



Structuring options for key employees in limited liability companies under Russian law

 06/10/2020  EMPLOYMENT AND LABOUR⁵, RUSSIA

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Granting options to key employees is considered as a promise of grant of shares in the corporate capital of the company or a monetary reward upon occurrence of certain conditions – achievement of Key Performance Indicator(s) (hereinafter – “KPI”). It is used as an effective way to motivate employees.

KPIs are generally indicated in the option and may be linked to various achievements (such as reaching certain revenues, opening a new business areas, working in the company for a certain period, attracting an investor for a certain dollars, etc.). It is possible to use a combination of KPIs or even different KPIs for different periods. KPI must be confirmed by certain documents that are agreed by the parties in the option.

Options can be used for employees in joint stock companies as well as in limited liability companies. In this article we will focus on the procedure for structuring options in a limited liability company.

An option can be classic or phantom. Under the terms of the classic option the employee receives a real share in the authorized capital of the company and all corporate rights. Under the terms of the phantom option the employee does not get any corporate rights, but simply receives a monetary reward corresponding to the phantom share. In both cases the employee enters into an agreement with the participant(s) of the company.

1. Classic option

The current Russian legislation allows to grant classic options in two ways:



- by entering into an option to conclude an agreement (Art. 429.2 of the Civil Code of the Russian Federation (the “Civil Code”));
- by entering into an option agreement (Article 429.3 of the Civil Code).

Option to conclude an agreement

An option to conclude an agreement is, in fact, an irrevocable offer. The parties agree on the conditions, terms and circumstances under which it can be accepted.

There is a two-stage sale and purchase of shares. First, the employee is provided with an offer to acquire shares in the company at specific conditions. Then, if the employee fulfills all conditions, he/she will have the right to accept the offer and become a participant of the company. The option is finalized automatically at the time when the offer is accepted. The company does not need to additionally express its will.

An option to conclude an agreement is beneficial for the employee as it increases the assurance that the employer will exercise the option. But the company is less interested in such an option because it loses the opportunity to change the terms afterwards.

Option agreement

An option agreement is a bilateral option agreement according to which one party, at certain conditions, has the right to demand from the other party to perform an action within a certain period. In case of an option agreement with an employee, upon occurrence of the relevant conditions, he/she will be entitled to request assignment of the shares in the company.

This type of option differs from the option to conclude an agreement as it does not automatically entail the transfer of the shares in the company to the employee. Additional actions and expressions of will of the employee and employer are required.

Such agreement is safer for employers, especially if there is a clause in the agreement on its possible amendment or early termination.

1.1. Essential conditions and form of a classic option

An essential condition of an option is its subject-matter. The subject-matter includes the following:

- the right to conclude a share purchase agreement;
- material terms of the share purchase agreement, namely amount of shares and share price.

When granting an option to a key employee, it is necessary to comply with the legal requirements for transactions with shares. In particular, it is necessary to notarize the option (Art. 429.2 of the Civil Code and Art. 21 of the Federal Law as of 08/02/1998 No. 14-FZ "On Limited Liability Companies"), otherwise the agreement will be null and void.

An option to a key employee can be drafted as a separate agreement or incorporated into the text of another agreement (for example, into a corporate agreement).

1.2. Setting the term of the option

The option should specify the conditions and terms under which the employee can redeem the share. If the term for acceptance of the offer is not specified in the option, then the term is considered to be one year.

In practice, two models are used for determining the term:

1. indication of the date or period when the employee can accept the offer and receive a share



Example: An employee has the right to exercise the option until October 1, 2020 inclusive, if the company's revenue has reached X dollars.

2. indication of certain suspensive conditions, after which occurrence the employee receives the right to accept the offer within a certain period of time. Such conditions may depend on the will of one (or both) of the parties.

For example: If the company reaches X revenue, an employee has the right to exercise the option within 2 months.

If within such period the option is not activated, the right to conclude the main agreement on the terms specified in the option is lost.

1.3. Option premium and share cost

As a general rule, the options are granted against payment (clause 1 of article 429.2 of the Civil Code). It is provided for the so-called option premium. However, the Civil Code allows the possibility to grant gratuitous options as well (Art. 423, 429).

In case of options for key employees, the agreement usually indicates that the option premium is equal to zero or is offset against payment under the main agreement. The share price is often at par or even below par value.

Both the amount of the shares to be granted and the share price can be fixed or be determined by a formula. It is recommended to indicate the exact amount of the shares in order to protect everyone's interests in case of possible increase or decrease of

the corporate capital of the company.

2. Phantom option

A phantom option is concluded as an agreement not named in the Civil Code on the basis of the principle of freedom of agreement. A phantom option is, in fact, a promise to pay a monetary remuneration equivalent to a "phantom" share in the corporate capital of the company, which an employee will receive upon achievement of certain KPIs.

In Russia and in international practice employers often provide phantom options, since they are easier to exercise.

As a general rule, the following conditions must be fixed in the phantom option agreement:

- KPIs;
- the term of the option;
- the amount of remuneration.

The hard part in realization of a phantom option is to determine the initial share price. Since the shares of limited liability companies are not traded on the stock exchange, it can be difficult to estimate the actual market value thereof. To that purpose, the company may rely on accounting data or use of specialized appraisers.

A phantom option can be concluded in simple written form. No notarization is required.

3. Risks and how to avoid them

- (i) As a general rule, the rights under the option may be assigned to another person, unless otherwise provided by the agreement or unless it follows from its essence. Therefore, if the company does not want the employee to assign the option to another person, the prohibition must be explicitly stated in the agreement.
- (ii) Not all participants of the company may be parties to the option agreement. In order to avoid problems with the preemptive right



of other participants when exercising the option, waivers of the preemptive right are granted by other participants at the time of signing the agreement and the waiver of the preemptive right is acknowledged in the corporate agreement.

- (iii) To prevent the party obliged under the option to alienate its shares in the corporate capital of the company, it is recommended to include special provisions in the corporate agreement (for example, providing for the obligation not to sell the shares and establishing a penalty in favour of the employee in case of violation thereof).
- (iv) It is also recommended to provide for an obligation to renegotiate in the event of reorganization or liquidation of the company.

- (v) Another condition that might be included in the agreement is a penalty clause. The agreement could state that an employee is obliged to return the shares if he/she leaves the company within a certain period of time.

- (vi) It should also be borne in mind that, by receiving a share, an employee becomes a full-fledged participant of the company and obtains the same rights and obligations as other participants. Thereby, in the corporate agreement it is necessary to clarify the procedure for interaction of the employee-participant with other participants.

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