

## **CORPORATE COUNSEL ASSOCIATION**

### **THE PRACTICE OF USING SHAREHOLDERS' AGREEMENTS AND THE ISSUES RELATED TO THE RESPONSIBILITY OF THE GOVERNING BODIES, SHAREHOLDERS AND PARTICIPANTS IN JOINT STOCK COMPANIES AND LIMITED LIABILITY COMPANIES**

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#### **LEGAL FEATURES OF CORPORATE AGREEMENTS**

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Corporate agreements provide a civil law foundation for horizontal relations among the participants in business entities, being not merely a legal tool for regulating the most important aspects of corporate activities but an attribute of well-developed legal systems where the standards of corporate governance are observed or being steadily improved and great importance is given to the performance of investments.

On the face of it, it appears ironic that it is not until the twentieth year of a market economy in Russia that corporate agreements were introduced into RF legislation. However, the whole thing cannot be attributed to the slowness of the law-making process. In our professional services market, such legal products as shareholders' agreements involving large and medium-sized businesses have always been implemented by foreign specialists working on the basis of non-Russian law, and there was no visible need to introduce this method for regulating the relations of participants/shareholders into RF legislation.

Business practice brought this contractual form into existence quite a long time ago, when the essence of share capital and portfolio investments had changed and the investors had become to be driven by their passion and seeking for developing their liquid assets though the increasing capitalisation of the company rather than by future profit and dividends. In the 1990's and especially during the recent period, the business community has seen an extremely fast change in the value of promising companies, and it has made their shares one of the most attractive targets for high-risk investments.

This immediately placed on the agenda the issue of a deeper non-regulatory determination of business relations among the participants with respect to those matters which were not addressed in the constitutional documents, having in mind the following goals:

1. to provide legal protection in the investment process, to describe and allocate investment risks;
2. to obtain further assurances of control over the company and to improve its governance on a basis to be agreed upon; and
3. to provide a legal opportunity to withdraw from any projects and to mitigate any possible financial losses.

It is especially relevant given that the participants/shareholders, unlike the investors in 19<sup>th</sup> century corporations, bear practically no material obligations arising from the laws or constitutional documents. Indeed, a shareholder is only obliged to:

- 1) give written notice to the other shareholders and the company itself of his intention to sell his shares to a third party;
- 2) make a payment in accordance with the principle that at least 50% of the company's shares issued upon its incorporation must be paid up within three months;
- 3) give timely notice to the company's registrar regarding any change in his details; and
- 4) issue an instrument of proxy to any transferee of his shares or vote himself at a general meeting as directed by such transferee.

The practice of using corporate agreements in the RF ceased to be satisfactory because it has only a minor influence on the development of this area of Russian law and not only failed to improve the Russian legal and judicial system but often distorted national corporate governance. The amendments to the laws "On Joint Stock Companies" and "On Limited Liability Companies" have entitled the participants to enter into an agreement regarding:

- 1) the use of voting rights;
- 2) "concerted" governance activities; and
- 3) forced redemption of shares/interests on pre-determined terms.

However, Article 32.1 of the Federal Law "On Joint Stock Companies" disables the parties to:

- 1) agree upon any candidates to be elected to the governing bodies of the company;
- 2) determine the powers of the governing bodies;
- 3) modify the quorum required to decide any matters related to the company's business; and
- 4) redistribute any dividends among the shareholders.

We can see that the legislator has shown excessive caution at this stage by including the relevant articles in the procedure for exercising the rights of shareholders/participants and overlooking the task of legal support by them and the company of investments from both the participants themselves and any third parties, because it does not appear from the language that they can be parties to such agreements. In another respect, the drafters of the amendments have behaved in a consistent way and refrained from reproducing the language associated with English and U.S. law which emphasises the priority of an agreement as a second charter.

The trend for giving the force of constitutional documents to agreements among company participants is largely based on the idea of such entities as a certain association of persons which has a contractual nature. In this model, a legal entity is described as an artificial body that acts in civil transactions through its individual representatives. This approach is widespread in the legal doctrine of England and the United States. For instance, the principal constitutional document of a company under English law is the so-called Articles of Association, a document analogous to the Russian charter but having a contractual nature. Together with the Memorandum of Association,

they form what is called a company's constitution in the literature. The provisions of the Articles of Association apply to all company members and their amendment requires a certain formal procedure to be followed. Shareholders' agreements make it possible to set rules binding not upon all of the company's members. They constitute a further contract among shareholders which may provide for certain things not addressed in the contractual Articles.

Under that doctrine, the shareholders are viewed as one of the groups which also include the managers, the creditors and the employees.

Ladies and gentlemen, for all of us, practicing lawyers who have repeatedly worked with numerous non-Russian texts of corporate agreements, the first-priority question is as follows: to what extent may the conventional structures and language be usable in drafting documents under Russian law? We tend to believe that no obligation arising from corporate agreements may pass to the new transferee unless the assignment and novation procedure, as determined in Chapter 24 of the RF Civil Code, is complied with, and by virtue of Article 142 of the Civil Code which provides that the rights evidenced by securities are indivisible. The main useful feature of a share is the authenticity of its properties and encumbrances which constitute the public particulars of such a security. Assuming that a new shareholder will automatically find himself a debtor under any agreement entered into by his predecessor, dealing in such high-liquidity assets will be substantially impeded.

Much has been said regarding the fact that corporate agreements establish mutual obligations among the parties which must be identified or at least identifiable at the time when the document is executed, therefore no covenant drafted in the English style, like "Shareholder A will vote on all items of the agenda at any general shareholders' meeting in accordance with the instructions of Shareholder B", will be binding upon the parties.

The principal consideration in connection with "voting in a certain manner" under a corporate agreement would take the form of an act (voting) or omission (non-voting), whereas any consent to comply with any unidentified instructions could be treated as an unlawful waiver of a right (Article 9(2) of the Civil Code). It should be noted, however, that the legislator has used a rather rare term in describing the powers of the participants, namely "to agree upon the voting alternative", i.e. to enter into arrangements which would, most likely, have no binding nature, since it would probably be difficult to establish the substance of the act promised with respect to voting if a dispute arises. It appears that it will be difficult to implement the "redemption" expressly envisaged by the amendments by means of the so-called option, if it, being a new and non-typical concept for Russian law, is not embraced by court practice. We believe that, in order to implement the obligation to make shares available for redemption, it is appropriate to use Articles 328, 314, 327 and 320 of the Civil Code (regarding the time-frame of performance under obligations, counter-obligations, methods for performance, offers etc.).

In light of the amendments made to the laws, it is not without interest to consider the issue of international private law as to whether corporate agreements among participants in Russian legal entities may be governed by foreign law. According to an interview by the Chairman of the Supreme Commercial Court (*Zakon*, December 2008), the answer is apparently no, but it should be confirmed by an off-standard official explanation of the Court, since even if we assume that corporate agreements will be governed by the personal law of any relevant legal entity under Article 1202(2)(1) (due to the expression "in particular"), then this rule will only be binding upon Russian state courts, because, under Article 28 of the 1961 European Convention on International Commercial Arbitration, the arbitrators will, regardless of the place of arbitration, choose such conflict of law system as they deem applicable, therefore any foreign commercial arbitration tribunal will review the choice of any non-Russian law under the rules of international private law and render awards without regard for Article 1202. And, in order to deny recognition of such an

award in the Russian Federation, one should refer to one of the items included in the list of irregularities as set forth in Article V of the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards, of which only one would be suitable, namely that it would be contrary to the public policy of the Russian Federation, apparently due to the failure to apply the mandatory Russian rules. However, this concept of “positive” public policy is adopted nowhere, nor is it contained in any RF laws.

Another thing is interesting, however: any parties which have decided to choose a venue of arbitration outside Russia for the resolution of their future disputes arising from their corporate agreement will avoid the application of Russian law due to Article 230(5) of the RF Code of Civil Procedure which still contains the obsolete rule that the Russian state courts have the power to reverse any foreign arbitral award if it is based on any rules of RF law, irrespective of the country where it was rendered.