

RUSSIAN LEGISLATION ON THE TRANSFER OF RIGHTS TO A LEGAL ENTITY

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The conception of a commercial organization as nothing more than the means of carrying on the business of its promoters does not to a full extent reflect the legal nature of such an entity as the principal subject of entrepreneurial relations and an independent unit.

The Law confers on business companies a legal personality: the capacity to perform legal acts and be independently liable therefor.

Such independence is reflected by the use of special civil law category - a "legal entity". Legal entities are deemed to be organizations regarded in law as separate parties to commercial transactions with their own particular features of being separate: the name, organizational unity, etc. Civil law establishes legal equality for all the parties.

Equality relates to scope of legal capacity, limits of liability or equal opportunities of natural and legal persons and in no way means basic analogy among them. The legal position of individuals and organizations is so different that the two per-

sonalities are quite dissimilar in character. The company may, in virtue of its innate qualities, be also be an object of legal relations. The company may be dissolved, renamed, merged, joined, split, or its articles of association may be re-registered. Finally, the company may, as opposed to human being, be transferred to other parties (another party).

It is customary in certain cases to refer to the "sale" of the company. Though this rather means not the sale of a legal entity in the proper sense of this word, but an assignment of all the rights of its members (shareholders) for value.

The term "sale" means in law the transfer of ownership against payment of a certain sum of money. In literature and even special legal publications authors use the terms: "the right of ownership of a joint-stock company", "co-owners of a legal entity", etc. The use of such concepts is not always sufficiently justified.

It is necessary in our opinion to distinguish between the powers of its mem-



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bers with respect to the assets of a legal entity and their rights to own the legal entity itself.

In accordance with the Principles of Civil Law (art.II, p.2) members of a legal entity may be retain either personal or real rights with respect to the separate property of this entity. Members of companies, participants and business associations are not entitled to exercise a basic power to alienate the property of a legal entity, since they have only personal rights arising out of their membership: to receive dividends, to participate in the management by voting at shareholders' meeting, and also to vote at the election and appointment of operational management bodies of the legal entity.

In some particular cases the promoter reserves basic real rights to assets contributed to the legal entity to be formed.

An example is the formation of subsidiary enterprises (article 22 of the Principles of Civil Law) by the owner. The assets in such a case are not to be alienated by way of a contribution to the share capital but transferred for business purposes to a subsidiary enterprise on the basis of a derivative real right.

In accordance with the provisions of the Principles of Civil Law the Promoter, retaining the right of ownership of the assets of the legal entity, i.e. the right to sell

the assets to third parties (most often this is the State represented by an appropriate body), is entitled to constitute operational management bodies and to decide upon its reconstruction. Therefore, the purchaser of assets, transferred to a legal entity, does not buy the legal entity itself, but, as a result of the acquisition of its assets, obtains directly the appropriate scope of authority to appoint, elect and dismiss officers and the right to decide upon the reconstruction.

Where such an acquisition of the assets of a legal entity is not linked to powers of control and management, the acquisition of the entire assets in no way affects the rights to a legal entity. For, instance a limited liability partnership which has transferred the right of ownership of its entire assets remains a partnership without assets, and its members do not lose any powers of management, to receive dividends, to appoint directors and the like.

A particular reference should be made to certain provisions of the Russian Law entitled "On Enterprises and Entrepreneurship" whose operation must, as a general rule, exclude provisions of the Principles incompatible therewith.

The assets of joint-stock companies and limited liability partnerships are under the Law co-owned by their members and



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shareholders. This is a quite unacceptable position for legal entities established by joining capital (shares) and was quite justifiably criticized since it frustrated the principle of separate liability and property of legal persons. The practice has made the requires amendment of this rule.

The High Arbitration Court of Russia in its letter of April 30, 1991, No. 1-13/OPIP-174 clarified that the assets of a limited company or a limited liability partnership are owned by the company or partnership themselves. Therefore, since the ownership of one and the same thing cannot be vested in a legal entity and simultaneously its co-ownership be vested in its members, the construction of the members' co-ownership must apply to shares of the partnership or shares of stock of the company only after dissolution.

Whether the term "sale of a legal entity" is in principle possible if it is understood as an assignment for value of all the rights of management and payment of dividends and the transfer of the property in appropriate objects by way of corresponding property rights, or such a problem cannot be viewed in terms of sale transactions since all these may be effected by individual under rules of private law, is a matter linked directly to the clarification of the legal nature of legal entities as a whole,

which was at one time the research subject of some prominent lawyers members of European schools of law.

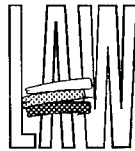
Nearly all legal entity doctrines date to the 19th - early 20th centuries, a period of the growing domination of economics and exchange of goods requiring, *inter alia*, a theoretical study of basic concepts of law governing appropriate relations.

The well-known German jurist Savigny deemed a legal person a fictitious existing only in contemplation of law.

Believing that an artificial entity exists for legal purposes only, he regarded it as having no legal capacity as distinct from its management bodies constituted by real personalities, individuals.

The basic rules of this doctrine were embodied in the case law of English system of law regarding a corporation as "an artificial being, invisible, intangible, and existing only in contemplation of law". Such a definition was made by the US chief Justice DMarshall as far the early 19th century.

The principles of another most common "organic theory" were developed by Savigny's compatriot Gierke. In contrast to the fiction doctrine a legal person is deemed herein as an independent person of



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reason and will and a joint personality, an entity. This theory found many supporters from among jurists in continental law countries.

Both "a joint personality" and "a fictitious being" cannot obviously, be an object of ownership and the subject of a contract of sale as being incompatible by their features with such a transaction.

If a legal entity is, however, considered from the viewpoint of "property manager" which has become quite common in our national theory (Vendiktov is one of its authors), then the treatment of the transfer of all the rights of its member to a legal person as the acquisition of such property by them as owners is no doubt acceptable and justifiable.

The two main features of companies lie on the basis of their being capable of passing from one person to another:

the existence of this entity separately from persons constituting it (promoters, members and shareholders), and its individual value depending on its commercial position, prospects and goodwill making up a company's "chances".

The purchaser of a legal person bills in right away the "niche" in the economy which his predecessor has earned.

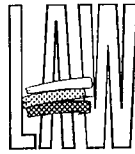
The goal of acquisition of a company may be a desire to have the privileges and

advantages that have granted to it or arise from its legal status. Of a certain interest may be legal persons that have obtained in a legal manner licenses to transact business on securities market, to mine mineral deposits, to export strategic commodities, to sell armaments, or a right to a long-term lease of realty, or a profitable building contract. The privileges may relate, say, to a certain share of foreign investments in the share capital (customs privileges), or to a company being incorporated by a certain public organization having a special status (tax privileges).

The acquisition of a company may also be linked to other goals: in view of urgent necessity and avoiding the registration procedure to obtain "one's own enterprise", - in such a case rights to unused, inactive, legal entities are assigned; or, say, to optimize a complex business operation to meet the requirements of the tax, customs or foreign currency legislation, i.e. the purchase for once-only purposes.

Expensive equipment may, for instance, be imported as a contribution to the share capital of a company specially incorporated for this purpose.

In doing so it is not necessary to pay an import custom duty, a tax on profits and in certain cases, a value added tax.



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The mode of acquisition of companies is nearly always specific under the laws of different countries, i.e. it must be adjusted to a country's restrictive business practices policy and the rules of an appropriate law. The simplicity, clarity and speed of such a mode are, on the other hand, the most important conditions of share holding investment (investments in securities of legal entities).

The most convenient legal form of association to be acquired are such legal entities the membership of which is linked to the ownership of shares, i.e. joint-stock companies.

The mode of the transfer of rights, effected in this particular case by the sale of shares, must be fairly simple. The Russian law-maker has, unfortunately, when drawing up and enacting appropriate rules of law, failed to attach a serious importance to the matter of clear legal regulation of the procedure relating thereto.

The acquisition of companies under the existing law is subject to such a package of conditions as make it quite complicated.

Shares may not be sold (circulated) unless they have been issued.

The issuance of securities is subject to:

- the registration of a securities issue, a cumbersome procedure not fully meeting the requirements of the present-day economy;

- the payment of stamp duty (a tax on securities transactions);

- the acquisition of 15% of shares of any joint-stock company requiring a prior notice to the Ministry of Finance of Russia, and 35% - a permit of the Anti-Monopoly Committee wherein the consideration of such applications takes at best 1 month (p.50 of the Regulations of the Issuance and Circulation of Securities and Stock Markets);

- a significant additional restriction on medium and big business is the compulsory sale of securities if their total value exceeds 50 million rubles on a stock market through the so-called "general offer", i.e. if some one wishes to buy such shares of a company, both the buyer and the seller must attend the stock market sale (p.42 of the Regulations of the Issuance and Circulation of Securities and Stock Markets).

The list of conditions is not confined to these: the purchase of shares transactions shall be deemed invalid under p.3.3 of the Ministry of Finance Regulations No.5-1-04 entitled "On the Mode and Terms of the Issuance of Licenses to Print and Import into the Russian Federation Securities Forms", if in doing so the use was



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made of securities forms printed without the appropriate license.

A failure to fulfill any one of the above conditions renders the acquisition of a joint-stock company unlawful.

It would hardly be reasonable to consider the notification and permission to buy 15% or 35% of shares of each joint-stock company by one person, regardless of their value and other parameters, as a necessary degree of control and an effective means of implementing the anti-monopoly policy.

Nor is any more favourable the other condition of the sale of securities in excess of 50 million rubles on the stock market. It fully eliminates the possibility of investments through private subscription, say, in insurance and banking wherein any investment below the above amount is hardly acceptable in principle.

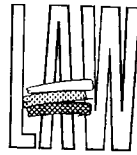
Particularly noteworthy is the above-said Ministry of Finance Regulations No.5-1-04. They run counter to all the fundamental principles of law whatsoever since they make a transaction whose subject-matter is the acquisition of the membership rights (i.e. the legal effect of the corresponding reciprocal obligations of the buyer and the seller) dependent on whether an authorization to print or import securi-

ties forms, which, after having been filled in, will evidence the shareholders' property rights, was obtained by the person who printed or imported them.

It is important in practice to keep in mind that shares circulation transactions will always be governed by special legislation and be subject to additional conditions.

In our experience we were sometimes amazed by the extent certain law firms effected the "sale" of companies by the signing a contract for the sale of 100% of shares just like the sale of building materials or garments. And it was under such contracts that the minute of the election of a new general manager was drawn up and new individuals got the authorization to have access to the company's bank account. One needn't be highly imaginative to picture the consequences that such a purchase of a legal entity may have for the new owners when after a certain period of profit-making business they will be confronted with a problem of having no rights to the company, all of its assets, funds, property, etc.

Neither the unfavourable legislation governing securities transactions, not other unsettled matters relating to the mode of acquisition of rights to a legal entity affect other legal possibilities to assign rights, which is not linked to the disposition of



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securities.

The effective method of "sale" within the scope of prescribed possibilities is linked to the use of other legal forms of association - a limited liability partnership or even a cooperative.

The cooperative, as the pioneer of entrepreneurship in the former USSR, though hardly a popular type of an enterprise, may be regarded as the most convenient entity for the "sale" since the admission and expulsion of its members requires neither registration, not the payment of fees, nor the fulfillment of any other conditions. No formalities are virtually required for any three parties, the buyers, to become members of a cooperative and then, by a decision of its meeting, to approve the retirement of all its other members, in effect the sellers, for a certain sum of money. There is no necessity for them to register the issuance of securities since they do not exist, or obtain some other authorization from the Anti-Monopoly Committee, the Ministry of Finance and the like.

In another respect, however, it appears to be practically impossible to use the legal form of a cooperative for the sale for the reason of a binding obligation to work therein as a condition of being a member there of under the law, and the ambiguous status of cooperatives which are not pro-

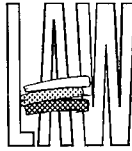
vided for as a type of an enterprise in the Russian Law entitled "On Enterprises and Entrepreneurship".

The only possible effective and legal mode of sale has proved to be a limited liability partnership whose advantage in this respect is just that its status of a legal entity has not been settled in detail.

Most advantages of a partnership compared to a joint-stock company are due to the absence of shares of stock evidencing the members' rights and are, therefore, not subject to the unfavourable legislation governing their issuance and circulation.

There are certain significant differences in the position of shareholders of a joint-stock company and members of a limited liability partnership.

A share of stock's a formal instrument, the property in which evidences the shareholder's powers, generalizes the dynamics of such powers, their transfer and acquisition. Shareholding is a kind of a binding condition of membership which terminates exclusively on its passing to another party. Upon retiring from a joint-stock company a shareholder may claim the market value of the share sold and none of the assets of the joint-stock company.



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The retirement of a member of a partnership differs in that he is to get a share of the limited liability partnership's property in proportion to his share in the authorized capital (p.69 of the Regulations No.590 entitled "On Joint-Stock Societies and Limited Liability Societies", June 19, 1990).

The absence of a developed securities market in Russia makes the acquisition of rights to a joint-stock company, in view of the problems of ascertaining the market value of shares, more complicated than through a similar transaction of the assignment of a share in the authorized capital of a limited liability partnership, the value of which must correlate with the value of the property accruing to a retiring partner.

There is another delicate matter - the purchaser of a share acquires net rights, i.e. no other liabilities of rights of his predecessor with respect to the company or its members pass to him.

If a shareholder, subsequently selling his share, is bound to do something in favour of the company, he is not relieved from his liability by the sale of his share since the share evidences only three powers: to receive net profits by way of dividends, to participate on the management of the company and to a part of the assets remaining after the winding-up of the com-

pany.

The acquisition of rights to the membership of a partnership implies conversely a complex succession the limits of which must, incidentally, be specified in the contract for the sale of a share or the assignment of rights to membership (subp. 3, p.67, the Regulations No.590).

The assignment results in succession to the rights and liabilities of a partner, but not to those of the promoter of a limited liability partnership. It is often assumed that the assignment of a share in a partnership's authorized capital must imply the substitution of a party to the partnership agreement and, therefore, the necessity to amend of the partnership instruments: such an erroneous assumption, which might not be obvious at first sight, raises no doubts after analyzing the content and subject-matter of a limited liability partnership agreement.

As can be seen from its very name, the partnership agreement must govern the reciprocal rights and duties of partners in connection with:

- 1) the drafting of the articles of association;
- 2) the registration of the partnership instruments;
- 3) the election or appointment of the original members of management bodies;



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4) the payment - in of shares.

There may also be other obligations, but they cannot be deemed essential as compared to those above.

The partnership agreement specifies obligations to demand whose performance the partnership is not entitled since it does not yet exist as a legal entity at the time the agreement is concluded as a legal personality, but parties to the agreement, i.e. other promoters, are. In the case of the acquisition of a share, succession is effected also to the relations with the partnership itself, which arises not from the partnership agreement, but from the relations between the partner and the partnership. The condition of such succession is the performance of the main obligation of the promoter-seller - the payment of a share into the authorized capital (subp.3, p.67 of the Regulations No. 590).

In accordance with p.1, art.73 of the Principles of Civil Law an obligation is discharged by its proper performance, consequently, the main provisions of the partnership agreement become ineffective in most cases and so does the agreement as a whole as a result of the authorized capital having been paid in.

In a limited liability partnership, formed in effect by combining capitals

(shares), the dealings with shares are entered in the register of its partners. The partnership is entitled to acquire a partner's share for itself for a period not exceeding one year (p.67, subp.11 of the Regulations No.590). The transfer of a share is entered in the partners' register and the one assigning his share ceases to be a partner, but this does not signify that under the partnership agreement, the subject-matter of which is a package of measures relating to the formation of the partnership, the partnership itself substitutes him as a partner.

It is only in one case that the acquisition of shares requires additional formalities. The purchase of a share in a limited liability partnership by a foreign national must be registered with the Ministry of Finance of the Russian Federation (art.35 of the RSFSR Law of Foreign Investments).

The condition specified in art. 35 of the Law requires a subsequent registration with the RF Ministry of Finance, i.e. such a registration as is not a precedent condition of the validity of the transaction. If it is assumed that the transfer of a share requires a registration of amendments in the partnership instruments, then the requirement of art.35 of the Law appears meaningless in view of the fact that all the amendments come into effect as of the time of the registration and their conse-



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quences are as if a foreign national, substituting a promoter, was among the parties forming a Partnership.

Another argument can be cited in favour of the fact that the assignment of a partner's share in a partnership does not entail an amendment of the partnership agreement (the insertion of the names of promoters in the partnership's articles of association, as opposed to a joint-stock company is not required under the Russian law).

If in a limited liability partnership, whose articles of association permit the assignment of a partner's share with the consent of the majority of the other partners, such an assignment does occur with the majority consenting and a minority objecting, in the multilateral contract, that is the promoters' partnership agreement, there follows a change in liable parties with the creditors objecting, and the novation of, say, a debt without their consent, which is

contrary to art.69 of the Principles of Civil Law whereunder the novation of a debt must be effected with the creditors consent.

Thus it has been shown that a limited liability partnership remains the only legal form of association fully suitable for transactions relating to the effective transfer of rights to a legal entity under the Russian law.

The enactment of a civil code, company and securities laws should contribute to the clarification and settlement of many other matters including those dealt with in the present article. The drafters of documents aimed at renovating and improving the Russian company law can obviously use both the experience of the application of the existing rules and, included in this particular subject, materials of the comparative law study and problematic publications by national and foreign jurists to a far greater extent than their predecessors.

1. Principles of Civil Law.
2. The RSFSR Law entitled "On Enterprises and Entrepreneurship", December 25, 1990.
3. The Letter of the High Arbitration Court, pp.1-13 OPR-174, April 30, 1991.
4. The Regulations of the Issuance and Circulation of Securities and Stock Markets in the RSFSR, December 28, 1991.
5. The Finance Ministry's Regulations No.5-1-04 entitled "On the Procedure for and Conditions of the Granting of Licences to Print and Import Securities into the Russian Federation".
6. Regulation No. 590 entitled "On Joint-Stock and Limited Liability Companies", June 18, 1990.
7. The RSFSR Law entitled "On Foreign Investments in the RSFSR", July 4, 1991.