ON REMEDIES AVAILABLE TO A FOREIGN SHAREHOLDER IN ONE OF THE MOST NOTED TRIALS IN THE HISTORY OF THE RUSSIAN STOCK MARKET (1995-2000)

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The year 1994 was characterized by a booming stock market in Russia and investors' growing interest in securities of Russian issuers. There was the hope that the purchase of shares meant partaking of the profits of privatised state enterprises constituting the backbone of Soviet economy. Russia's many brokers and new financial institutions were busy buying up super-lucrative shares to amass a controlling interest and then sell it at a profit. The demand for shares was «stimulated» by foreign pension funds and investment companies with a so-called «share of risky investment» in the clients' assets they controlled.

The securities issued by companies owning basic elements of national infrastructure (communications, electricity supply and so on), steadily and predictably profitable due to the rising demand for their services and products, were, in the vigorous revival of Russia's stock market, objects of active speculation and frequent resale, spurred by hopes of a rise in value. Against the backdrop of growing prices of such shares, these securities offered the most lucrative prospects to invest available capital.

At the same time, however, one admits that the regulating, administrative and controlling mechanisms of the stock market needed streamlining. There were frequent disputes, misunderstandings and amusing incidents, related to security transactions. Our law firm took part in one of the most illustrious, edifying and fascinating cases in which many legal niceties came to light.

I. Peculiarities of Circulations of Shares

The advent of the new economy was characterized by high profitability in some of the business sectors. First came retail trade (i.e. the kiosk trade in literal sense), followed by wholesale, based on massive import of short-supply but cheap consumers' goods in the yet inchoate system of quality and compliance control. Second in yield was the commercial activity of banks vying with each other in promises to pay a higher interest on deposits and operating outside the rules of supervision over the safety of the clients' funds.

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From the year 1994 one observed a booming trade in shares, supported by licensed and specialized participants: registrars, depositaries, investment institutions, consultants and so on.

A special role in facilitating the deals with the widespread non-documentary shares was assigned to the «register-holder» or «registrar». His function was to promptly enter into the electronic database the accurate results of many transactions which, if executed, would trigger a continual change of owners of different blocks of shares. The company would be managed, based on the registrar's data, because the individuals, entered in the register as shareholders, would get the appropriate number of votes for the shareholders meeting to take a decision. Moreover, the registrar also determined the amount of dividends paid out only to individuals registered as owning the required number of shares in the registration system. So the data derived from the registrar was final and binding for the executive bodies of the joint stock company.

In the pursuit of their activity, the stock market agents had an economic interest in having minimum formalities. The advantage would go to the buyer or seller executing a deal faster than others during a clear rise or fall of prices. For this reason most shares sales agreements were signed, with the seller still having to buy an agreed number of shares under another, previously signed agreement on stock purchase in order to gain from the change of prices. Thus, the speculative deals were carried out outside the shares register system and the registrar's data. There was great convenience and opportunity for people carrying out transactions through the electronic trading system whose rapidity, reliability, discipline and the sense of responsibility of the actors were factors of effective marketing of the securities. In the year 1994, however, many deals were closed outside the stock market, through acceptance of offers coming not from well known sellers, who, under the existing market customs, would not be asked to confirm the respective registration of their rights in the register.

Another reason for the high development of the market outside the stock exchange was that the profit taxation system stimulated the participation of foreign, mainly offshore companies, which, settling their reciprocal payments for the transactions with Russian shares abroad, did not pay taxes in the Russian Federation. As to the income of the Russian legal entities, who, unlike foreign companies, could obtain a license of a professional stock exchange participant, it was to be deposited on the ruble accounts and thus to be taxed.

The mechanisms of control over elementary reliability and bona fide nature of stock exchange operations were still imperfect, albeit spelled out in detail. The registrar was supposed to make an entry in the register and eliminate the previous entry if someone with powers of attorney would present the so-called transfer order from the shareholder. Two stamps affixed to the said documents were enough to transfer a block of shares worth, say, several million dollars, into the ownership of another person mentioned in the transferring instruction.

Ignorance concerning the reliability and the bona fide nature of parties to transactions was thought to be compensated by the procedure whereby investment institutions and banks registered agreements on stock acquisition. The registration was supposed to be accompanied by verifying the legal entity of the transaction participants, and that to the registrar keeping the register, the stamp of the bank or the investment institution was thought to be proof that they either knew or recognized the counterparts. In practice, however, banks and investment institutions would register deals without due verification. Not responsible for the results of the execution of the contracts, they tried to increase the receipts from such an overly simple service by not encumbering it with formalities and thus attracting a large number of clients.

II. Issues of Legal Regulation of Non-documentary Shares

During and after 1994, major issues of non-documentary securities regulation persisted. The basic legislation (Regulation on the register of shareholders of a joint-stock company (approved by RF Goskomimushchestvo Instruction No.840-r, of 18.04.94) and the Federal Laws «On Securities Market» of 22.04.96 No. 39-FZ and «On Joint-Stock Companies» of 26.12.95 No. 208-FZ) were drafted in a less than perfect way. The principal deficiency, however, was the lack of clarity and «finesse» of the regulation concept and the content of the basic legal notions. Neither the legal regulations nor judicial practice nor even scholars themselves were unanimous in assigning the non-documentary shares to an appropriate type of property – rights or things. A fascinating dispute on this matter continued on pages of legal journals. Those claiming non-documentary shares to be rights managed to incorporate the notion of a «holder of a right to a non-documentary security» in Article 149 of the RF Civil Code.

At the same time, it was not clear how the bona fide purchaser rule was applied to such shares (which applied to material objects only), without which a normal and sustainable turnover of stock is impossible since a defect or disruption in the remotest link of the chain of preceding transactions could nullify any shareholder's right to a non-documentary security under the well-known Roman axiom: nemo ad alium plus juris transferre potest, quam ipse habet (nobody can transfer more rights than he has), laid down in Article 384 of the RF Civil Code.

The law-makers have vainly tried to solve the problem, only creating glaring and large-scale contradictions in regulation. The term «right of ownership on issued securities», including non-documentary, was incorporated in Article 28 of the Law «On securities market». It was still unclear whether the expression of the «right of ownership" on non-documentary securities as intangible assets ought to be considered as conventional, as there could be no ownership as regard with a right, or the enactment of specific rule actually aimed at changing the legal status of non-documentary shares.

The provisions concerning the bona fide acquisition of non-documentary shares did not quite correspond to the *jus civile* concept of this principle as laid down in Article 302 of the RF Civil Code. Article 2 of the Law «On securities market» introduced the notion of a «bona fide purchaser». He is a person who, without the knowledge of the illegality of his counterpart, has already payed for the acquired securities. Consequently, the purchaser who hasn't paid for the shares due to the provision on delayed payment, could not be protected, while under the RF Civil Code (Article 302) the bona fide attribute means being unaware of the illegality without exercising of negligence in concluding the transaction, even if it happens to be free of charge. The Provisional Regulation "On maintenance of register of the nominal securities owners" (approved by decision of 12.07.95 No. 3 of the Federal Securities and Stock Market Commission under the RF Government) was effective from July 1995. This subordinate legislation came to include the rule (part 3.1.7), which further blurred the significance, role, scope and application of the legal principle in question. According to the provisional regulation, nominal non-documentary securities could not be requested from the bona fide purchaser. It was still unclear whether the rule should not apply either because it contradicted the RF Civil Code, supreme legislation, or because it resulted from the poor legislative drafting in attempt to extend the legal regime of "things" to the non-documentary securities concerning the protection of the bona fide purchaser through exposition of only a part of the rule. The said regulation could cover a more limited number of cases – only the impossibility of recovering non-documentary securities, while if they, were stolen, then the general rule would require them requested. At the same time, certain legal scholars considered the rule provided by the Provisional Regulation as a legitimate exclusion from the RF Civil Code.

Another problem in the legal regulation of non-documentary securities was the ambiguity of the registrar's legal status, his competence and responsibility. Certain commentators characterized him as the person who essentially keeps the clients' shares as «alien corn in the barn» and thus is responsible for their loss or incorrect transfer. Others asserted that the registrar merely performs the technical registration of transaction results as the professional controller of their accurate entry, responsible for safe maintenance of the register.

It did not clearly follow from the analysis of those regulations whether or not the registrar was a kind of issuer's representative, authorized to keep the register. In the former case the registrar had to obey the issuer, while the latter was supposed to be responsible for the actions of the registrar. At the same time, on the one hand, there was the term «independent registrar», while on the other — rules were being introduced to the effect that the issuer «shall not be released from responsibility» for the maintenance and conduct of the register (Article 5.3, Regulations on register of shareholders of joint-stock company).

The said principal issues of legal regulation of non-documentary securities were bound to generate difficulties and obnoxious omissions when the parties

sought an effective way of legal defense. This is what happened during the court hearings which we address below.

III. Theft of a Large Block of Shares from The AO Rostelecom Register and the Ccircumstances of the Ensuring Dispute

In November 1994 a certain gentleman came to the organization (hereinafter, the «Responsible Registrar») which kept the register of AO Rostelecom. He was provided with powers of attorney from the shareholder (hereinafter, the «Foreign Shareholder») and an instruction to transfer a large block of shares of a Bahamas company (hereinafter the «Bahamas company»), as well as powers of attorney from the Bahamas company and the transferring instruction on the further transfer of the securities to the account of a company in Cyprus (hereinafter the «Purchaser»). He also presented the agreements to purchase the shares. Sensing nothing suspicious in the overly routine and oft-repeated operation, the Responsible Registrar's officials transferred the shares to the account of the Purchaser and made the appropriate entry in the register. Quite a long time passed before the Foreign Shareholder discovered that he had a much smaller number of shares.

A dispute arose. The claims of the Foreign Shareholder (hereinafter the «Plaintiff») were mainly addressed to the Responsible Registrar who, it turned out, made the entry based on forged documents, thus allowing a major theft to happen. Unidentified frauds had illegally appropriated and sold to the Purchaser a block of shares which, at the peak of their value, amounted to 15 million dollars. The request of the Foreign Shareholder to have the entry restored was declined by the Responsible Registrar. The latter produced from his files two powers of attorney, two transferring instructions and two simple share sale agreements with one forged bank entry concerning registration. The only apparent negligence of the Responsible Registrar's officials was not paying any attention to the fact that the transfer order indicated the Foreign Shareholder as the nominee holder of the shares while the register referred to him as a shareholder.

The head of the Foreign Shareholder claimed that he did not sign either the powers of attorney or the transferring instruction. In the ensuing criminal case, the block of shares held by the Purchaser, was arrested under Article 175 of the RF Criminal Procedural Code. The investigator ordered an expert examination which found that the signatures on the powers of attorney and the transferring instruction were forged. It became clear that such a fraudulent scheme could be devised by those with access to the Foreign Shareholder's confidential information, possibly through his employees or persons who had been monitoring the operations on the stock market. By now are we able to observe that the authors of this crime are still not found after seven years. But let us now come close to the ensuing economic dispute.

IV. Initial Stage of Litigation

Shareholder claimed that the two successive transactions shall be found null and void and that the entries be restored in the shareholder register. The principal defendants in the case were the Responsible Registrar and our client, AO «Rostelecom». The sides to the transactions were called to join the litigation as third parties. Following this legal logic, the Foreign Shareholder accomplished some temporary results. The block of shares, held by the Purchaser, was arrested once again as a collateral, while the claim was granted with the ruling: «to obligate the registrar to restore the entry in the register».

The Responsible Registrar attempted to defend himself by adducing two arguments, but to no avail. Firstly, he asserted that, in making the entry, he acted *prima facie* in good faith and in accordance with the applicable procedure. Secondly, the Responsible Registrar suggested the following qualification of the transaction between the Bahamas company and the Purchaser: it must be valid since the Purchaser received the shares encumbered with the rights of a third party, i.e. the Foreign Shareholder, which should only reduce the purchase price of the shares (Article 78 of the USSR Fundamentals of Civil Legislation). However, the latter version failed to get upheld by the court. The latter deemed both transactions invalid according to presented evidences, and accordingly adjudged the Responsible Registrar to restore the entry in the register.

The Court passed a judgment which was quite bizarre in its essence. As to the claim to apply the consequences of the nullity of the invalidity of transactions, the court, firstly, did not call any of the participants as defendants, but only chose to treat them as third parties, which, by their procedural status could not be compelled to compensate, although the invalidity of the transactions leads to restitution between the parties and the obligation to return whatever had been received under the transaction in question; secondly, it obligated the Responsible Registrar to restore the entry, i.e. the rights of the Foreign Shareholder to the non-documentary shares, but did not specify from whom these non-documentary shares should have been taken. It was natural that such a paradoxical decision could not stand, and soon it was appealed and rescinded, while the case was returned for a new adjudication by the Court of original jurisdiction.

In our opinion, such a failure of the court proceedings is explained by the wrong choice of remedy. We believe that the Plaintiff could obtain positive results much faster and simpler if he submitted a claim only to the Purchaser, without calling a plurality of persons to participate in litigation. In the meantime, the Part 1 of the RF Civil Code had already came into effect. Article 149 permitted obligating the Purchaser, not the Responsible Registrar, to restore the rights of the Foreign Shareholder, as supported by the non-documentary shares under Article 12, Part 3 of the RF Civil Code, because the Foreign Shareholder, firstly, was incorrectly and against his will deprived of the possession of shares and, secondly, these rights as a form of property were individualized and kept on the personal account of the

Purchaser and under arrest. It was the Purchaser, not the Responsible Registrar, that was the possession of these rights. The fact of their potentially bona fide acquisition was of no legal effect as it was possible to assert that the rule to defend the bona fide purchaser under Article 384 of the RF Civil Code was not applicable to the rights. The Foreign Shareholder's lawyers preferred however to stick to certain interpretation of the legal status of the registrar, which proved to be quite disadvantageous for them. They obviously considered him to be the responsible holder of the shares who in this particular case made a mistake and displaced things belonging to the Foreign Shareholder from one cell and put it in another, so nothing could prevent him, the holder, from restoring the shares to the first cell. As opposite to the above position, Article 149 of the RF Civil Code describes the registrar as the one who merely registers or fixes the rights of shareholders, and to whom the function of keeping the register is delegated by the joint-stock company under certain conditions.

V. New Claims from the Foreign Shareholder. The Number of Litigeous Participants Increases

In that complex and drawn out case our law firm represented the interests of the issuer of the shares Joint – stock company (AO)»Rostelecom» and his New Registrar who replaced the previous after such an outrageous and notable case of fraud. Not long before our joining the case, almost two years after it's start, the Foreign Shareholder filed three new claims, aiming at having his losses indemnified either at the expense of the Purchaser or the Responsible Registrar or at the expense of AO «Rostelecom» – the largest and well-solvent participant from whom the indemnification would be the simpler and faster. The Foreign Shareholder claimed that the AO «Rostelecom» compensate the damage based on part 1 of Presidential Decree No. 1769 of 27.10.93 «On Measures to Safeguard the Rights of Shareholders», that the issuer is obligated to ensure the keeping of the register. This claim in question was the most dangerous one for our client, and if granted, could amount to losing the case. Two more requests, aimed at satisfying the claims to the Purchaser or the New Registrar, in our opinion, were not quite promising in concept, given that the prospect of having them satisfied under that circumstances was not reasonably estimated.

The content of the new claims from the foreign shareholder and the way his arguments were coordinated should be addressed briefly.

In the second hearing of the original case, the Foreign Shareholder changed the content of the pleading part of his claim and invoked a new remedy – to apply the consequences of the invalidity to two null and void transactions which successive performance resulted in the block of shares getting transferred to the Purchaser. In this regard the Bahamas company and the Purchaser, who had concluded the allegedly null and void transaction were indicated as defendants.

Purchaser was claimed to be obligated to return the shares as the transaction to purchase the shares was invalid for the reason of «being based on a previous invalid transaction».

The second claim was based on the use of the concept of losses and, as mentioned above was addressed not to the Purchaser but to our client, AO «Rostelecom», and to the Responsible Registrar. The claim contained a reference to the general rule that AO «Rostelecom» was responsible, firstly, for the choice of the registrar, and, secondly, for the accurate conduct of the register and the safety of the entries. The demands of the second claim relied on joint liability of the debtors that were commercial legal entities (Article 322 of the RF Civil Code). Satisfying the second claim opened the door for recovery of the equivalent of the fair market value of AO «Rostelecom» shares or the positive price margin, if, in different case, the Foreign Shareholder was awarded to get the non-documentary shares in kind.

The third claim against the New Registrar and AO «Rostelecom» pleaded for recognition of invalidity of the register entries on Purchaser's ownership of shares and restoration of the previous entry that had been annulled as a result of the fraudulent actions by the unidentified criminals. The Foreign Shareholder's lawyers presented the following argumentation supporting their claims. The entry on the transfer of the block of shares from the personal account of the Foreign Shareholder to that of the Bahamas company was made without due juridical grounds and thus was invalid, i.e. having no legal implications, which was why the previous entry had to be restored. Our client (the AO «Rostelecom») was involved as a co-defendant, since under part 5.3 of the said Regulation "On the register of the joint-stock company" the issuer was responsible for the registrar's mistakes. The Foreign Shareholder's lawyers insisted on defining the legal status of the Responsible Registrar as the representative of AO «Rostelecom».

The fourth claim pleaded as follows: to recognize the rights of ownership of the shares, to request the return of the shares from the Purchaser's unlawful possession. The claim filed against the Purchaser as a defendant, while the AO «Rostelecom» was indicated as the third party. The Foreign Shareholder's claim was based on inaccurate legal construction of the nature of a share as a security: the non-documentary security was not only referred to as a tangible asset, subject to the right of ownership (contrary to Article 149 of the RF Civil Code, this is asserted by Article 28 of the Law «On Securities Market»), but also admitted of splitting the right of ownership with regard to non-documentary shares.

There was no doubt that in this case the Claimant's lawyers had been misled. According to their own reasoning one could, still remaining the so-called "owner of the shares", transfer a part of the rights to them and thus forfeit the corresponding self-legitimacy as the titular shareholder. It turns out that the person entered in the register may not be the owner of all the rights to the shares, since the previous shareholder transferred to him only a part of the rights. There is no need to dwell

at length on how much this contradicted to the very notion of a security as a document or an entry which linked all the rights in a way that they could not be transferred or exercised without the transfer or presentation of the appropriate document or data on the entry (part 1, Article 142 of the RF Civil Code). As an instrument of a market economy, shares can only exist as instruments publicly certifying the rights unencumbered with liens or property-related powers «in a pure form». If a security could be linked with undesignated encumbrance or a reduced set of rights, this would have meant that the principal function of securities couldn't be realized.

Representing the defendants, we were satisfied with this ambiguity of claims, which had not been eliminated at the Court's initiative as it should have happened in the case like that. In the contested proceeding, hearing out the arguments of the parties, the judge is supposed to specify the substance of the demands and, if they are not formulated correctly, suggest their adjustment. Regardless of the above the court must decline the claims presented so incorrectly that their satisfaction and enforcement would be simply impossible.

The most conspicuous, and perhaps the most amusing case in point is the third claim to recognize the entry, made by the Responsible Registrar, invalid «in virtue of failure to accord to the actual circulation of shares» and to restore the previous entry.

It appears that the entry itself cannot be deemed invalid in the *civilis* meaning of the word. Invalid or devoid of legal effect there could be admitted the acts (such as transactions), or the legislative acts of authorities i.e. the legal facts that affect the emerge or existence of legal relationship. It is more correct in some situations to describe an entry as false, incomplete and so on.

If the court accepts that the grounds for making an entry are invalid, this does not deprive the entry itself of a legal meaning. «Restoring the previous entry» is an imprecise term, for it is not possible to recreate what has disappeared or been destroyed, one can create something new but identical to the old.

The entry complying with the formal requirements always has a legal meaning. What is admissible its replacement with another «valid» entry based on the transfer of ownership rights by according to contractual obligations or Court's order.

Notable Russian legal scholar, E.A. Sukhanov points out that «an entry on the account», stored in the computer memory and made by its «owner» cannot be lost or transferred to another person despite the observance of any amount of formalities: it is just that one entry is simply changed or destroyed and replaced by another entry».[1]

In our opinion, there was also little promise in the case involving application of the consequences of invalidity of null and void transactions. Firstly, in the event of satisfying these related claims the block of shares should have been transferred to the Bahamas company and then the Bahamas company would turn it over to the

[1] Commentary to the part 1 of Civil Code RF, Moscow. 1996, p. 22.

Foreign Shareholder. Considering, however, that the foreign claimant and two foreign defendants participated in the case, it would tend to substantially prolong the process. Secondly, it was still unclear why the second transaction should be deemed invalid as it had been «based on the previous invalid transaction». To support the latter, the Foreign Shareholder's lawyers actively used an ambiguous argument that the second transaction between the Bahamas company and the Purchaser must be admitted found void, since the Bahamas company disposed shares that had not belonged to it «in the right of ownership» at the time of the contract conclusion, although it is common knowledge that the seller has the right to enter agreements on transfer of movable property as well as ownership rights (part 4, Article 454 of the RF Civil Code) that he only intends to purchase (part 2, Article 455 of the RF Civil Code) and these rules are also applicable to the transfer of shares.

VI. The Course of the Court Hearing

The second stage of the court hearings was notable because a large number of defendants and third parties participating in different cases and different combinations. It was unavoidable for the defendants to be divided by their own preferences concerning the litigation strategy such as the possibility to speed up or suspend certain court proceedings with the help of trial ploys. Our client's interest was that the Court reached a decision awarding the Foreign Shareholder to recover all from the Purchaser. Other participants were interested that under the second claim our client (a largest nation communications operator) would have to indemnify all Foreign Shareholder's losses, including of what had constituted the price difference in the block of shares. The latter decision would threaten the well-being of AO Rostelecom and thus at least procedural barriers ought to have been erected to prevent it. The hearings on the third claim to restore the entry were also fraught with a decision unfavourable to our second client – the New Registrar. The claim however was based on arguments already rejected by the court of appeals which had dismissed the first decision.

In the above cases (on recovery of losses and restoring the entry) we planned to file the motion to suspend the hearings on the ground of the impossibility of a decision being passed before the end of proceeding on the related cases.

Regardless of this, our lawyers carried out a painstaking legal analysis and elaborated the substantial arguments on the matter.

As to the case of the losses recovery, we filed the points of defence, where we asserted, that according to the applicable civil doctrine, the circumstances of the case should be construed as tort (causing harm) that is to be indemnified by the actual tortfeasor (Article 1064 of the RF Civil Code, Article 126, parts 1, 5 of the USSR Fundamentals of Civil Legislation).

We pointed out that the grounds for civil obligations accrual are limited to those that listed in articles 3, 57 of the USSR Foundations of Civil Legislation

(Article 307 of the RF Civil Code). In his claim, the Foreign Shareholder cited the provisions related to extra-contractual obligations to compensate the losses, i.e. the damage, notwithstanding the fact that Article 1064 of the RF Civil Code (Article 126 of the USSR Foundations of Civil Legislation) provided a mandatory principle that the caused harm should be compensated solely by the tortfeasor.

We further asserted that by the time of the unlawful withdrawal of the shares (November 1994) there were no legal regulations concerning the responsibility of the issuer (AO «Rostelecom») for the mistakes of the registrar. The provision concerning responsibility for the actions of the Registrar were enacted only in 1995 according to an amendment into the President's Decree «On Measures to Safeguard the Rights of Shareholders» No. 1769 of 27.10.93 and thus could not be applied to the circumstances that had existed before. In addition, the issuer who authorized Responsible Registrar to conduct the register, is only responsible for the technical safety of the register entries in general and its ceaseless conduct, but not for the actions of the Responsible Registrar which fall within the framework of carrying out his professional and licensed activity of register the transactions with the issuer's shares, on which the latter is not informed at all.

In our response to the claim it was also accented that the arguments of the Foreign Shareholder on the alleged existence of the solidary obligations of the Responsible Registrar and AO «Rostelecom», had no legal authority because in the year 1994 the applicable rules were those of the Foundations of Civil Legislation of the USSR and the Union Republics, part 2, Article 67, which provided direct statement of law or the parties' agreement as sole condition for joint liability, which was not the case at that time.

Our firm also raised the following objections to the claim:

The New Registrar had the status of an independent Register Holder (Registrar). Article 149 of the RF Civil Code provides that in cases defined by the law, the person who had been granted a license could register the rights certified by named non-documentary security.

The applicable regulations provided limited grounds for making changes in the register:

– the owner's order to transfer securities;

– other documents confirming the transfer of the rights to securities under the RF Civil Code (for instance, the Court addressed to the shareholders or documents of inheritance).

By the time of litigation, the New Registrar was not obligated to make entries as there were no orders from Court or persons included in the register.

All the three new claims were filed in November 1997.

The most important of claims had failed from the outset. The shares recovery claim was declined by the court on the ground that the address of the Defendant (Purchaser) had been provided in English. The court applied the rule on the formal defect of the claim, citing Article 8 of the Code of Arbitral Procedure, which

indicates Russian as the official procedural language. To file a corrected claim would have opened the possibility for the Purchaser to raise the objections as to the statute of limitations. As to the expiration of the three-year statute of limitations, it could be asserted by Claimant that he was not supposed to know about the violation of his rights exactly in November 1994 because he had not been obligated to inquire on the condition of his account in the register and also because the filing of a claim as to the case of the nullity of the transactions restored the limitations term (Article 203 of the RF Civil Code). Nevertheless, apparently in order to avoid the risk, the Court's decision to decline the claim on the said formal ground was appealed by the Foreign Shareholder.

The court of appeals upheld the decision of the lower Court, however the Foreign Shareholder prevailed in the Court of cassation, and the case for the recovery of the shares, the most favourable case for us, was sent to the court of the original jurisdiction to be adjudicated.

The case on losses recovery was initially dismissed according to the motion of the Responsible Registrar. The latter had discovered that under the Foreign Shareholder's Charter, the powers of attorney on its behalf should be signed by two directors simultaneously. The Claim was signed although by a person who had been authorized by the powers of attorney which had been signed by one of two directors. The Foreign Shareholder appealed the court decision to dismiss which was satisfied only by the court of cassation, the latter had considered not only the provisions of the Charter but also the Irish law on companies of 1965-1990. Construction of the provisions of that law admitted of the effect of the powers of attorney issued by one director. Thus, the case on losses recovery, the most unfavourable one for the AO «Rostelecom», was also passed to the first curcuit court.

Prior to the beginning of hearings on the recovery losses case, the Foreign Shareholder filed a motion to suspend the hearings until the resolution of the disputes regarding the invalidity of the transactions and recovery of shares. It is not clear what reasons or estimations brought the lawyers of the Foreign Shareholder to another strategic mistake. Suspending a case could hardly be deemed reasonable. The case was favourable to them and non-contradicting to any of the other filed claims, moreover the participation of foreign companies was not required in the proceedings otherwise there was no need to notify them through diplomatic channels. Apparently, the Foreign Shareholder was convinced that the case on invalid transactions was a most important for them. Meanwhile, the court of cassation' decision declining the previous decision regarding two successive deals as invalid, pointed to the need to «specify the requirements of the Plaintiff.» In the judicial parlance this meant that the claim ought to be changed in question and the grounds for it should be based on different rules and so on.

The motion was very actively argued in hearings. The Purchaser categorically objected to the suspension of the case, alleging that the recovery of losses case,

was a separate matter, that the clarification of circumstances and modalities of the liability of the Responsible Registrar and the AO «Rostelecom» was in no way related to the nullity of the deals and the application of appropriate legal consequences, and that the real issue was mere proof of negligence of AO «Rostelecom» in choosing the registrar, etc. We supported the motion, arguing that without the court's most important determination on whether the Purchaser had acted in good faith the possible guilt of the Foreign Shareholder and the involvement its responsible employees in fraud, it was impossible to consider issue of liability of the AO «Rostelecom» and its ex-registrar. The court granted a motion and suspended the case, which was the most unfavourable one to our client.

It is noteworthy, that the court decision to dismiss the claim to recover the losses was actively appealed by the Purchaser, who participated in hearing as a third party. His appeal was declined. The court of cassation upheld the following arguments which were raised by us in response to the claim.

In response to the Purchaser's allegation that the court may suspend the case only after it had started to adjudicate it on the merits, we cited the provision of Article 81 of the RF Arbitral Procedure Code, which provides the rules applicable to the pre-hearing proceedings but not to the adjudicating the case on the merits and argued that, under Chapter 14 of the RF Arbitral Procedure Code, the first stage of litigation was the submission of claim rather than Court hearing (Chapter 16 of the RF Administrative Procedure Code).

In his cassation appeal the Purchaser also alleged that the court had significantly restricted his procedural right under Articles 33 and 39 of the RF Arbitral Procedure Code by narrowing the framework of the hearing to a mere consideration of the motion. We objected to this since the very concept of case suspension, as laid down in Chapter 8 of the RF Arbitral Procedure Code, is not aimed to restrict the rights of the individuals involved in the case, but rather at ensuring the examination of all relevant evidence after the hearing renewal. The rights of parties to a case are observed to a greater extent after the court has resumed examining the losses recovery case following the delivery of the decisions in other trials since, for instance, the circumstances of the shares recovery case are directly linked with the grounds for the claim in the case in question, and delivered decisions could have res judicata effect for the suspended case.

We have also managed to reach the suspension of case on restoration of entry.

Thus, the proceedings which threatened our clients turned out to be suspended.

Then the Purchaser tried the same stratagem to suspend the shares recovery case, in which he was the principal Defendant. This was to no advantage for our clients, therefore we actively objected his motions. The court of appeal granted our motion not to suspend the case.

Further on, however, the other consequences of the conceptual strategic mistake of the Foreign Shareholder's lawyers in choosing a wrong request, which was to apply the consequences of the invalidity of void transactions, came to effect. This implied judicial proceedings involving a large number of foreign participants had no interest in adjudication. In preparing for the hearings, the court had to, (according to Russia's commitments under the 1954 Hague Convention Relating to Civil Procedure (Article 1), notify foreign respondents and third parties through diplomatic channels. This led to an automatic and, alas, inevitable delay in litigation. With the aim to delay the resolution of the shares recovery case, the Purchaser succeeded in decision to call the Bahamas company as a third party in the case that was most disadvantageous to him. Unfortunately, such decision is not subject to appeal under Article 160 of the RF Arbitral Procedure Code. The failure of foreign participants appear for the hearings had forced the judges to postpone hearings by three to six months at a time. Over a year elapsed in this manner.

VII. Crucial Motion from AO «ROSTELECOM»

Our clients were not happy with the development of the proceedings. The situation kept them on edge and involved expenditures; worse, pending cases that involved claims worth millions of dollars tended to affect the financial indicators in the reporting periods and made the AO «Rostelecom» stock less attractive to investors.

We were asked to speed up the dispute – resolution process, therefore an additional analysis of the proceedings was conducted that brought us to the following conclusion: (1) to move for elimination of Bahamas company from the process, because the latter, as followed from the newly presented documents, had been temporarily excluded from the register of legal entities at the place of incorporation for failure to pay the annual fee (2) to explore the matter of the Purchaser having acted obviously in bad faith when buying the shares.

We drafted and filed the addendums to the statement of defence to the Court and to the parties, where we argued that in the shares recovery case there existed the following circumstances indicating the Purchaser's bad faith.

1. The Purchaser acquired the disputed shares through his proxy, a broker on the securities market. Less than two weeks before the acquisition of the shares from the Bahamas company, the Purchaser had signed a contract with the broker, under which the latter had acted on behalf and at the expense of the Purchaser as his representative.

2. The counterparty of the Purchaser under the brokerage services contract entered a sales agreement sygned by someone with a Russian name, indicated in the text of the agreement as «the authorized representative acting in accordance with the Charter» of the Bahamas company. Meanwhile, the person authorized to sign agreements, under the RF legislation and under the 1989 Law of the Bahamas

Islands, should be either the director (general director, president) of the company or a person acting under legalized powers of attorney.

We argued that the above circumstances should have arisen the suspicions of a prudent contractor who concluded the agreement worth several million US dollars as regards the autharity of the Purchaser's counterpart to dispose of the shares. We insisted that the Purchaser's representative did not duly abided the business customs as they had developed on the Russian stock market by 1994 and did not exercise due diligence, which brought about a situation in which the Purchaser himself could be regarded as a person acting in bad faith and committing, through his broker, an act of gross negligence.

The above developments, as we stated in the addendum to the statement of defence, made it possible to reach at a sufficiently well-grounded conclusion to the effect that, at any rate, there was no exercise of due care, caution and diligence in establishing whether the person disposing of the shares as benefit of the Purchaser had the authority to do so.

We further asserted, on behalf of the client, that there were grounds for satisfying the claim at the expense of the Purchaser by virtue of his representative having acted in bad faith in purchasing the disputed block of shares.

The motion to exclude the Bahamas company from the proceedings was based on Article 161 of the USSR Fundamentals of Civil Legislation on the personal status of the legal entity and the interpretation of the provision of the Bahamas foreign companies law to the effect that the legal entities excluded from the register but not liquidated had their legal capacity restricted and thus could participate in litigation only as defendants. Hence, we concluded that such persons could not act on the side of the Plaintiff or the third party and that was why their participation in court proceedings on the territory of Russia was not possible and meant no importance for the dispute resolution.

Outrunning the story, we should mention here, that the addendum to the statement of defence, although not evaluated by the court by virtue of the circumstances outlined below, produced due effect: having considered them, the Purchaser entered into negotiations with the Foreign Shareholder to settle the dispute and to conclude an agreement. Under the settlement agreement and for an appropriate undisclosed consideration, the Foreign Shareholder withdrowed all the claims and these withdrawal were accepted by the court. The Purchaser became due owner of the block of shares he had purchased. AO «Rostelecom» and the New Registrar were only supposed not to objection to the revocation of the claims. Thus, this long-drawn-out, complex and one of the most noted cases ended favourably to our clients, who were not required to reimburse or transfer anything to anyone.

VIII. In Remedies Avaliable to Purchaser of Non-documentary Shares. Conclusions

The court proceedings described above, require a separate analysis and discussion for a number of reasons. They brought to light some of the problems of legal regulation of the times when our national economy was going through the first period of rapid growth, not based on actual development of production of goods or services but merely on investment expectations, and therefore was fraught with a similarly rapid meltdown of the financial markets. The said drawbacks of the legal regulation on securities circulation and the lack of judicial practice regarding the respective legal concepts, revealed themselves in the proceedings and cases described.

Since, non-documentary registered shares have gained wide commercial usage in Russia, the crucial legal issue of protection of good-faith purchasers has also emerged. Article 302, which is included in Chapter 20 on «Protection of Right of Ownership and Other Rights In Rem», of the RF Civil Code only applies to the rights *in rem*, but not to the right *in personam*. Although, Article 28 of the Law «On Securities Market» provides the ownership right to the non-documentary securities, the latter could not be construed as the material objects. That would directly contradict to the literal meaning of Article 149 of the RF Civil Code.

The mixture of non-documentary shares and *things* could cause a great confusion and many misunderstandings as the entire structure of the civil concept of ownership is designed for the regulation of the material objects. For instance, if one considers non-documentary shares as material objects, one must admit that they remain with the registrar, whose legal status is to be then determined by the bailment regulations under Article 906 of the RF Civil Code, that the registrar is obligated, as regard to each and every shareholder, to deliver an appropriate number of shares, and that in general there is direct correlation between the registrar and the bank collecting the deposits from clients. However, this does not quite conforms with the nature of the registrar-shareholder relationship. The former never collects shares from a client and is not obligated to return them in the event, for instance, of a new issue of shares, distributed in proportion among the shareholders. This is a function of the issuer.

Furthermore, if one admits that non-documentary shares have material substance, while the things are property with material substance (weight, form and dimension), and that such shares are «kept» by the registrar, the liability for negligence (part 2, Article 901 of the RF Civil Code) and any mistakes of the latter should be regulated by the provisions of the contract of bailment, and one can file a claim to have an entry in the shareholders' register restored. It would not be realistic however to have such a claim adjudicated because of the intangible essence of non-documentary securities.

If one treats non-documentary shares as things, the agreement to sale them automatically falls within the provisions of part 3, Chapter 30 of the RF Civil Code on goods supply agreements, while these provisions explicitly barred from application to the sale of such shares.

The above mentioned civil case has made it possible to conclude that it could only be accurate to consider non-documentary securities as property rights, rather than things. The concept of ownership does not apply in this case, because in the event of an actual dispute, the remedies in rem proved to be inapplicable.

Meanwhile, it is vitally important for the securities market to have the *bona fide* purchaser concept as regard to non-documentary shares. The aim of the concept is to protect the commercial turnover from unjustified claims by third parties that could undermine the confidence of any shareholder in the soundness and integrity of his or her title.

It is a common knowledge that there are rights *on* shares (the right to sell or mortgage them, or otherwise dispose of them) and the rights derived *from* shares (the shareholder's right to participate in the shareholders meetings, to vote and to distribute dividends and assets upon liquidation). The rights on shares are always rights *in personam*, regulated by law of obligations. When we talk about in rem remedies available for bona-fide purchaser of shares we only refer to the rights *on* shares. The documentary medium formalizes and makes as of the characteristics and essential features of a share precise and accessible. That is why the rights on shares circulate, similar to things, that have their useful attributes, so to say, «laid out.»

The property rights certified by non-documentary shares have an even higher degree of reliability and clarity of essence than the *things* which characteristics only reveal when being utilized. In this sense they are quite different from the rights *in personam*, which substance is not visible for third persons. The public authenticity of non-documentary shares is even greater than that of a documentary security, as information about the former is accessible simultaneously to a wider circle of persons.

Another feature distinguishing non-documentary shares from the rights *in personam* is that they do not get terminated or cease to exist in the event of the death or liquidation of the shareholder/lender, but rather remain unchanged to certify the scope of legal faculties of the heirs or the purchaser through their being realized as part of the liquidation assets. In this sense, the non-documentary shares are closer to things. That is why the in rem remedies should be available for their bona-fide purchaser as well.

Addressing the importance of soundness of commercial circulation of non-documentary shares, the RF High Arbitration Court ruled in 1999 that the bona-fide purchaser concept should also be applicable to non-documentary securities as well. Commentators, however, did not readily and fully support the above decision

RF High Arbitration Court: «Article 128 of the RF Civil Code considers the securities as things, and under Article 149 of the RF Civil Code securities, including shares, could be issued in non-documentary form, but even latter this case they are not excluded from the objects of the rights in rem.»[2] Thus, it is suggested that non-documentary securities should be referred as things, which, as the hearing of the above civil cases has demonstrated, leads to many misunderstandings in practice. Furthermore, Article 149 explicitly addresses «holders» rather than «proprietors» or «owners» of non-documentary securities. Part 2 of this Article stipulates the mandatory registration of «restrictions on the rights.» It is hard to assume the rights arising from shares could be restricted on an individual basis. Hence what we consider here are encumbered rights on non-documentary shares, such as arrest, lien, and etc. These are not explicitly stipulated in the list of the rights in rem, in civil code they must be implied for the list of those rights is open.

We are clearly confronted with an issue that should have been resolved by amending the laws on securities without coming into conflict with the concept of Article 149 of the RF Civil Code. In accordance with the opinion of Professor E.A. Sukhanov, the issue of regulating governmental non-documentary securities in Germany, for instance, was solved by «making such rights *in personam* subject to the legal regime of movable things (regarding primarily procedures of their transfer and protection of *bona-fide* purchasers) by establishing a "juridical fiction"».

In our opinion, Article 302 of the RF Civil Code could be applied for protection of bona-fide purchasers of non-documentary shares by the following reasons. The rights on shares and those derived from shares, as described above, are the rights of a general character, but there are also others, for instance, the right to receive extracts from the register, the right to transfer shares to a nominee holder, and so on. Firstly, given the nature of securities, all the legal rights exist inseverably, i.e. in their combination (part 1, Article 142 of the RF Civil Code). Secondly, the rights on shares are primary (they are the first to be acquired, while the rights from shares follow them).

All said rights on non-documentary shares rights from non-documentary shares are in the nature of the right *in personam*, and they cannot be an object of in rem remedies. But the right to obtain a certain number of shares in documentary form, accordance to the register data – i.e., the right to acquire certain things in the future - is precisely of an in rem nature since the shareholder may require any third person to refrain from actions violating this right. This is not the shareholder's right in personam addressed to the issuer regarding the delivery of a certain number of shares, the ownership right which first goes to him and then is transferred to the shareholder, but rather it is the right in rem on a future documentary security, which become an object of ownership right as soon as such a movable asset appears in documentary form. According to provisional (not-limited) list of rights in rem

[2] T.S Shapkina, Bulletin of RF Higher Arbitral Court. 1999 No. 5, on 91.

(part 1, Article 216 of the RF Civil Code), the right to a future movable asset under Article 305 of the RF Civil Code may be accompanied by a legitimate objection from the bona-fide purchaser. The right to a future documentary share is one of the rights of the shareholder, when his or her company has issued non-documentary securities. The remedies against the claims of previous shareholder (who had lost his possession of shares as a result of illegal action) are available through application of Article 302 of the RF Civil Code, which considers the bona-fide purchaser as the legitimate holder of the right to future documentary shares according to the register data and also of all the other related rights, i.e., as the owner of the entire set of interrelated rights in personam as certified by the non-documentary security. Ordinary registered shares, which useful attributes are the so-called rights derived from shares transferred through an assignment of rights (Article 146 of the RF Civil Code) and cannot enjoy the protection based on in rem remedies. What is protected is the right to the share derived from the right to own the documentary medium of the share.

We believe that this analogy justifies the application of the bona-fide purchaser concept to non-documentary shares as to non-material objects.