

# International Feature

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## A practical instrument or a legal fiction? The law and practice of shareholders' agreement in Russia

### KEY POINTS

- Shareholders' agreements are commonly used in Russia. In the past, they were governed by foreign law because Russian law did not recognise this instrument.
- There are serious doubts as regards enforceability of a shareholders' agreement governed by foreign law where it is entered into vis-à-vis a Russian company.
- Very recently, the concept of a shareholders' agreement was introduced into the Russian legislation. Thus, Russian law may now be express choice of law for this instrument.
- The legal status of a shareholders' agreement under Russian law remains largely uncertain and unclear due to considerable issues and difficulties surrounding it.

### THE STATUS OF A SHAREHOLDERS' AGREEMENT GOVERNED BY A FOREIGN LAW

Similarly to the western jurisdictions, shareholders' agreements in Russia have traditionally been used to deal with a wide variety of matters. Such as, for example, appointment of directors and other company office-holders, voting arrangements, termination of a joint venture, departure of shareholders, restrictions on transfer of shares, deadlock situations and so on. The use of this versatile instrument was particularly necessitated due to certain deficiencies and rigidity of Russian company law which has been prone to abuse.

As follows from the conflict of laws provisions of the Russian Civil Code, transactions (as well as other types of legal relations) involving a foreign (non-Russian) party and/or any other foreign 'component' may be governed by a foreign law. This meant that in purely domestic deals and projects, where only Russian parties (natural persons, companies or other entities) were involved and there was no other foreign 'component' or angle, a shareholders' agreement (governed by a foreign law) could not be used at all. This should, however, have technically allowed the use of an instrument such as a shareholders agreement, which was not known as a matter of Russian law, to regulate various important aspects of a joint venture, the operation of a JV company or a new business and so on, in an international context, provided that the agreement is expressly governed by a foreign law.

Nonetheless, the position in relation to a shareholders' agreement under foreign law in Russia is not straight forward. In fact, there are serious doubts as to its enforceability where the agreement concerns a Russian company. These doubts were cast following the rulings of the Russian courts in (at least) two major cases: *'Megafon'* (the decision of

the Federal Arbitrazh Court of the West Siberian Circuit, 2006) and *'Russkiy Standart'* (the Moscow Arbitrazh Court, 2006).

In the former case, the appeal court of the second instance held that the status of a Russian company/legal entity, rights and obligations of its shareholders and a number of key aspects of corporate governance may not be governed by a foreign law. As a result, the relevant provisions of the shareholders' agreement (which was expressly governed by Swedish law) were declared to have no legal effect.

In the latter case, the court has ruled that 'the [shareholders'] agreement purports to regulate the legal status of a [Russian company], the procedure for establishing it, the extent of its legal capacity, internal relations between its shareholders, ie all the matters which should be governed by the personal law of the legal entity, as follows from Art 1202 of the Russian Civil Code; in relation to a Russian company, this law is the law of the Russian Federation. The principle of the freedom of contract (art 1210 of the Civil Code) [which permits to choose a specific law to govern contractual relations] does not apply where this would conflict with the imperative provisions of the legislation of the Russian Federation'. Therefore, the shareholders' agreement governed by English law which was at the heart of the dispute was held unenforceable.

The above decisions were not appealed to the highest judicial instance, ie to the Russian Supreme Arbitrazh Court. Thus, it may be suggested that the position under Russian law in relation to the validity and enforceability of shareholders agreements governed by foreign law is not settled. However, the two major cases mentioned above gave lawyers and businessmen much food for thought. The Russian legal community has expressed considerable criticism of the rulings, their logic and outcome.

Another interesting case was that of a Russian closed joint stock company *'KM Invest'* (March 2008) where the Moscow Arbitrazh Court refused to uphold certain terms of a shareholders' agreement on the basis, *inter alia*, that they contradicted the relevant mandatory provisions of the Russian law regulating joint stock companies (most notably, the terms concerning the mechanism for approval of high value transactions the company was party to).

Because of this uncertain and, frankly, alarming situation as regards the legal status in Russia of a shareholders agreement governed by a foreign law (notably, vis-à-vis a Russian company), foreign investors acquiring Russian assets commonly use a composite structure where a foreign holding company wholly owns a Russian subsidiary which, in turns, owns the assets in question. A shareholders agreement is then entered into by the members of the foreign holding company and the crucial question of its enforceability against a Russian company does not arise.

may contain a provision concerning sale and purchase of shares at a specific pre-determined price or upon occurrence of a specific 'trigger' event in the future. Therefore, at least on the face of it, such a provision should be enforceable.

However, it is suggested that, in case of both a shareholders' and participants' agreement, unless the events which trigger the 'drag along' and 'tag along' rights are very clearly and specifically defined, the relevant clauses will not be enforceable. Furthermore, if any party has any influence over the occurrence (or otherwise) of a 'trigger event' for the purpose of the 'drag along'/'tag along' rights, the relevant provision is very unlikely to have any legal effect.

Also, where a participants' agreement incorporates a 'drag along' or 'tag along' provision and/or a 'put' or 'call' option, it is suggested that the agreement itself will have to be notarised. Alternatively, the above provisions would have to be part of a separate agreement which would need to be concluded in a notarised form.

## CONFIDENTIALITY

It is well known that, as a matter of English law and practice, a shareholders' agreement is, generally, a confidential document which is not available in the public domain. There are very few exceptions where a shareholders agreement may have to be registered in the Companies House (for example, if it purports to amend the articles of association or contains other matters for which the Companies Act 2006 prescribes a special resolution).

Under Russian law, it appears accepted that a shareholders' agreement is a non-public document. However, there is an exception which applies to 'public' companies whose share issue is set out in a registered prospectus. In that case, a party to a shareholders' agreement is required to notify a relevant state body supervising the activities of the Russian securities' market where:

- this party becomes empowered by a shareholders' agreement to set a voting procedure/ mechanism for the purposes of decision-making at a general shareholders' meeting; and
- it acquires (directly or indirectly, by itself or together with any of its affiliated persons or companies, as the case may be) more than 5 per cent, 10 per cent, 15 per cent, 20 per cent, 25 per cent, 30 per cent, 50 per cent or 75 per cent votes arising from ordinary shares.

The above notification should also be sent to the company itself. The company is required to safe-keep such notifications as well as a list of the parties to the shareholders' agreement. Only the company's members may have access to this information. Therefore, save for where any information is received by the relevant state body pursuant to the legal requirements set out above, it is normally not publicly available.

## CONFLICT WITH MANDATORY STATUTORY PROVISIONS

Should any clause or provision in a shareholders' agreement come into a conflict with the mandatory provisions of the Russian JSC or LLC Laws, the logic dictates that the statute should prevail. However, the position is not entirely clear as illustrated below.

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## Biog box

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For example, the parties to a shareholders' agreement may sometimes wish to establish equal rights to nominate and appoint members of a board of directors regardless of the actual (unequal) size of their participation in the company's share capital. However, as follows from a recent case, the mandatory procedure of cumulative voting provided for in the JSC Law will prevail and any contrary provisions in a shareholders' agreement will have no legal effect.

As regards voting arrangements, it is likely that a clause in a shareholders' agreement which attempts to set a voting threshold above what is prescribed by the law, will have no legal effect. For example, if a shareholders' agreement sets a minimum voting requirement for a decision regarding the company's re-structuring at, say, 90 per cent of all the votes, this would be in conflict with a provision of the JSC Law whereby only a qualified majority of the votes (ie three quarters) is required. A clause of this kind in the company's charter would clearly have no legal effect whatsoever. In the absence of any relevant Russian case on the point, the position in relation to a shareholders' agreement is not entirely clear. However, there is a strong feeling that Russian courts will be very reluctant to render it effective.

## THE APPROACH OF RUSSIAN COURTS UNDER THE NEW REGIME

Since the relevant amendments to the JSC and LLC Laws were made, there have been very few cases dealing with the legal status and enforceability of shareholders' agreements under the new regime in Russia. However, some examples exist already.

In a recent case of LLC 'Verny Znak' (March 2010), the Moscow Arbitrazh Court has ruled that certain provisions in a participants' agreement governed by Russian law were contrary to the mandatory provisions of the Russian legislation. The court considered, among others, such matters as:

- whether it is possible to join the company itself (ie LLC 'Verniy Znak') as a party to the participants' agreement;
- whether a member may be stripped off their voting right as a punishment for breach by that member of the participants' agreement;
- restrictions on disposal or transfer of shares.

Despite the finding of contravention of the law, the court has dismissed the action on a technical ground. An appeal is pending. Thus, it so far remains unclear to what extent (if any) the terms of a shareholders' (or participants') agreement under Russian law may contradict a statutory rule or the company's own charter. Views of the Supreme Arbitrazh Court on this subject would certainly be welcome.

## REMEDIES FOR BREACH

The LLC Law does not specify remedies for breach of a participants' agreement. So the position is governed by the general provisions of the Russian Civil Code concerning liability for breach of a contract. Under those rules, the aggrieved party's claim may, most typically, lie either in damages or in contractual penalties.

The JSC Law specifically mentions the remedies available for

breach of a shareholders' agreement, ie damages, penalties or a pre-determined amount agreed by the parties to be payable in case of a breach. However, in practice, the first two remedies would not be easy or straight forward to obtain where a shareholders' (or a participants') agreement is breached, as explained below.

In relation to damages, the extent of loss and damage suffered as a result of a breach of an agreement of this kind would be very difficult to prove and assess as a matter of Russian law and practice. It is very likely that complex evidence would be required for a Russian court to make an award of damages in such a case.

As for contractual penalties, though recognised in principle in Russian law (Arts 330-333 of the Civil Code), the parties' freedom to specify a sum of money payable as a penalty in case of a breach is considerably curtailed by Art 333 of the Civil Code. The latter rule empowers a court to reduce, as it thinks fit, the amount of penalty agreed by the parties where this amount is 'clearly disproportionate to the [actual] consequences of the breach'. In practice, Russian courts often slash contractual penalties dramatically by invoking Art 333.

In order to receive an effective straight forward compensation, parties to a shareholders' agreement may agree that a specified sum of money, other than a penalty, would be payable in the event of a breach (or, alternatively, provide a formula/mechanism for the calculation of a sum payable in such circumstances). This is not unlike 'liquidated damages' under English law. Similarly, the amount of compensation would have to be a realistic estimate taking into account potential consequences of a breach and be proportionate to them.

The above solution is clearly available in relation to a shareholders' agreement because the JSC law specifically provides for it. However, the position is less clear in relation to a participant's agreement because the LLC Law is silent on the point.

## CONCLUSION

While flexibility and overall efficacy of a shareholders' (or participants') agreement under Russian law is being tested, lawyers and businessmen alike remain sceptical. A common view is that, if this instrument, versatile and comprehensive in other countries, were to crumble under the rigidity of Russian company law, there will be little point in employing it. There are also various lacunas and uncertainties. As a result, foreign law continues to be (despite the doubts as to enforceability) a popular choice as a governing law for a shareholders' agreement in Russia.

This does not mean that a shareholders' (or participants') agreement under Russian law has little or no future. These agreements exist already but they are used by Russian companies with a great deal of caution. Because of all the difficulties and uncertainties, the drafting has to be extremely careful not to offend any relevant statutory provisions, etc.

As for the future of these new instruments under Russian law, much will depend on willingness of the courts to overcome rigidities and resolve other problems. The legislator may also have a say in terms of any subsequent amendments to fill in lacunas and solve issues. So the best stance to take would be 'wait and see'.