*.

In conclusion, the Russian Constitutional Court pointed out that respect for the rights and legal interests of holders of fractional shares should be ensured through appropriate legal mechanisms applicable to consolidation of shares and through effective judicial review of decisions made by the board of directors and the general meeting of shareholders.

In this regard, it should be noted that the Kyrgyz Constitution of June 27, 2010 contains the provisions that are very similar to those of Article 35 of the Russian Constitution. Thus, Article 12 of the Kyrgyz Constitution of the Kyrgyz Republic reads as follows: *“Private property is inviolable. No one may be arbitrarily deprived of his property. **Taking of property against the will of the owner is allowed only by a court order.** Forcible taking of property without a court order is allowed in cases provided by law in the interests of national security, public order, health or morals, and for the protection of the rights and freedoms of others. The legality of such taking is subject to mandatory judicial review”*.

In view of the foregoing, in theory, we cannot exclude the risk of claims being brought by third parties seeking constitutional review of Article 68 of the Companies Act before the Constitutional Chamber of the Supreme Court of the Kyrgyz Republic. Undoubtedly, the Constitutional Chamber will undertake a thorough and deep analysis of the matter by reviewing both legal theory and case law.

In general, the conclusion of the Russian Constitutional Court on consolidation of shares and redemption of fractional shares seems reasonable, since otherwise the provisions concerning, for example, an increase in authorized capital of a limited liability company with the admittance of new shareholders, or issuance of new stock would be deemed unconstitutional and contrary to the constitution. In both cases, dilution occurs, which may be unreasonably interpreted as a

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<sup>1</sup> Article 35 (1, 2 and 3) of the Constitution of the Russian Federation reads as follows: 1. The right to private property is protected by law. 2. Everyone is entitled to have property, possess, use and dispose of it both individually and jointly with others. 3. No one may be deprived of property otherwise than by a court decision. Forcible alienation of property for public use is only possible against payment of fair and adequate compensation.

partial loss of property and violation of shareholders' rights. Obviously, such an approach would be contrary not only to law, but also to logic and common sense.

Indeed, the issue of redemption of fractional shares is quite complex and ambiguous, as it has not yet been sufficiently explored and elaborated. It is very important that the decision on consolidation of shares be made with due regard for the rights and legal interests of shareholders owning fractional shares redeemable at the time of consolidation. Respect for their rights is ensured by determining the fair market price of fractional shares by the board of directors based on conclusions of independent appraisers, observing the time limits and procedure for redemption of fractional shares, etc. The utmost protection of rights of shareholders in connection with redemption of fractional shares shall be ensured by judicial remedies and government guarantees of impartial and objective judicial review. Any shareholder feeling that his rights have been violated as a result of consolidation of outstanding shares and/or redemption of fractional shares can go to court<sup>2</sup> and judicial review is the main legal remedy to protect the rights of shareholders.

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<sup>2</sup> Under Article 25.3, the shareholder has the right to defend his rights in court, challenge the decisions made by the company, including the decision of the general meeting of shareholders on consolidation of outstanding shares and redemption of fractional shares, as well as challenge the market price of fractional shares approved by the board of directors, provided that this decision violates the property rights of this shareholders and inflicts property damage thereto.