



INTERNATIONAL FINANCE CORPORATION
A Member of the World Bank Group



Good corporate governance contributes to a company's competitiveness and reputation, facilitates access to capital markets, and thus helps develop financial markets and spur economic growth. With this in mind, the International Finance Corporation and the U.S. Department of Commerce have combined their efforts to provide Russian managers, directors, and shareholders with a practical tool to implement good corporate governance practices – the Russia Corporate Governance Manual. This Manual refers to and is based on the principal laws and regulations that apply to open joint stock companies. It follows the recommendations of the FCSM's Code of Corporate Conduct and refers to internationally accepted principles of good corporate governance.

“Corporate governance is vital to the interests of every economy, and government has a role to play in establishing the framework for reform - but it is companies that have the tough job of putting governance reform into practice. This is where the Corporate Governance Manual can provide excellent help. It offers a comprehensive workbook for company directors, officers, and advisers in taking up the challenge of corporate governance improvement. Shareholders and stakeholders alike should applaud IFC for bringing practical, and professional advice within reach of every boardroom.”

Anne Simpson, Manager,
Global Corporate Governance Forum

“Corporate governance reform in Russia is the continuation of the more general processes of change affecting the country as a whole. Taken together, these developments have created a new environment, new rules regulating the relationships between the market and regulators, between shareholders, shareholders and managers, etc. In the business community there is a growing awareness of the benefits of corporate governance reform, and companies are now working on improving the quality of their corporate governance ...”

Ruben K. Vardanian, President of Troika Dialogue; Chairman of the Board,
OJSC Rosgosstrakh; and Chairman of the RSPP Corporate Governance Committee

“Good corporate governance is a key driver of financial transparency and managerial accountability, essential ingredients for national prosperity in a global economy. We congratulate the U.S. Department of Commerce and the International Financial Corporation of the World Bank for their initiative in bringing about the publication of the Russia Corporate Governance Manual.”

Andrew B. Somers, President,
American Chamber of Commerce in Russia

Questions on corporate governance should be addressed to the IFC Russia Corporate Governance Project, via CGPRussia@ifc.org

An electronic version of the Manual is available on the website of the International Finance Corporation under www.ifc.org/rcgp and the U.S. Department of Commerce under www.mac.doc.gov/ggp

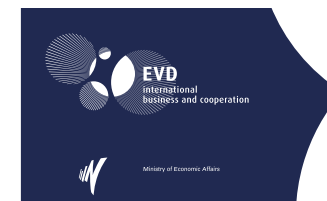
The Russia Corporate Governance Manual

V Part V Special Focus Section



Prepared and Published by the International Finance Corporation and the U.S. Department of Commerce

In Partnership with the Agency for International Business and Cooperation of the Dutch Ministry of Economic Affairs and the Swiss State Secretariat for Economic Affairs



The Russia **Corporate Governance** Manual

Part V

Special Focus Section

Prepared and Published by the International Finance Corporation
and the U.S. Department of Commerce

In Partnership with the Agency for International Business
and Cooperation of the Dutch Ministry of Economic Affairs
and the Swiss State Secretariat for Economic Affairs

First edition: 10,000 copies in Russian, 1,500 copies in English.

Published in 6 Parts

Printed in Moscow, Russia.

ISBN 5-9614-0085-9

Copyright © 2004 International Finance Corporation
2121 Pennsylvania Ave. NW, Washington, DC 20433, United States of America
A Member of the World Bank Group

Design copyright © 2004 Alpina Business Books

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, for commercial purposes without the prior permission of the International Finance Corporation.

Chapter 15

Corporate Governance in **Groups** of **Companies**

Table of Contents

A. GENERAL PROVISIONS ON GROUPS OF COMPANIES.....	4
1. Relationships Between Companies in Groups.....	4
2. Corporate Governance Issues in Groups of Companies	6
3. Groups of Companies in the Company Law	9
4. Groups of Companies in Other Areas of Legislation	10
B. SPECIFIC GROUP STRUCTURES	13
1. Parent-Subsidiary Company Structures.....	13
2. Dominant-Dependent Company Structures	20
3. Holding Companies.....	21
4. Financial and Industrial Groups	21
C. SUMMARY TABLE.....	23

The Chairman's Checklist

- ✓ Is the company part of a parent-subsidary structure? Is the parent company's Supervisory Board aware of its role and, in particular, of its responsibilities in such structures?
- ✓ Is there economic justification for establishing subsidiaries and dependent companies?
- ✓ If the company is a parent company, how does the Supervisory Board ensure that it oversees the management of subsidiaries? Are binding instructions of the parent to the subsidiary legally and economically justified?
- ✓ How does the Supervisory Board of the parent company make sure that minority shareholders of subsidiaries are treated fairly?
- ✓ How does the Supervisory Board of the subsidiary ensure that the rights of its minority shareholders are not violated by the parent company through related party transactions and other mechanisms?
- ✓ Do all directors fully understand the legal and economic implications of holding structures and Financial and Industrial Groups?

Companies often adopt complex structures in response to legitimate business needs. Some companies create identifiable sub-divisions, i.e. representative offices or branches.¹ Others establish or acquire participation in yet other companies, creating

¹ Civil Code (CC), Article 55, Law on Joint Stock Companies (LJSC), Article 5, Clause 1. The decision to establish representative offices/branches is a strategic decision, taken by the Supervisory Board. Representative offices represent and protect the company's interests, while branches may fulfill additional business functions. Representative offices/branches have no independent legal personality. This has a number of implications. For one, the manager of the representative office/branch is a part of the management structure of the company, and should be appointed by the company's Executive Board. The manager's authority is defined in special by-laws, the power of attorney issued by the company, and the employment contract with the manager. In addition, the representative office/branch is subject to the same internal control procedures as the company, which is of particular importance since the company is liable for the actions of branches/representative offices.

subsidiaries or dependent companies with a separate legal existence. In doing so, they create a group of companies. Either way, the decision to diversify the company's structure has important governance implications.

While complex business structures may serve legitimate purposes, cross-shareholdings, pyramid structures, and other arrangements can make the company difficult to understand for shareholders and other investors. Special vigilance on the part of the Supervisory Board is called for since such structures have been used extensively to expropriate and circumvent the rights of (some) shareholders.

This chapter draws attention to the corporate governance and legal implications of groups of companies, including parent-subsidiary relations, holdings, and Financial and Industrial Groups (FIGs).

A. General Provisions on Groups of Companies

1. Relationships Between Companies

Companies set up or acquire control in other companies for a variety of legal and economic reasons. These include diversifying business operations, complying with legal and administrative requirements, enjoying the limited liability available to shareholders (of the parent), or identifying assets in separate legal entities for the purposes of secured borrowing. In such cases, companies remain independent legal personalities, with their own charter, governing bodies, and charter capital. Relationships between companies can vary in terms of:

- **The extent of share participation.** A Company can hold small or large blocks of shares in the charter capital of another company. Companies can further have reciprocal holdings in each other. Alternatively, companies may not have any share participation whatsoever, but base their relationships on contracts granting certain control rights.
- **The degree to which companies integrate or cooperate in their businesses.** Companies can be economically dependent on each other with varying degrees of intensity. This holds particularly true for different areas of

Chapter 15. Corporate Governance in Groups of Companies

decision-making, such as strategic development, marketing, production, asset management, management of financial flows, human resources, or research and development.

- **Whether the group of companies includes both financial and non-financial institutions.** Groups of companies that include financial institutions may be registered as FIGs. Other groups may take the form of holdings.
- **Whether the companies are a part of a wider network of legal entities and the degree of complexity of this network.** Companies can be organized “vertically,” that is with one parent company at the top. Such groups are often referred to as “holding companies.” When there are several layers of holding companies, they are referred to as “pyramids.” Companies can also be organized “horizontally,” that is with several parent companies.

Best Practices: The EU defines groups of companies in its Seventh Company Law Directive on Consolidated Accounts.² Two basic types of relationships exist: vertical and horizontal.

Vertical control relationships exist when:

1. Company (A) controls the majority of the voting rights in Company (B);
2. Company (A) is a shareholder in Company (B), and has the right to appoint and dismiss the majority of the Supervisory Board members of Company (B);
3. Company (A) exercises “dominant influence” over Company (B) by means of a contract;
4. Company (A) exercises “dominant influence” over Company (B), by virtue of a provision in the company’s charter;
5. Company (A) controls the majority of shares as a result of an agreement with other shareholders of Company (B);
6. Company (A) exerts “dominant influence” over Company (B) by means not mentioned above; or
7. Company (A) manages Company (B) on a unified basis.

² See <http://europa.eu.int/scadplus/leg/en/lvb/l26010.htm>.

The Directive identifies two types of associative links that tie together horizontal groups:

1. Companies that are managed on a unified basis; or
2. Companies that are tied together through interlocking directorates.

Cash-flow links and cross-shareholdings are not specifically mentioned in this Directive, although they typically feature in horizontal groups as well.

2. Corporate Governance Issues in Groups of Companies

Relationships between companies serve modern commercial realities; yet they also give rise to some particular corporate governance issues that require management's and, in particular, the Supervisory Board's attention:

- **Lack of transparency of control and economic interdependence of a group of companies.** Complex ownership structures are often used to obscure control relationships between companies, making it virtually impossible to determine when transactions are being conducted in good faith, or when self-dealing, transfer pricing, and similar abuses occur. Just as important are situations in which such structures obscure liabilities or potential risks associated with other companies in the group.

Best Practices: Transparent ownership structures are important prerequisites in both the U.S. and EU. The same should hold true for Russian companies, and the following are some of the best practices for implementing this principle.

- Significant attention is given internationally to the disclosure of holdings and voting power in listed companies. For example, in the U.S., the disclosure of voting blocks in excess of 5% in listed companies is required; in the EU, this requirement is established at the level of voting power in excess of 10%.
- It is extremely important to provide adequate financial information on the economic interdependence of the group of companies. In the EU, for example, the consolidation of group accounts is a legal requirement since the adoption of the Seventh Company Law Directive in 1978. The EU system was recently updated and all listed companies in the EU will need to consolidate their financial reports according to International Financial Reporting Standards as of 2005.

- The EU deems coherent and accurate disclosure of group structure and intra-group relations as a crucial precondition for protecting the rights of shareholders and creditors. Thus, the parent company of each group is to be made responsible for appropriate disclosure practices.
 - In addition to the above, the EU is particularly concerned about pyramidal groups that include listed companies, especially those placed on lower levels of the chain of control. In those cases, for example, the recommendation is made for securities markets not to accept for trading shares of holding companies whose sole or main assets are shareholdings in another listed company.
-
- **Ability of the dominant company to control the decision-making of its subsidiary, contrary to the interest of the subsidiary.** There is a real danger that a dependent company or subsidiary can be made to operate in the interests of the dominant or parent company, to its detriment.

Best Practices: German law, which contains comprehensive regulation on groups, envisages the possibility for a controlling company to issue mandatory instructions to the directors of the controlled company.

- In the case of contract-based groups, the instructions issued can even be to the detriment of the subsidiary as long as the interests of the group as a whole are served.
- The latter condition does not apply in the case of so-called integrated groups, whereby the participation in the subsidiary's capital exceeds 95%.
- With regard to the third category of groups recognized by German law, the *de facto* groups, the parent company cannot issue instructions disadvantageous to the subsidiary without providing compensation. Under this particular group structure, directors of the dependent company are required to prepare a "dependence report," listing the circumstances of its transactions, and disclose this report to the company's External Auditor.

French law accepts the notion of the group's predominance over its members' interests. When making decisions, the parent is thus entitled to take the group's interests into account and is not required to indemnify the subsidiary. However, two exceptions exist. First, the subsidiary may not enter into transactions with other group entities that would jeopardize its solvency. Second, that a certain "*quid pro quo*" between the parent and subsidiary exists, i.e. that a just balance be struck between the burden imposed on the subsidiary and the advantages it receives from its participation in the group.

Similarly, the 2004 OECD Principles of Corporate Governance (OECD Principles) mention that some countries are now moving toward controlling the negative effects [of groups of companies] by specifying that a transaction in favor of another group company must be offset by receiving a corresponding benefit from other companies of the group.³

- **The need to protect minority shareholders of dependent companies or subsidiaries against abuse by the controlling powers of the dominant company.** Minority shareholders in subsidiaries or dependent companies may be particularly vulnerable to abuses by controlling shareholders. Subsidiary or dependent companies are not generally publicly quoted, so minority shareholders may not receive full information or have the ability to sell their shares in the market.

Best Practices: Some important areas of concern for companies wishing to follow good corporate governance in terms of minority shareholder protection in groups include:

- Providing minority shareholders with reliable information on the company's management and the actual relations between companies.
- Providing security for the profit interests of the subsidiary's shareholders. Under German law for example, minority shareholders can be offered security in the form of a guaranteed dividend, the amount of which is determined in relation to past or future profits.
- Minority shareholders have the right to withdraw from the company against an appropriate compensation, when the dominant company has acquired 90% (for example, in the U.K.) or 95% (in France) of the company.

- **The need to protect creditors of the dependent company or the subsidiary against fraud or under-capitalization of the subsidiary.** Creditors may also find themselves in a weaker position with respect to their ability to receive

³ OECD Principles of Corporate Governance, Annotations to Principle II on the Equitable Treatment of Shareholders, Section A.2. See also: www.oecd.org.

Chapter 15. Corporate Governance in Groups of Companies

the payments that they are due. Some potential responses are mentioned below:

Best Practices: Creditors of the subsidiary could be protected by a variety of means, such as:

- The obligation of the dominant company to compensate creditors for any annual deficits of the subsidiary (as is the case, for example, in Germany); or
- Extending the liability of the parent for the debt of the subsidiary under specific circumstances (France, Spain, and the Netherlands).

3. Groups of Companies in the Company Law

The Company Law does not recognize groups of companies as a single legal entity. It does, however, regulate the relationships between parent companies and their dependent or subsidiary companies for the purposes of protecting shareholder and creditor interests.⁴

Best Practices: Legal systems the world over are confronted with issues of groups of companies. Some have developed formal rules; others have left developments to case law. Formal regulation has mainly been developed in Germany, Portugal, and in some Eastern European countries. Brazil and Senegal are examples where group law has formally been introduced in company law, although it is unclear how the law is actually applied. Other jurisdictions, such as the U.S., have extensive rulings on groups of companies, developed by the courts, but no laws on groups.

In the absence of regulation on groups, Russian companies — wishing to follow good corporate governance practices — should regulate their group structure in the company charter, in particular, the main governance rights and responsibilities between the parent and its subsidiaries. The charter provisions may further be complemented with a specific by-law on the group.

⁴ LJSC, Article 6.

4. Groups of Companies in Other Areas of Legislation

Tax and Antimonopoly laws both have significant implications for a company's decision to use group mechanisms. These laws place important constraints on companies, limiting their ability to create and/or expand their group structure.

Moreover these laws have their own definition as to whether a group of companies may be characterized as interdependent (apart from the corporate parent-subsidiary relationship).

a) Interdependent Companies under Tax Legislation

The Tax Code provides for a special definition of interdependent companies for tax purposes.⁵ The main legal consequences which it envisages with regard to interdependent companies, relate to the tax regime of transactions concluded between these companies.⁶ The regime aims to regulate a company's ability to trade commodities or transfer assets at prices below market rates.

Mutual dependence exists when a relationship between companies is capable of affecting the terms or economic results of their activities or the activities of persons represented by them. More specifically, the Tax Code identifies the following cases of interdependent companies:

- A company has direct and/or indirect participation in another company exceeding in total 20% of its capital.

Mini-Cases 1–3:

1. **Direct ownership:** Company (A) owns 21% of shares of Company (B).
2. **Indirect ownership:** Company (A) owns 50% of shares of Company (B). Company (B) owns 50% of shares of Company (C). The participation of Company (A) in Company (C) is calculated as the multiple of the direct participation by Company (A) in Company (B), and Company (B) in Company (C), hence 25%.

⁵ Tax Code, Article 20.

⁶ Tax Code, Article 40.

3. **Combination of direct and indirect ownership:** Company (A) owns 16% of shares of Company (C) directly, and 50% of shares of (B), which in turn holds 10% of shares of Company (C). Company (A) thus indirectly holds 5% of shares in Company (C) through its ownership in Company (B). Thus, the total direct and indirect ownership of Company (A) in Company (C) amounts to 21% of shares of Company (C).

- Courts have recognized two companies as being interdependent based on criteria other than those described in the examples above, e.g. when the relations between them can influence the results of transactions in providing goods, labor, or services.

b) Groups of Persons and Affiliated Persons under Antimonopoly Law

The Law on Competition and Restricting Monopoly Activities on the Commodities Markets (Antimonopoly Law) has its own definition of groups of persons and affiliated persons for the purposes of antimonopoly control. The emergence of groups or affiliation relationships requires notification or preliminary approval by the Ministry of Antimonopoly Policy and Entrepreneurship Support (MAP).⁷ The question of whether such groups or affiliations exist under Antimonopoly Law must be examined independently of the question as to whether such companies form a dominant-dependent or parent-subsidiary relationship under the Company Law and/or an interdependent relationship under the Tax Code.

Under Antimonopoly Law, a group of companies exists in the following situations, as presented in Table 1:⁸

⁷ Law on Competition and Restricting Monopoly Activities on the Commodities Markets (Antimonopoly Law), Article 18. Table 1 only covers those relationships mentioned in Article 18 that relate to companies.

⁸ Antimonopoly Law, Article 4.

Table 1: Company Relations under Antimonopoly Law	
Direct Relationships	Indirect Relationships
<ul style="list-style-type: none"> • Based on an agreement, Company (A) has the right of disposal of more than 50% of voting shares of another Company (B). This right of disposal can take a direct or indirect form, including on the basis of a contract. The Antimonopoly Law specifies that indirect participation means the possibility for <i>de facto</i> control through a third person with regard to which Company (A) has the same rights. • Company (A) has the right to determine the decisions of Company (B), including the conditions for its entrepreneurial activity, on the basis of a contract or other form, or to fulfill the functions of the executive bodies of Company (B) by virtue of a contract. • Company (A) has the right to appoint the General Director and/or more than 50% of Executive Board members of Company (B), or, on the basis of its proposal more than 50% of members of the Supervisory Board or collective body have been elected. 	<ul style="list-style-type: none"> • The same individuals (or their relatives) or persons proposed by one of the companies represent more than 50% of Executive Board or Supervisory Board membership of Companies (A) and (B), or upon the proposal of one of the companies, more than 50% of members of the Supervisory Board or collective executive body of Companies (A) and (B) have been elected. • Employees of Company (A) are the General Director or more than 50% of members of the Supervisory Board or a collective executive body of Company (B). • The same individuals (or their relatives) have the right of disposal with more than 50% of voting shares in both Companies (A) and (B). • The individuals or legal entities who have the right of disposal over more than 50% of voting shares of Company (A) are at the same time the persons constituting more than 50% of members of the Supervisory Board or collective executive body of Company (B). • Companies (A) and (B) are members of the same FIG.

For the purposes of antimonopoly control, companies are considered to be affiliated persons when:⁹

- Companies (A) and (B) belong to the same group of companies;
- Company (A) has the right to dispose of more than 20% of voting shares of Company (B); or
- The members of the executive bodies and the Supervisory Board of Company (A) are affiliated persons to Company (B), when both companies are members of the same FIG.

→ For more on affiliated parties, see Part III, Chapter 12, Section B.1.

⁹ Antimonopoly Law, Article 4. The list includes only those relationships listed in Article 4 that relate to companies.

B. Specific Group Structures

Specific group structures or regimes are differentiated from one another, depending on the legal regulation and their economic features. In many cases, these structures may overlap or exist simultaneously. Such structures will refer to:

- Parent-subsidiary;
- Dominant-dependent;
- Holding structures; and
- FIGs.

1. Parent-Subsidiary Company Structures

a) Definition of Parent and Subsidiary Companies

Companies (A) and (B) are defined as parent and subsidiary companies when Company (A) can control decisions adopted by Company (B) by virtue of:¹⁰

- Predominant participation in the capital of Company (B); or
- A contract to that effect executed between the two companies; or
- Other forms of control.

Thus, there are no strict formal criteria for the definition of parent-subsidiary relationships. It requires the examination of the degree and nature of the influence of the parent company over subsidiary decision-making. This approach allows for a greater degree of flexibility in reflecting the different relations between companies. At the same time, a clear definition of a parent-subsidiary relationship is imperative under the Company Law, which attaches important consequences to situations in which shareholder or creditor interests are put at risk.

The following types of parent-subsidiary relationships exist under the Company Law:

1) *Parent Company as a Predominant Shareholder of the Subsidiary*

The Company Law does not contain an exact percentage of share participation needed to qualify as a parent company. The requirement for “predominance” must be satisfied in specific cases in conjunction with the possibility to determine the decisions of the subsidiary company. Two factors in particular must be taken into account:

¹⁰ CC, Article 105, Clause 1; LJSC, Article 6, Clause 2.

The Russia Corporate Governance Manual

- The actual share ownership in the capital of a company; and
 - The type of quorum and voting majority required by the charter for the decision-making of the company.
- For more information on the quorum and voting majorities of the General Meeting of Shareholders (GMS), Part III, see Chapter 8, Sections C.3 and E.

Table 2 illustrates the level of control in a company based upon the percentage of share ownership.

Participation in the Capital of Another Company	Control Implications
100%	The parent company (A) has full control over the decision-making of its subsidiary Company (B).
75% to 100%	Company (A) controls all decisions of the subsidiary's GMS, which — according to the Company Law or the charter — require 3/4-majority of voting shares or more.
50% to 75%	Company (A) controls all decisions of the subsidiary's GMS, which require a simple majority.

2) *Contractual Relationship*

A contract between two companies can provide that Company (A) is able to control decisions of Company (B). This means that even if Company (A) does not have a predominant participation in the charter capital of Company (B), a contract can provide for certain control rights. Such control rights include the right to appoint and dismiss directors and/or managers, approve or veto certain transactions, or instruct the company to act in a specific manner.

Russian law does not provide specific regulation with regard to the contents or the form of a contract that will influence the decision-making of a subsidiary. Some level of control can result from different types of contracts, such as joint ventures, bank credits, pledges of securities, or asset management contracts.

In these cases, specific rules applicable to individual contracts need to be observed. It is important to note that the provisions of the contract must be consistent with relevant legislation.

3) *Other Relationships*

The Company Law does not exhaust the cases in which a company has the potential to control the decisions of another company, thus qualifying as a parent-subsidiary relationship. In concrete circumstances, specific tests will be needed to identify such relationships (see examples in Mini-cases 4 and 5).

Mini-Cases 4 and 5.

4. **Pyramidal structures:** Company (A) has majority control of Company (B), and Company (B) has majority control of Company (C). As a result, Company (A) only controls Company (C) indirectly, but its control can be as effective as that of direct control. (A) is thus considered a parent company of (C).
5. **Control of affiliated companies:** Neither Company (A) nor Company (B) have majority control of Company (C). Yet, together companies (A) and (B) can have sufficient control to determine the decisions of Company (C). Both (A) and (B) are considered parent companies when they exercise control over (C).

b) Parent-Subsidiary Relations and the Decision-Making of the Subsidiary

A parent company and its subsidiary are separate legal entities that are legally independent from each other. The decision-making of the subsidiary, however, is by definition subject to the influence of the parent company. This section describes the mechanisms through which this influence occurs. Such mechanisms frequently exist in combination.

A parent company is able to influence decisions of a subsidiary through standard governance mechanisms available to controlling shareholders (shareholders with a predominant participation in the charter capital of the subsidiary), including the ability to:

- Directly control the outcome of issues that fall under the decision-making authority of the subsidiary's GMS;
- Nominate and elect representatives to the Supervisory Board of the subsidiary; and
- Nominate and elect representatives to the executive bodies of the subsidiary.

Best Practices: It is good practice to authorize the Executive Board of the parent company to complete certain tasks related to subsidiaries, such as to:¹¹

- Set agenda for the GMS of wholly-owned subsidiaries, except when this authority is vested in the Supervisory Board of the parent;
- Appoint representatives of the parent company to the GMS of wholly-owned subsidiaries and issue voting instructions to them; and
- Nominate candidates for the Supervisory Board, the executive bodies, or other bodies in companies in which it participates.

Executive Board members or the General Director of the parent company frequently sit on the Supervisory Board or the executive bodies of the subsidiary. For this, the prior consent of the parent company's Supervisory Board is needed.¹²

Best Practices: It is important in such cases to ensure that the General Director of the parent has enough time to fulfill his tasks in both legal entities, but most importantly at the parent level.¹³ Establishing an Executive Board at the parent level to spread managerial responsibilities or prohibiting side activities per contract are means of achieving this end.

Russian law allows parent companies to issue mandatory instructions to their subsidiaries. This right is, however, only allowed if predetermined in the contract between the two companies or charter of the subsidiary company.¹⁴

c) Protecting Shareholders of the Subsidiary

When a subsidiary is not 100% owned by the parent company, there are, by definition, other shareholders. Depending on the amount and type of their holdings, such shareholders may affect the decision-making of the subsidiary and exercise minority shareholder rights.

¹¹ FCSM Code, Chapter 4, Section 1.1.4.

¹² LJSC, Article 69, Clause 3.

¹³ FCSM Code, Chapter 4 Section 2.1.4.

¹⁴ CC, Article 105, Clause 2; LJSC, Article 6, Clause 3.

In addition to the general rules protecting minority shareholders, the parent company is directly liable when it deliberately damages the interests of the subsidiary.¹⁵ Such liability emerges when:

- The parent company has exercised its rights to influence the actions of the subsidiary; and
- As a result of this, the subsidiary has incurred losses; and
- The parent company has acted knowing that, by such act, the subsidiary will likely suffer losses.

The Company Law does not vest this right with the subsidiary itself, but instead with its shareholders. Accordingly, shareholders must file their claim on behalf of, and in the interest of, the subsidiary and against the parent company.

d) Protecting Creditors of the Subsidiary

A parent company can endanger the interests of the subsidiary's creditors in a variety of ways, ranging from obfuscating risks involved in contracts between the subsidiary and its creditors, to transferring assets between parent and subsidiary companies. Creditors of the subsidiary enjoy the general protection granted to creditors of commercial companies by Russian law.

Additional guarantees to creditors of a subsidiary exist. For example, the subsidiary is not liable for any debts of its parent company.¹⁶ Further, the parent company — at least in principle — also enjoys limited liability with respect to the debts of its subsidiary. There are, however, a number of important exceptions to this rule.

1) *The Parent Company Has the Right to Give Mandatory Instructions*¹⁷

A parent company is liable for the debts of its subsidiary, when:

- The parent company has the right to issue mandatory instructions to the subsidiary; and
- This right has been envisaged in a contract between the parent company and the subsidiary, or in the charter of the subsidiary; and

¹⁵ CC, Article 105, Clause 3; LJSC, Article 6, Clause 3.

¹⁶ CC, Article 105, Clause 2; LJSC, Article 6, Clause 3.

¹⁷ CC, Article 105, Clause 2; LJSC, Article 6, Clause 3.

- The debt of the subsidiary was incurred as a part of a transaction fulfilling such mandatory instructions.

In such circumstances, joint and several liability of the parent company for the debts of the subsidiary exists. This means that a creditor can choose to direct its claim, or a part of it, to the subsidiary or to the parent, or to both.¹⁸ If the claim is directed to the subsidiary but no satisfaction of the claim, or only a partial satisfaction, is received, the creditor can direct the claim (in full or the outstanding part of the claim) to the parent company. Thus, the parent company remains liable until the full amount of the debt has been satisfied.

2) *The Subsidiary's Insolvency Has Been Caused by the Parent Company*

A parent company can also be held liable for the debts of its subsidiary, when:¹⁹

- The subsidiary has become insolvent (bankrupt); and
- The insolvency of the subsidiary has been caused by the parent company, by exercising its rights and/or influence; and
- The parent company acted knowing that such action would result in the insolvency of the subsidiary.

The purpose of this exemption from the limited liability rule is to prevent parent companies from deliberately causing the bankruptcy of the subsidiary and thereby defrauding its creditors. (A great number of insolvencies in Russia during the mid- to late 1990s were in fact deliberately and fraudulently caused by parent companies and went un-punished due to poor enforcement mechanisms.) In such cases, the Company Law provides for the liability of the parent in addition to that of the insolvent subsidiary. This means that the subsidiary remains the main debtor, to which the creditor directs all claims first.²⁰ Only if the subsidiary is unable to satisfy the claim or fails to react to the claim within a reasonable time can the parent company be held liable.

e) **Establishing Subsidiaries**

Subsidiaries can be established by founding a new company, through the reorganization of an existing company or by acquiring shares of an existing company.

¹⁸ CC, Article 323.

¹⁹ CC, Article 105, Clause 2; LJSC, Article 6, Clause 3. See also: Insolvency Law, Article 10, Clause 4.

²⁰ CC, Article 399.

Chapter 15. Corporate Governance in Groups of Companies

A subsidiary can be created by founding a new company. The parent company can:

- Invest the entire amount of the initial charter capital, thus becoming the only shareholder of a fully-owned subsidiary; or
- Contribute to the initial charter capital and become the majority shareholder of the subsidiary, along with other companies or individual shareholders.

In this case, the parent company needs to comply with all legal requirements regulating the founding of a new company in the respective legal form, for example a joint stock company or limited liability company.²¹

Accordingly, the parent company is subject to the duties and liabilities of the founders of a company, as specified in Table 3.

Legal Source	Duties and Liabilities
The Company Law	<ul style="list-style-type: none">• Joint and several liability for debts incurred in the process of forming the new company;²² and• To take all steps and actions necessary for the state registration of the company.²³
Securities Legislation	→ <i>For the requirements as to founders, see Part III, Chapter 11.</i>
Antimonopoly Legislation	<ul style="list-style-type: none">• Founders need to notify the MAP within 45 days of the state registration if the sum of the founders' assets, according to the last balance sheet, exceeds 200 thousand times the minimum wage.²⁴
Tax Legislation	<ul style="list-style-type: none">• The company needs to notify the tax authorities at its location about its participation in the new company within 30 days.²⁵

A subsidiary can also be created through the reorganization of a company in the form of split-up or spin-off.

→ *For more on company reorganization, see Part V, Chapter 16.*

²¹ CC, Article 51.

²² LJSC, Article 10, Clause 3.

²³ LJSC, Articles 11 and 13, Law on State Registration of Legal Persons, Articles 12 and 13.

²⁴ Antimonopoly Law, Article 17, Clause 5.

²⁵ Tax Code, Article 23, Clause 2.

A company can finally acquire shares in an already existing company. In such cases, the following requirements apply:

- The acquiring company must notify and disclose the acquisition of 20% of voting shares of the acquired company, and any subsequent 5% increases thereof, to the Federal Commission for the Securities Market (FCSM) within a month of the acquisition or increase.²⁶
- When the acquiring company has the right of disposal of more than 20% of voting shares of the acquired company, the company must:
 - Seek the consent of the antimonopoly body *ex ante*, when the sum of the assets of the founders according to the last balancesheet exceeds 200 thousand times the minimum wage or when one of the founding companies (or the persons who have a predominant participation in the capital of such a company) has a market share of more than 35%;²⁷ and
 - Notify the MAP, when the sum of the founders' assets according to the last balance sheet exceeds 100 thousand times the minimum wage.²⁸

2. Dominant-Dependent Company Structures

Another type of regime in a group of companies is that between dominant and dependent companies, which is regulated by the Company Law. The legal regime regulating dominant-dependent companies is quite similar to that of the parent-subsidiary regime, though, differences exist. The main difference between dependent companies and subsidiaries relates to the degree of control exercised by the parent/dominant company, and the legal obligations toward minority shareholders and creditors of subsidiary/dependent companies.

Thus, Company (B) is considered dependent on Company (A) when Company (A) holds more than 20% of the voting shares in Company (B).²⁹ Dependency consequently occurs on the satisfaction of a formal criterion (the acquisition of a percentage of voting shares) and not the nature of the relationship between the companies.

²⁶ CC, Article 106, Clause 2; LJSC, Article 6, Clause 4.

²⁷ Antimonopoly Law, Article 18, Clauses 1 and 2.

²⁸ Antimonopoly Law, Article 18, Clause 6.

²⁹ CC, Article 106, Clause 1; LJSC, Article 6, Clause 4.

Chapter 15. Corporate Governance in Groups of Companies

When dependent company structures exist, the following should be kept in mind:

- **Disclosure Obligation:** Company (B) is obliged to disclose its 20% stake in (A), as determined by the FCSM;³⁰ and
 - *For more information on such disclosure requirements, see Part IV, Chapter 13, Section B.3.*
- **Rules on Related Party Transactions:** The acquisition of more than 20% of shares in another company triggers special provisions of the Company Law when these two companies engage in certain transactions.³¹
 - *For more on related party transactions, see Part III, Chapter 12, Section C.*

Other than these two rules, the Company Law does not regulate relations between the dominant and dependent companies.

3. Holding Companies

The holding company concept was introduced by Presidential Decree in relation to groups of companies created in the process of transforming state-owned enterprises (SOEs) into joint stock companies for privatization.³² A holding company is defined as a company whose assets include control shares of another company or a group of companies.³³ Control shares are defined as any form of share participation that ensures the unconditional right of approving or rejecting specific decisions of the GMS and its executive bodies.

4. Financial and Industrial Groups

Russian law recognizes the existence of FIGs. FIGs are created for the purposes of technological or economic integration based on:³⁴

³⁰ LJSC, Article 6, Clause 4.

³¹ LJSC, Article 81, Clause 1.

³² Decree No. 1392, the President of the Russian Federation, Temporary Statute of Holding Companies Established in the Process of Transforming State Companies Into Joint Stock Companies (Decree No. 1392), 16 November 1992. Note that following this decree, a draft law on holdings has been discussed by the State Duma, but has yet to be adopted.

³³ Decree No. 1392, Clause 1.1.

³⁴ Law on Financial and Industrial Groups, Article 2.

- Legal entities acting as parent and subsidiary companies. In this case, both the parent company and the subsidiary form the FIG;³⁵ or
- Legal entities that have fully or partially unified their tangible or intangible assets on the basis of a contract for the establishment of a FIG.

Central to the FIG is a legal entity established by a contract between all parties, or a parent company authorized by law or contract to act as one.³⁶

The most important legal requirements applicable to FIGs are:

- The establishment of the FIG is subject to state registration;³⁷
- In the cases set forth by tax legislation, the contract for the establishment of a FIG can provide for tax consolidation of the members of the FIG.³⁸ Similarly, the contract can provide for accounting consolidation;³⁹
- The participants in the FIG bear joint and several liability for the debts incurred by the central company in realizing the activities of the group. The specific aspects of this liability are regulated by the contract for the establishment of the FIG;⁴⁰
- The FIG is required to prepare an annual report within 90 days of the end of the fiscal year.⁴¹ The report must reflect the results of the inspection of an independent External Auditor. This report is submitted to all participants of the group and to the authorized state body; and
- The FIG is subject to annual state control, including the possibility of an audit.⁴²

³⁵ Law on Financial and Industrial Groups, Article 3, Clause 5.

³⁶ Law on Financial and Industrial Groups, Article 11, Clause 1.

³⁷ Law on Financial and Industrial Groups, Article 5.

³⁸ Such provisions have not been made to date.

³⁹ Law on Financial and Industrial Groups, Article 13. Also, see Regulation No. 24, the Council of Ministers, on the Procedure for Keeping Consolidated Accounts, Reports, and Books of Financial and Industrial Groups, 9 January 1997.

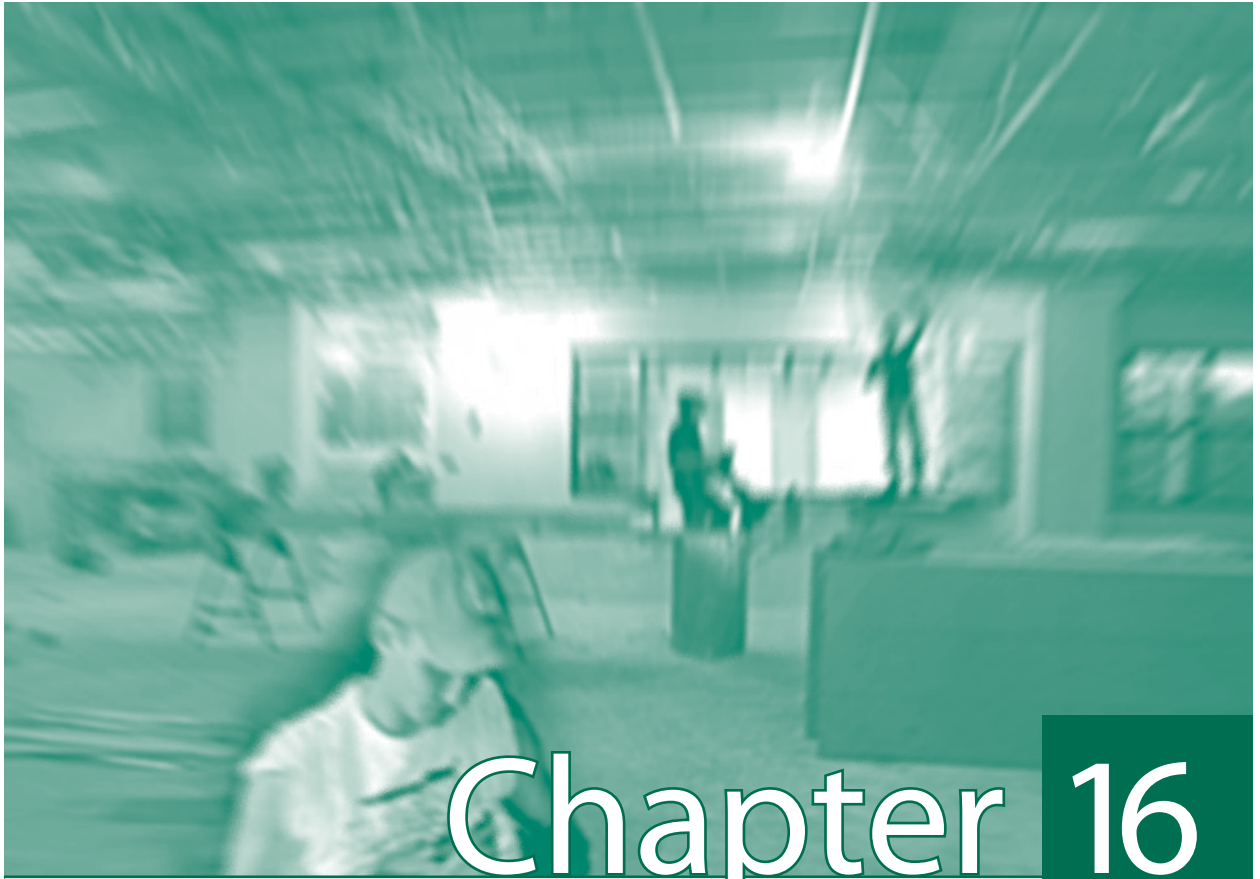
⁴⁰ Law on Financial and Industrial Groups, Article 14.

⁴¹ Law on Financial and Industrial Groups, Article 16.

⁴² Law on Financial and Industrial Groups, Article 17.

C. Summary Table

Table 4: Summary of Corporate Governance in Groups of Companies		
	Legal relationship in another company recognized	Legal consequences
Dependent companies (the Company Law)	Holding 20% or more of voting shares	Disclosure obligation
		Applicability of provisions regarding related party transaction
Parent-subsidiary (the Company Law)	Possibility to control decisions by virtue of: <ul style="list-style-type: none"> • Predominant share participation (typically, more than 50%), • Contract, or • Other. 	The parent can issue mandatory instructions regarding the business of the subsidiary if provided in the subsidiary's charter or the contract between parent and subsidiary.
		Extended liability of the parent for debts of the subsidiary if: <ul style="list-style-type: none"> • The debts are incurred in exercise of the parent's right to issue mandatory instructions (and parent <i>mala fide</i>), or • The insolvency of the subsidiary has been brought about by the parent (and parent <i>mala fide</i>).
		The parent is liable to the subsidiary's shareholders for losses caused deliberately.
Interdependent companies (Tax Code)	<ul style="list-style-type: none"> • Direct or indirect participation exceeding 20% • Other relationship with effect on the results of the transactions in realizing goods or providing labor or services, when recognized by a court. 	Notification obligation and tax liability.
Groups of persons (Antimonopoly Law)	Direct or indirect relationships. → See Section A.4.b in this Chapter	Requirements for notification or <i>ex ante</i> approval.
Affiliated persons (Antimonopoly Law)	→ See section A.4.b in this Chapter	Requirements for notification or <i>ex ante</i> approval.
Financial and Industrial Group (Law on Financial and Industrial Groups)	Group of companies based on: <ul style="list-style-type: none"> • A parent-subsidiary relationship; • A special contract for the establishment of the FIG. 	Requirements for state registration and enhanced state regulation.



Chapter 16

Corporate Governance **Implications** of **Reorganizations**

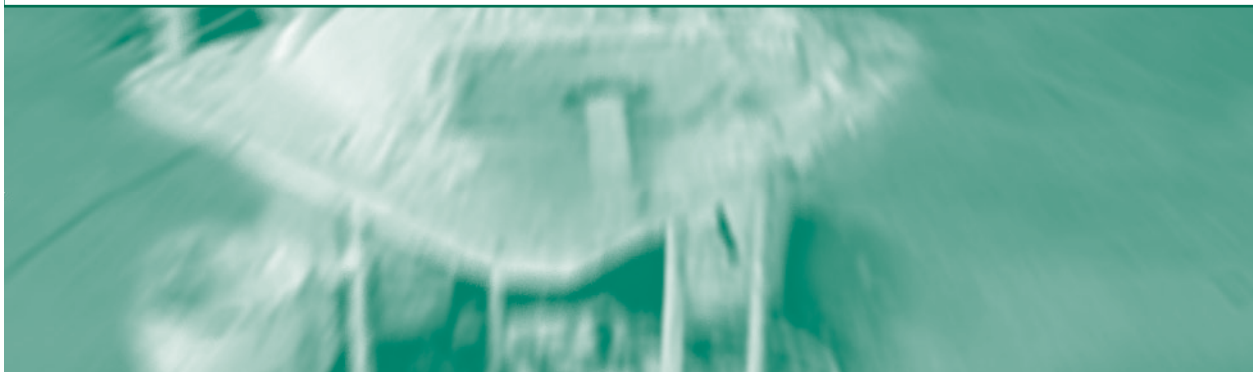


Table of Contents

A. GENERAL OVERVIEW.....	29
1. <i>Types of Reorganizations</i>	29
2. <i>Voluntary and Mandatory Reorganization</i>	29
B. SHAREHOLDER PROTECTION DURING A REORGANIZATION.....	30
C. CREDITOR PROTECTION DURING A REORGANIZATION	31
D. REORGANIZATION PROCEDURES.....	33
1. <i>The Proposal for a Reorganization</i>	33
2. <i>The Preliminary Approval</i>	33
3. <i>Approval</i>	35
4. <i>Transactions with Shares During a Reorganization</i>	36
5. <i>State Registration</i>	37
E. CONSOLIDATIONS	38
1. <i>Documents and Decisions Required for a Consolidation</i>	39
2. <i>Specific Aspects of the Decision-Making Procedure</i>	40
3. <i>Retiring Shares</i>	41
4. <i>Approval by the Competition Authorities</i>	41
5. <i>State Registration</i>	42
F. MERGERS.....	43
1. <i>Documents and Decisions Required for a Merger</i>	44
2. <i>Specific Aspects of the Decision-Making Procedure</i>	44
3. <i>Retiring Shares</i>	44
4. <i>State Registration</i>	45
G. SPLIT-UPS.....	45
1. <i>Documents and Decisions Required for a Split-Up</i>	45
2. <i>Specific Aspects of the Decision-Making Procedure</i>	46
3. <i>State Registration</i>	46

H. SPIN-OFFS OR DIVESTITURES.....	47
1. <i>Documents and Decisions Required for a Divestiture</i>	48
2. <i>Specific Aspects of the Decision-Making Procedure</i>	48
3. <i>Converting, Distributing, or Acquiring Shares</i>	48
4. <i>State Registration</i>	49
I. TRANSFORMATIONS	49
1. <i>Documents and Decisions Required for a Transformation</i>	50
2. <i>Decisions of Participants in the New Legal Entity</i>	50
3. <i>State Registration</i>	50

The Chairman's Checklist

- ✓ Is management's reorganization proposal economically justifiable and legally feasible? Have negotiations with other companies participating in the reorganization been conducted with due diligence and in good faith?
- ✓ Has the Supervisory Board considered the company's reorganization as part of the company's long-term development strategy? If so, has the Supervisory Board carefully deliberated financial, legal, and social implications?
- ✓ Have all documents needed for the approval of the reorganization by the General Meeting of Shareholders been prepared and submitted to shareholders on a timely basis? Are these documents sufficient for shareholders to make an informed decision?
- ✓ Have creditors been duly notified of the planned reorganization? Has the legal succession of all debt been ensured? Has the potential cost of early repayment of debts been properly estimated?
- ✓ Have all the requirements of state registration (including of charter amendments) been met? Have the appropriate state bodies been notified of the reorganization or, if applicable, has their preliminary approval been obtained? Are there any aspects of the proposed reorganization that involve international or foreign rules and regulations?

Companies often respond to a dynamic and changing business environment by reorganizing their operations, for example by recasting their legal structure. They may decide to restructure on a relatively small scale by streamlining, for example, a division or function, or by changing reporting structures.

There are other times when companies will restructure or reorganize themselves on a larger scale. They may acquire or merge with other companies in order to take better advantage of markets or assets, or to achieve greater economies of scope or scale. The joining of existing businesses is generally referred to as a "consolidation" or a "merger". There are other situations when the isolation of business operations, assets, or liabilities is needed. These are generally

Chapter 16. Corporate Governance Implication of Reorganizations

referred to as “spin-offs, sales, or divestitures”. A change to another legal form of company such as, for example, a limited liability company, is referred to as a “transformation”.

Whatever the justification may be for a corporate reorganization, it is typically a complex process that involves the interaction of the company’s governing bodies; it will also typically have corporate governance implications for the rights of shareholders and creditors, as well as other stakeholders, such as employees.

A. General Overview

1. Types of Reorganization

Russian law envisages five different types of company reorganization.⁴³ Figure 1 describes the simplest cases of each type.

2. Voluntary and Mandatory Reorganization

A reorganization is generally voluntary. In specific circumstances, however, legislation may require a company to reorganize.⁴⁴ Such reorganization can take the form of a split-up or divestiture, and is carried out pursuant to the decision of an authorized state body or court ruling.⁴⁵ For example, the Ministry of Antimonopoly Policy and Entrepreneurship Support (MAP) can force the split-up or divestiture of companies if they:⁴⁶

- Have a dominant market position; or
- Have committed two or more violations of antimonopoly legislation.

Companies may also be forced to restructure themselves in the context of bankruptcy proceedings. This chapter refers to reorganizations in the

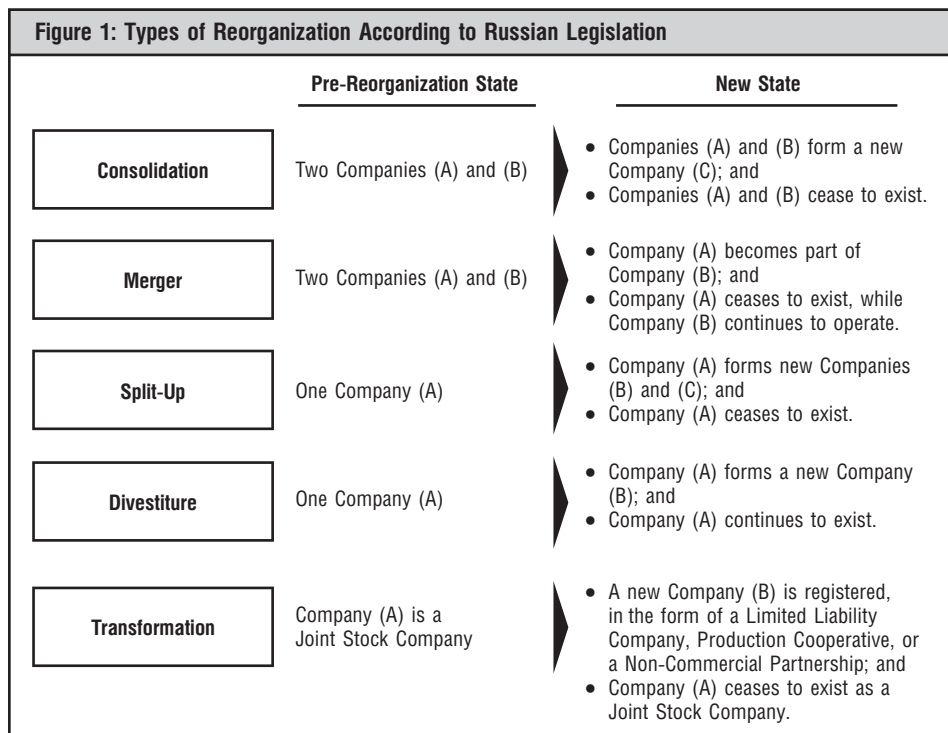
⁴³ Civil Code (CC), Article 57, Clause 1; Law on Joint Stock Companies (LJSC), Article 15, Clause 2.

⁴⁴ CC, Article 57, Clause 2; LJSC, Article 15, Clause 1.

⁴⁵ CC, Article 57, Clause 2.

⁴⁶ Law on Competition and Restricting the Monopoly Activities on the Commodities Markets (Antimonopoly Law), Article 19.

broader sense and focuses only on large-scale voluntary reorganization of companies.



Source: IFC, March 2004

B. Shareholder Protection During a Reorganization

Reorganization is a significant event in the life of a company with potentially far-ranging implications for shareholders. Legislation provides rules that guarantee shareholders access to information about the reorganization, participation in the decision-making process and, in certain circumstances, the right to exit from the company. Some requirements in case of reorganisation include:

Chapter 16. Corporate Governance Implication of Reorganizations

- **Longer notification periods for the General Meeting of Shareholders (GMS):** Notice of the GMS must be given no later than 30 days in advance of the GMS, if the decision to reorganize is placed on the agenda.⁴⁷
- **Longer access periods for information:** Information must be made available 30 days before the GMS.⁴⁸
- **Additional information must be made available to shareholders.**⁴⁹
- **Preferred shareholders have the right to vote on agenda items related to the reorganization.**⁵⁰
- **A supermajority (3/4-majority) of votes is required for the approval of the reorganization.**⁵¹
- **Redemption rights:** Holders of voting shares can demand the redemption of all or part of their shares if they voted against the reorganization or did not participate in the voting during the GMS.⁵²
- **The right to receive the same type of shares in cases of split-up or divestiture:** Shareholders of a company being reorganized either through split-up or divestiture who did not vote on the decision or voted against it are entitled to receive a proportional number of shares in the newly established company(ies) granting them the same rights as before.⁵³

C. Creditor Protection During a Reorganization

Reorganizations may also have important implications for creditors. Changes may be made to the company's assets and/or liabilities that could have an impact on the degree of risk affecting the repayment of debt, or on the terms of the debt agreements themselves. Thus, legislation guarantees the following rights to creditors during a reorganization:⁵⁴

⁴⁷ LJSC, Article 52, Clause 1.

⁴⁸ LJSC, Article 52, Clause 3.

⁴⁹ Federal Commission for the Securities Market (FCSM) Regulation No. 17/ps on Additional Requirements to the Procedure of Preparing, Calling, and Conducting the General Meeting of Shareholders (FCSM Regulation No. 17/ps), 31 May 2002, Section 3.5.

⁵⁰ LJSC, Article 32, Clause 4.

⁵¹ LJSC, Article 49, Clause 4.

⁵² LJSC, Article 75, Clause 1.

⁵³ LJSC, Article 18, Clause 3; Article 19, Clause 3.

⁵⁴ It is also important to keep in mind that contractual agreements with creditors may provide additional guarantees that benefit lenders in the event of the company's reorganization.

a) Notification Requirement

The governing body of the company must notify creditors about the reorganization.⁵⁵ This must be done within 30 days of the day of:

- The decision on the reorganization if this involves a split-up or divestiture; or
- The decision on the reorganization adopted by the last company involved in the reorganization if it involves a consolidation or merger.

Further, the company must notify creditors by:

- Written notification; and
- Publication of the decision in the print media where information on the state registration of companies is published.

b) Options of Creditor Actions

Creditors have the right to request the termination or early performance of the company's obligations, as well as compensation for losses.⁵⁶ Creditors are granted 30 days from the notification day to file a written claim against the debtor.⁵⁷

c) Rules on the Succession of Company Liabilities

Legislation guarantees that liabilities are assumed by the new entities resulting from reorganization. Thus:

- The transfer act and the divided balance sheet required for the reorganization must allocate the rights and obligations of the reorganized entity(ies) to the new entity(ies), thus ensuring legal succession.⁵⁸ If no such provision is made, the state registration authority must refuse the registration of the reorganization.⁵⁹
- If the transfer act or the divided balance sheet makes it impossible to determine the precise legal successor of the reorganized company, all newly established companies will be jointly and severally liable for the debts of the defunct entity(ies).⁶⁰

⁵⁵ CC, Article 60, Clause 1; LJSC, Article 15, Clause 6.

⁵⁶ CC, Article 60, Clause 2.

⁵⁷ LJSC, Article 15, Clause 6.

⁵⁸ CC, Article 59, Clause 1.

⁵⁹ CC, Article 59, Clause 2.

⁶⁰ CC, Article 60, Clause 3; LJSC, Article 15, Clause 6.

D. Reorganization Procedures⁶¹

1. The Proposal for a Reorganization

The executive bodies of a company typically decide how to reorganize, based on the company's goals, and act to initiate and implement the reorganization. The initiation of the reorganization should be consistent with the company's overall strategy as developed and approved by the Supervisory Board and shareholders.

Best Practices: A corporate reorganization is a complex and resource intensive undertaking. Most reorganizations in fact destroy rather than create shareholders value. Some of the preparatory steps that management will thus want to carefully consider include:

- Conducting a full analysis of the commercial and legal (as well as social and political) implications of the reorganization. The analysis should include an assessment of the role of, and the impact upon, shareholders and other stakeholders during and after the reorganization;
- Negotiating the (preliminary) terms and conditions of the reorganization with the executive bodies of other companies participating in the reorganization;
- Preparing documents that will enable the Supervisory Board and the shareholders to make an informed decision on the reorganization; and
- Preparing drafts of the main documents required by the Company Law for the reorganization. These documents are then submitted to the Supervisory Board and the GMS for approval (as well as regulatory bodies where applicable).

2. The Preliminary Approval

A preliminary approval of the Supervisory Board is usually required for a reorganization. The Supervisory Board should consider whether the proposed reorganization is in the best interests of the company and its shareholders. It will

⁶¹ This section summarizes procedural steps common to all types of reorganization. The specific aspects of different types of reorganizations are discussed in this Chapter's Sections E through I.

also need to consider other issues, such as the fate of the reorganizing company's employees. The Supervisory Board must then submit a proposal on reorganizing the company to the GMS for shareholder approval.⁶²

Best Practices: The decision to submit a reorganization for approval to the GMS should only be made after the Supervisory Board has concluded that the reorganization is necessary, and after determining that the negotiated terms are acceptable to the company. The Supervisory Board must be provided with all information necessary to make an informed decision. In addition to the draft documents required for the reorganization, the Supervisory Board should be provided with:⁶³

- Annual reports and balance sheets for the last three reporting years of all companies participating in the reorganization in the case of a consolidation or merger;
- Quarterly reports compiled no later than six months prior to the date of the GMS which will consider the issue of reorganization, if more than six months have passed since the end of the reporting year; and
- The rationale for the reorganization.

In addition, the Supervisory Board should participate actively in finalizing the terms of the company's reorganization.⁶⁴ The Supervisory Board may be involved in the reorganization in a number of ways:

- Individual directors may participate in negotiations conducted by executive bodies; and
- A special, or *ad hoc* Supervisory Board committee, task force, or working group can work with the executive bodies before, during, and/or after the negotiations regarding the reorganization.

Reorganization is of such importance to a company that close oversight by the Supervisory Board during the final stages of the negotiation process is indispensable.

The Supervisory Board should approve the final drafts of the documents by a simple majority vote, unless the charter or by-laws require a supermajority.⁶⁵

⁶² LJSC, Article 16, Clause 2; Article 49, Clause 3.

⁶³ FCSM's Code of Corporate Conduct (FCSM Code), Chapter 6, Section 3.1.2.

⁶⁴ FCSM Code, Chapter 6, Section 3.1.

⁶⁵ LJSC, Article 68, Clause 3.

Chapter 16. Corporate Governance Implication of Reorganizations

Best Practices: Supervisory Board members should be physically present at the Board meeting to recommend the approval of the reorganization by the GMS.⁶⁶ In addition, a higher quorum of $2/3$ of all directors is recommended.⁶⁷

The Supervisory Board should express its position (with minority dissenting views clearly appended to any Board opinion that is not unanimous) regarding the merits and disadvantages of the reorganization along with the other documents that are submitted to the GMS.⁶⁸

3. Approval

a) Preparing for the General Meeting of Shareholders

The preparation for the GMS, which will either approve or reject the corporate reorganization, should not be a last-minute exercise. First, there is a longer legally stipulated notification period (30 instead of 20 days); furthermore, there are also legally-mandated additional disclosure requirements.⁶⁹

A detailed list of information that must be made available to shareholders is set out in the Company Law and securities legislation; additional disclosure requirements may be mandated by the company's charter.⁷⁰

Best Practices: The company's charter should define the materials to be provided to shareholders, including the:⁷¹

- Rationale for the reorganization;
- Annual reports and annual balance sheets for the last three reporting years of all organizations participating in the reorganization;
- Conclusion of a professional securities markets expert;

⁶⁶ FCSM Code, Chapter 3, Section 4.4.

⁶⁷ FCSM Code, Chapter 3, Section 4.15.

⁶⁸ FCSM Code, Chapter 6, Section 3.1.1.

⁶⁹ LJSC, Article 52, Clause 1 and 3.

⁷⁰ LJSC, Article 52.

⁷¹ FCSM Code, Chapter 2, Section 1.3.1; Chapter 7, Section 3.2.1; FCSM Regulation No. 17/ps, Section 3.5.

- Quarterly reports if more than six months have passed since the end of the last reporting year; and
- Any additional information that might be relevant in influencing the decision to approve a reorganization.

Another aspect of GMS preparation relates to the agenda. Voting on the reorganization may involve adopting a number of separate but related resolutions (e.g., on the terms and conditions of the reorganization, on the conversion of shares, or on the election of new governing bodies).

Best Practices: For this reason it is recommended that companies group together, or combine, resolutions on related issues.⁷²

b) Conducting the GMS

The resolution on reorganization must be approved by a $\frac{3}{4}$ -majority vote of shareholders participating in the GMS.⁷³ Both common and preferred shares are allowed to vote on the reorganization of a company.⁷⁴

4. Transactions with Shares During a Reorganization

Different transactions with shares, namely retiring, placing, converting, distributing, or acquiring shares during the reorganization process are regulated by the Company Law, securities legislation, and the terms of the reorganization agreement.⁷⁵ The processes and methods of placing new shares are specified by the Company Law and securities legislation for each type of reorganization.

Best Practices: It is good practice for an Independent Appraiser to determine the conversion ratio of shares in order to ensure a fair transaction.⁷⁶

⁷² FCSM Code, Chapter 2, Section 1.4.3.

⁷³ LJSC, Article 49, Clause 4.

⁷⁴ LJSC, Article 32, Clause 4.

⁷⁵ LJSC, Article 37, Clause 2.

⁷⁶ FCSM Code, Chapter 6, Section 3.2.

Chapter 16. Corporate Governance Implication of Reorganizations

This appraisal should be communicated to the executive bodies, Supervisory Board and shareholders on a timely basis. Confidentiality restrictions should be limited in number and scope to only those that are strictly necessary in the legitimate business interests of the parties involved.

5. State Registration

The state registration of a reorganization is mandatory. Table 1 depicts the different registrations mandated, depending on the type of reorganization.

	Charter Amendments	Striking the Company Off the Register	Registration of Each New Company
Consolidation		✓	✓
Merger	✓	✓	
Split-up		✓	✓
Divestiture	✓		✓
Transformation		✓	✓

→ For more information on how to amend the charter of the reorganizing company, see Part I, Chapter 3, Section A.

a) Registering a New Legal Entity

When reorganization results in a new legal entity, it will need to be registered by the state registration authority at its location. When the new legal entity is located at a place different from that of the reorganized company, the registration requires the cooperation of different regional divisions of the state registration authority.⁷⁷

The following documents need to be submitted to the registration authorities:⁷⁸

⁷⁷ The procedure for this is provided by Regulation No. 440, the Government of the RF, 19 June 2002.

⁷⁸ Law on State Registration of Legal Entities, Article 14; LJSC, Article 15, Clause 6. Some of the documents are specifically mentioned in the CC, Article 59, Clause 2.

- A statement regarding each newly created company confirming that:
 - The founding documents of the newly created legal entity comply with legal requirements,
 - The information included in the founding documents and the statement is true,
 - The transfer act or the divided balance sheet includes provisions regarding the legal succession of all obligations with respect to all creditors,
 - All creditors of the reorganized company have been notified in writing about the reorganization, and
 - The reorganization has been approved by the appropriate state and/or municipal authorities if legally required;
- The founding documents of the newly established entity;
- The reorganization agreement and decision to reorganize;
- The transfer act or the divided balance sheet; and
- Proof of payment of the registration fee.

b) Striking the Reorganized Companies from the Register

The state registration authority makes a record that the reorganized companies cease to exist. It then strikes the reorganized companies from the register of commercial legal entities after receiving information from the registration division registering the newly established legal entities.⁷⁹

E. Consolidations

A consolidation is the combination of separate companies into a single one. It differs from a merger in that a new entity is created.⁸⁰ The newly created company assumes all rights and obligations of the companies participating in the consolidation according to the transfer act.⁸¹ Consolidations allow companies to:

- Achieve economies of scale or scope and operate more efficiently;
- Realize strategic benefits, such as entry into new markets in the case of cross-border consolidations;

⁷⁹ Law on State Registration of Legal Entities, Article 15, Clause 2.

⁸⁰ CC, Article 58, Clause 1; LJSC, Article 16, Clause 1.

⁸¹ LJSC, Article 16, Clause 5.

Chapter 16. Corporate Governance Implication of Reorganizations

- Increase the company's charter capital;
- Improve its capacity to borrow; and
- Raise revenues by the aggregation of sales, through increased market power and more efficient marketing efforts.

1. Documents and Decisions Required for a Consolidation

Each of the companies participating in a consolidation must adopt the documents and decisions as presented in Table 2.

Document	Information Contained in the Document
Consolidation agreement	<p>The consolidation agreement should include the terms and procedures necessary for implementing the consolidation, including:⁸²</p> <ul style="list-style-type: none">• The procedure for converting the shares of each of the consolidating companies into the shares of the new company;• The conditions for conducting the joint GMS of the new company (e.g. voting procedures); and• Other terms and conditions, such as the date of the consolidation, allocation of costs, management (executive) functions, and the liability for breach of agreement.
Transfer act	<p>The transfer act is the main document that deals with the succession of the company's obligations, including any contested obligations.⁸³ Certain documents should be attached to the transfer act.⁸⁴</p>

⁸² LJSC, Article 16, Clauses 2 and 3; FCSM Regulation No. 03-30/ps on the Standards of Security Issue and Registration of Security Prospectuses, 18 June 2003, Section 8.4 also provides for other methods of converting shares of the reorganized companies into the shares of the new company which, however, do not apply to the consolidation of Joint Stock Companies (it applies to Limited Liability Companies, Production Cooperatives, or Non-commercial Partnerships).

⁸³ CC, Article 59, Clause 1; LJSC, Article 16, Clause 5.

⁸⁴ Ministry of Finance Order No. 44n, on the Approval of Methodological Instructions on Formation of Accounting Statements in the Process of Reorganization of Organizations, 20 May 2003, Annex, Section 4.

Table 2: Documents Required for Consolidation	
Document	Information Contained in the Document
Charter of the newly created company	→ For more on charter requirements, see Part I, Chapter 3, Section A, as well as the model company charter in Part VI, Annex 2.
Decision on the reorganization	The decision adopted by the GMS of each consolidating company. ⁸⁵

2. Specific Aspects of the Decision-Making Procedure

a) Exemption from Provisions on Related Party Transactions

When one of the consolidating companies holds more than $\frac{3}{4}$ of voting shares of the other, then the legal provisions on related party transactions do not apply.⁸⁶

→ For more information on related party transactions, see Part III, Chapter 12, Section C.

b) Conducting a GMS of the New Company

A joint GMS of all consolidating companies shall be held after the decision of the companies to consolidate.⁸⁷

Best Practices: The notice of the joint GMS should be given by each consolidating company in accordance with the procedures established for that company by legislation and its charter.⁸⁸

The joint GMS adopts decisions on:

- Electing the governing bodies of the new company;⁸⁹ and
- Other issues related to the founding of the new company, such as adopting a new charter and by-laws.

⁸⁵ LJSC, Article 48, Clause 1, Section 2.

⁸⁶ LJSC, Article 81, Clause 2.

⁸⁷ LJSC, Article 16, Clause 3.

⁸⁸ FCSM Code, Chapter 6, Section 3.3.

⁸⁹ LJSC, Article 16, Clause 3. The Company Law does not describe the procedures for conducting the joint Supervisory Board meeting or joint GMS. It does, however, provide the possibility of specifying voting procedures in the consolidation agreement.

Best Practices: The GMS of the newly created entity should follow all of the regular voting procedures established by law, and its charter and by-laws.⁹⁰ In addition, the consolidation agreement should specify who will perform certain functions at the GMS, including its chairmanship. It is recommended to select individuals who perform these functions from the companies that are a party to the consolidation or from among outside persons who possess relevant special skills or experience. Finally, the agreement should specify individuals who will count the voting results.

3. Retiring Shares

Any shares that a consolidating company holds in another consolidating company, as well as any treasury shares, must be retired.⁹¹

→ For more on retiring treasury shares, see Part III, Chapter 9, Section C.1.

4. Approval by the Competition Authorities

The MAP exercises two forms of control over consolidations: 1) notification; and 2) preliminary approval.⁹²

a) Notification Requirement

Consolidating companies are obliged to notify the MAP within 45 days of state registration, if its assets exceed 100 thousand times the minimum monthly wage.⁹³

If the resulting entity potentially restricts competition, the MAP may prescribe corrective actions.⁹⁴

b) Preliminary Approval

For the consolidation of companies with assets of more than 200 thousand times the minimum monthly wage, preliminary approval of the MAP is required.⁹⁵

⁹⁰ FCSM Code, Chapter 6, Clause 3.4.

⁹¹ LJSC, Article 16, Clause 4.

⁹² This control is based on the general provisions of the CC, Article 57, Clause 3.

⁹³ Antimonopoly Law, Article 17, Clause 5.

⁹⁴ Antimonopoly Law, Article 17, Clause 6.

⁹⁵ Antimonopoly Law, Article 17, Clause 1.

To obtain the MAP's preliminary approval, consolidating companies must submit:⁹⁶

- An application;
- The same documents that need to be submitted to the state registration authority;
- Information on the economic activities and production (or service) volumes of the company; and
- Other information as may be required by the MAP.⁹⁷

The MAP must respond within 30 days of the written application (50 days with an extension).⁹⁸ The MAP may reject the application if:⁹⁹

- The information submitted in the application is untrue; or
- The approval of the consolidation would restrict competition.

Even if competition could be restricted as a result of consolidation, the MAP may grant the approval if:¹⁰⁰

- The applicant proves that negative effects will be offset by the positive effect of the consolidation; or
- The consolidating companies agree to carry out actions to safeguard competition.

The preliminary approval of the MAP is a pre-condition for state registration.¹⁰¹

5. State Registration

Companies are consolidated as of the date when state registration of the newly established company is completed,¹⁰² and the reorganizing companies are stricken from the register.¹⁰³

⁹⁶ Antimonopoly Law, Article 17, Clause 2.

⁹⁷ This list of possible additional information was introduced by the MAP Order No. 276, 13 August 1999.

⁹⁸ Antimonopoly Law, Article 17, Clause 2.

⁹⁹ Antimonopoly Law, Article 17, Clause 3.

¹⁰⁰ Antimonopoly Law, Article 17, Clause 4.

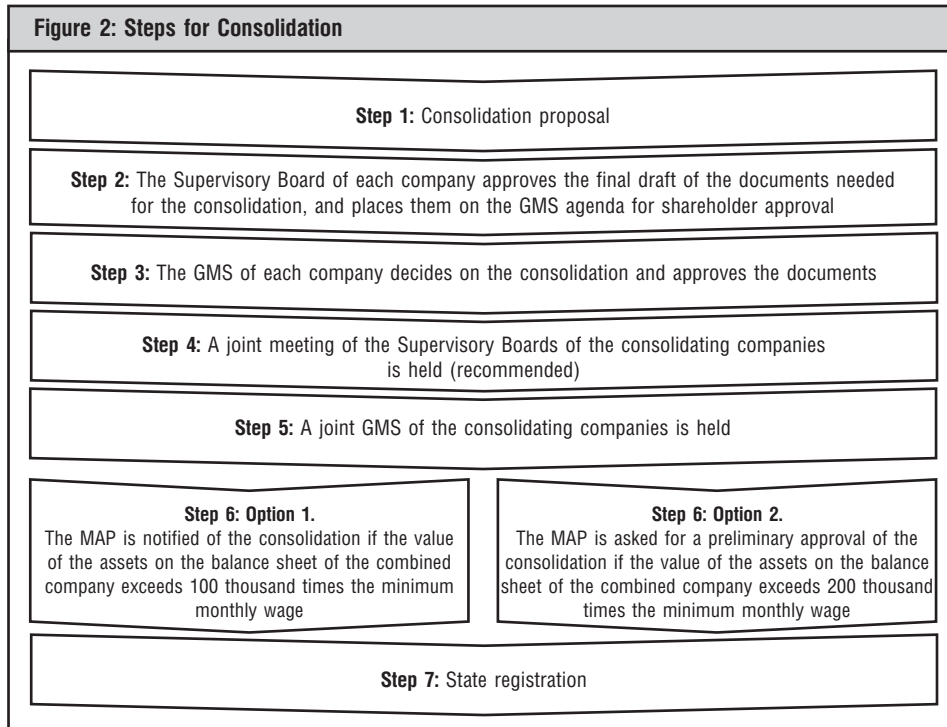
¹⁰¹ Antimonopoly Law, Article 17, Clause 8.

¹⁰² CC, Article 57, Clause 4.

¹⁰³ Law on State Registration of Legal Entities, Article 16, Clause 2.

Chapter 16. Corporate Governance Implication of Reorganizations

Figure 2 summarizes the steps involved in a consolidation.



Source: IFC, March 2004

F. Mergers

A merger is the combination of two or more entities into one, through a purchase or a pooling of interests. A merger differs from a consolidation in that no new entity is created from a merger. Mergers involve the transfer of rights and obligations of one or more companies to another company. One company survives and the other(s) is (are) stricken from the register.¹⁰⁴ The surviving company assumes all of the rights and liabilities of the merging company(ies) according to the transfer act.¹⁰⁵

¹⁰⁴ CC, Article 58, Clause 2; LJSC, Article 17, Clause 1.

¹⁰⁵ LJSC, Article 17, Clause 5.

The advantages of a merger are generally the same as for consolidations. The steps required to carry out a merger closely resemble those of a consolidation. This section focuses on the differences.

1. Documents and Decisions Required for a Merger

In a merger, the following documents need to be submitted to the GMS for shareholder approval by each of the merging companies:¹⁰⁶

- The merger agreement, which sets forth merger terms and conditions, the procedure for converting the shares of the merging companies into surviving company shares, the voting procedure for conducting the joint GMS of the surviving company, and other conditions;
- The transfer act; and
- The decision on reorganization through merger.

2. Specific Aspects of the Decision-Making Procedure

The joint GMS of the merging companies must make decisions on:¹⁰⁷

- Amendments and additions to the charter of the surviving company; and
- Other issues related to the merger, e.g. the adoption of new by-laws.

The decision-making procedure for the joint GMS is specified in the merger agreement.

3. Retiring Shares

Any shares in the merging company that are owned by the surviving company, as well as any treasury shares, must be retired.¹⁰⁸

¹⁰⁶ LJSC, Article 17, Clause 2.

¹⁰⁷ LJSC, Article 17, Clause 3.

¹⁰⁸ LJSC, Article 17, Clause 4.

4. State Registration

The merger is concluded with the registration of the merging company(ies) termination in the state register.¹⁰⁹

Figure 2 above also refers to the steps involved in a merger.

G. Split-Ups

A split-up of companies is the transfer of all rights and obligations of one company to a number of newly created companies, and the termination of the original company.¹¹⁰ The newly created companies assume all the rights and liabilities of the original company according to the divided balance sheet.¹¹¹ A split-up typically allows a company to:

- Rid itself of units (divisions) that are either underperforming, no longer important to the achievement of its strategic goals, or potentially worth more as separate units than as part of a whole;
- Grant legal personality to previously existing sub-divisions (e.g. in order for these to benefit from an Initial Public Offering (IPO));
- Comply with specific legal requirements in different jurisdictions in which the company now (or in the future) operates;
- Comply with the requirements of competition authorities or to reorganize in the context of bankruptcy proceedings; and
- Better resolve corporate conflicts with shareholders.

1. Documents and Decisions Required for a Split-Up

Figure 3 illustrates the decisions and documents needed to split a company:¹¹²

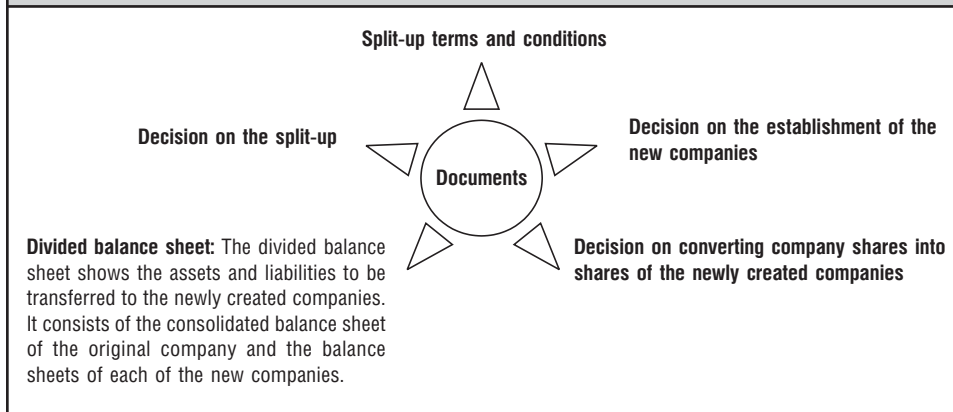
¹⁰⁹ Law on State Registration of Legal Entities, Article 16, Clause 5.

¹¹⁰ CC, Article 58, Clause 3; LJSC, Article 18, Clause 1.

¹¹¹ LJSC, Article 18, Clause 4.

¹¹² LJSC, Article 18, Clauses 2 — 4; Ministry of Finance Order No. 44n on the Approval of Methodological Instructions on Formation of Accounting Statements in the Process of Reorganization of Organizations, 20 May 2003, Annex, Section 4.

Figure 3: Documents Required for a Split-Up



Source: IFC, March 2004

2. Specific Aspects of the Decision-Making Procedure

The GMS of the original company is followed by separate GMS of the new companies created by split-up, each of which must:¹¹³

- Adopt a new company charter;
- Form governing bodies; and
- Decide on other issues related to the governance of the new company, such as adopting new by-laws.

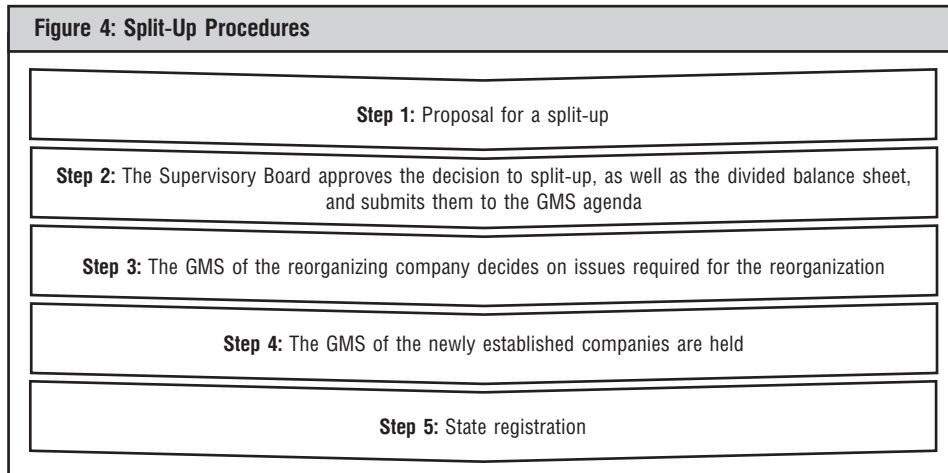
3. State Registration

The split-up is legally recognized as of the state registration of the last of the newly established companies.¹¹⁴

Figure 4 summarizes steps involved in carrying out a split-up.

¹¹³ LJSC, Article 18, Clause 3.

¹¹⁴ Civil Code, Article 57, Clause 4; Law on State Registration of Legal Entities, Article 16, Clause 3.



Source: IFC, March 2004

H. Spin-Offs or Divestitures

Spin-offs or divestitures are the establishment of one (or more) new company(ies) with the transfer thereto of a portion of the rights and obligations of the company being reorganized without its termination.¹¹⁵ Companies often choose to divest assets that are:

- Underperforming;
- Not part of the company's core business; or
- Worth more as separate entities than as part of the company.

A spin-off or divestiture may also be used to remedy mismatches between acquired companies and parent companies or to comply with the requirements of competition authorities. The newly created company(ies) assume(s) part of the assets and liabilities of the original company according to a divided balance sheet.¹¹⁶ Unlike in a split-up, the original company continues to exist.¹¹⁷

The steps for carrying out a divestiture closely resemble those of a split-up, and, therefore, the following text focuses only on differences.

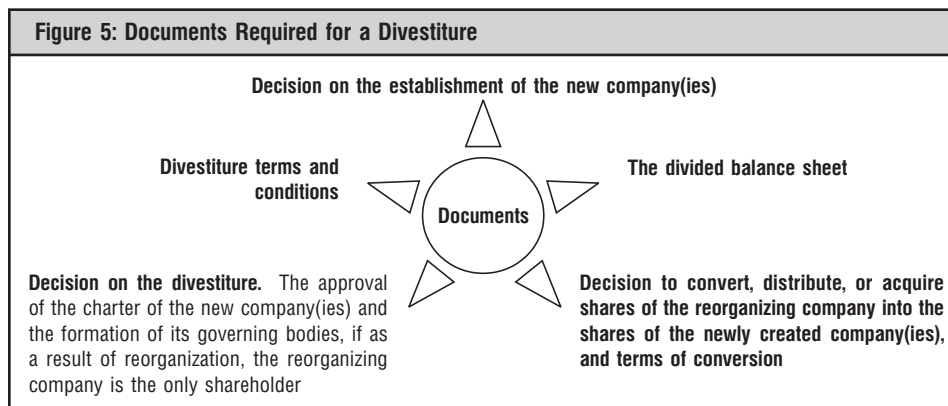
¹¹⁵ LJSC, Article 19, Clause 1.

¹¹⁶ LJSC, Article 19, Clause 4.

¹¹⁷ CC, Article 58, Clause 4; LJSC, Article 19, Clause 1.

1. Documents and Decisions Required for a Divestiture

Figure 5 shows the documents and decisions required to implement a divestiture.¹¹⁸



Source: IFC, March 2004

2. Specific Aspects of the Decision-Making Procedure

If the divesting company is not the sole shareholder in the spin-off, the GMS of each newly created company must:¹¹⁹

- Approve a new charter;
- Form governing bodies; and
- Decide on other issues, such as the adoption of new by-laws.

3. Converting, Distributing, or Acquiring Shares

The shares of the divesting company must be exchanged for the shares of the newly established company(ies). This can be done by:¹²⁰

- Conversion;
- Distribution of the new company's shares to the shareholders of the divesting company without consideration; or
- Acquisition of these shares by the divesting company.

¹¹⁸ LJSC, Article 19, Clause 2 and 3.

¹¹⁹ LJSC, Article 19, Clause 3.

¹²⁰ LJSC, Article 19, Clause 2.

4. State Registration

The divestiture is completed when the state registration of the last of the divested companies is completed.¹²¹

Figure 4 above also refers to the steps involved in carrying out a spin-off or divestiture.

I. Transformations

A joint stock company may transform itself into another type of legal entity. Transformation of a company involves the transfer of all rights and obligations to a newly formed legal entity based on a transfer act, whereby the joint stock company is terminated.¹²² The legal forms of entities include a:

- Limited liability Company (LLC);
- Production Co-operative; or
- Non-commercial Partnership.¹²³

Company Practices in Russia: Transformations frequently occur when minority shareholders are bought out by the company's controlling shareholder(s) who wish(es) to take the company private. Indeed, many companies involuntarily became joint stock companies through privatization, regardless of their size and ability to carry the costs of this legal form. A transformation, thus, continues to be a useful tool to make a company's economic identity consistent with its legal identity.

There are important differences between joint stock companies on the one hand, and LLCs, production cooperatives, and non-commercial partnerships, on the other. Mostly, these relate to the rights of shareholders (members), relationships between the governing and other internal bodies, and disclosure requirements.

→ *For a general discussion on the advantages (and disadvantages) of joint stock companies relative to LLCs, see Part I, Chapter 2, Section A.*

¹²¹ Law on State Registration of Legal Entities, Article 16, Clause 4.

¹²² CC, Article 58, Clause 5; LJSC, Article 20, Clause 4.

¹²³ Law on Non-Commercial Organizations, Article 8.

1. Documents and Decisions Required for a Transformation

The GMS must adopt the following decisions for the company transformation:¹²⁴

- Decision on the transformation;
- Decision on the terms and conditions of the transformation; and
- Decision on the conversion of shares into the stakes of members of a limited liability company or the contributions of the members of a production co-operative.

2. Decisions of Participants in the New Legal Entity

The participants in the new legal entity must decide on:¹²⁵

- The founding documents of the new legal entity; and
- The formation of the governing bodies of the new legal entity.

These decisions need to conform with applicable legislation for the particular legal form to be adopted.

3. State Registration

The company transformation is completed as of the moment of the state registration of the newly established legal entity, whereupon the original company ceases to exist.¹²⁶

¹²⁴ LJSC, Article 20, Clause 2.

¹²⁵ LJSC, Article 20, Clause 3.

¹²⁶ Law on the State Registration of Legal Persons, Article 16, Clause 1.

Chapter 17

Enforcement and Remedies



Table of Contents

A. GENERAL OVERVIEW.....	54
1. <i>Enforcement Structures</i>	54
2. <i>Available Remedies</i>	54
B. ENFORCEMENT BY JUDICIAL AUTHORITIES.....	55
1. <i>Court Jurisdiction</i>	55
2. <i>Provisional Remedies</i>	58
3. <i>Statute of Limitations</i>	66
4. <i>Types of Claims</i>	66
5. <i>Administrative Procedures in Arbitration Courts</i>	67
6. <i>Enforcement Authority of the Prosecutor's Office and Criminal Liability of Directors and Managers</i>	70
7. <i>Execution of Court Acts and the Role of Bailiffs</i>	73
C. ALTERNATIVE DISPUTE RESOLUTION	74
D. ENFORCEMENT BY REGULATORS AND ADMINISTRATIVE AUTHORITIES.....	76
1. <i>Enforcement by the Federal Commission for the Securities Markets</i>	76
2. <i>Enforcement by Other Regulatory Bodies</i>	79
E. STOCK EXCHANGES AND SELF-REGULATORY BODIES	80
1. <i>Listing Rules</i>	80
2. <i>Self-Regulatory Organizations</i>	82
F. PUBLIC PRESSURE	82
1. <i>Non-Governmental Organizations</i>	83
2. <i>Shareholder Activism</i>	84
G. SELF-ENFORCEMENT	85
1. <i>The Federal Commission for the Securities Market's Code of Corporate Conduct</i>	85
2. <i>Self-Enforcement Through Internally Established Procedures</i>	87
3. <i>Internal Dispute Resolution</i>	88

The Chairman's Checklist

- ✓ Does the Supervisory Board encourage the company's key executives and personnel to go beyond mere compliance with the minimum standards set out in the legal and regulatory framework for corporate governance?
- ✓ Does the Supervisory Board try to resolve all major conflicts with shareholders and other parties prior to judicial and/or administrative authorities becoming involved?
- ✓ Does the company have effective mechanisms in place for resolving conflicts? Does the Supervisory Board have a conflict resolution committee? How active is it in resolving conflicts?
- ✓ Does the company record conflicts and the measures taken for their resolution? Does the Corporate Secretary play a role in this process?
- ✓ Has the Supervisory Board included provisions of the Federal Commission for the Securities Market's Code of Corporate Conduct in its charter and by-laws, or chosen to draft its own, company-level corporate governance code?

Effective corporate governance involves the interplay of five key elements:

- Normative rules of corporate conduct embodied in the legal and regulatory framework, company charters, and other internal corporate documents;
- Formal enforcement of the legal rules in the courts by shareholders, companies, and/or regulators, and through regulatory agencies including the sanctions available to stock exchanges to enforce their rules;
- Voluntary standards of conduct above and beyond the minimum standards established by applicable laws and regulations;
- Alternate dispute resolution mechanisms; and
- Market forces that sanction poor conduct by driving down share prices and credit ratings of companies.

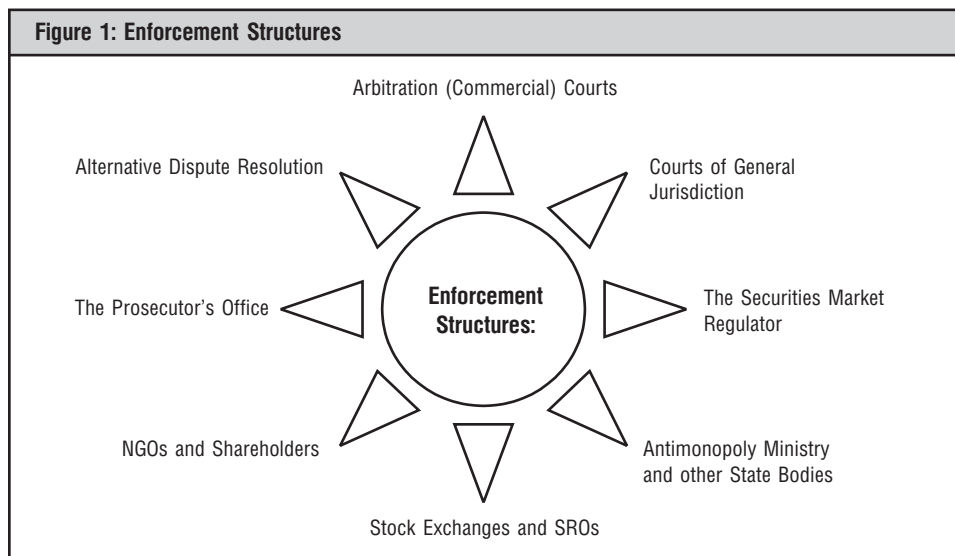
The Russia Corporate Governance Manual

This chapter addresses the mechanisms for, and practical issues associated with, the enforcement of corporate governance related rights.

A. General Overview

1. Enforcement Structures

The different structures involved in the enforcement of corporate governance are summarized in Figure 1.



Source: IFC, March 2004

2. Available Remedies

The Civil Code includes a non-exhaustive list of remedies available for the protection of civil rights.¹²⁷ Some of these remedies are available to shareholders and companies, and serve as a basis for various types of claims raised with relevant authorities, including the Federal Commission for the Securities Market (FCSM).

¹²⁷ Civil Code (CC), Article 12.

The list of remedies for disputes between shareholders, management, and companies includes:

- Acknowledgement of rights;
- Restoring the condition that existed prior to the violation of the right, and preventing violations of rights;
- Nullification of transactions;
- A decision ordering performance of an obligation in kind;
- Award of damages;
- Award of liquidated damages;¹²⁸
- Termination or modification of mutual rights and duties of parties; and
- Other remedies provided by law and/or agreement.

B. Enforcement by Judicial Authorities

1. Court Jurisdiction

a) Subject-Matter Jurisdiction of Arbitration Courts and Courts of General Jurisdiction

Two types of courts normally enforce shareholder rights: arbitration courts and courts of general jurisdiction. Arbitration courts and courts of general jurisdiction have different jurisdictions with regard to commercial disputes and play different roles in enforcement.¹²⁹ With the 2002 adoption of the new Arbitration Procedure Code and Civil Procedure Code, the role of courts of general jurisdiction has been greatly reduced in company disputes.

Arbitration courts have jurisdiction over disputes between companies and shareholders.¹³⁰ Generally, arbitration courts consider all commercial cases and other cases relating to business and economic activities, irrespective of the status of the parties, i.e. whether they are individuals, legal entities, or individual entrepreneurs.¹³¹

¹²⁸ Liquidated damages are defined as the amount required to satisfy a loss resulting from breach of contract, which is usually agreed in the contract itself.

¹²⁹ For more information see Handbook on Commercial Dispute Resolution in the Russian Federation (Washington, D.C.: U.S. Department of Commerce, 2000, Chapters 2 and 5. See also: www.mac.doc.gov/ggp).

¹³⁰ Arbitration Procedure Code, Article 33, Clause 1, Paragraph 4.

¹³¹ Arbitration Procedure Code, Article 27, Clause 1.

Company Practices in Russia: Courts of general jurisdiction in some Russian regions still consider corporate cases, although they are not supposed to. The Plenum of the Supreme Court issued a Resolution in 2003, which states that all disputes between shareholders and companies arising from the activities of companies (except for labor disputes) fall under the jurisdiction of arbitration courts and may not be considered by courts of general jurisdiction.¹³²

There is, however, an exception to this rule. When several related claims cannot be separated and some of these claims need to be tried and resolved by a court of general jurisdiction, the court of general jurisdiction considers the complaint as a whole, even if some of the claims are within the jurisdiction of an arbitration court.¹³³

b) Venue in Corporate Litigation

After the appropriate type of court has been selected, a plaintiff should decide where to file an action. Generally, an action is filed with an arbitration court at the location or place of residence of the defendant.¹³⁴ Thus, in most cases a shareholder, for example, would file an action against the company at the company's place of state registration.¹³⁵

There are certain exceptions to this rule. First, in some cases a plaintiff may choose the venue. Other exceptions relevant to corporate litigation are:¹³⁶

- A claim against a defendant whose location or place of residence is unknown may be filed where his property is actually located or at his last known location in the Russian Federation;
- If a claim is filed against several defendants, it may be filed at the location of any of the defendants at the discretion of the plaintiff;
- A claim against a defendant located or residing in a foreign country may be filed at the location of the defendant's property on the territory of the Russian Federation;

¹³² Supreme Court Resolution No. 2 on Certain Issues Arising in Connection with the Adoption of the Civil Procedure Code, 20 January 2003, Section 3.

¹³³ Civil Procedure Code, Article 22, Clause 4.

¹³⁴ Arbitration Procedure Code, Article 35.

¹³⁵ Law on Joint Stock Companies (LJSC), Article 4, Clause 2.

¹³⁶ Arbitration Procedure Code, Article 36.

- A claim arising from a contract that indicates the place of execution may be filed at the place of execution; and
- A claim against a legal entity arising from the activities of a branch or representative office may be filed at the location of the branch or representative office.

Parties may change the venue of an action by agreement before the acceptance of the case by an arbitration court.¹³⁷

In addition to these rules, the Arbitration Procedure Code establishes rules on exclusive territorial jurisdiction over certain claims. This means that only a court located at the place defined in accordance with the following rules may adjudicate cases:¹³⁸

- A bankruptcy notice may only be filed with an arbitration court at the location of the debtor;
- An “application for establishing circumstances of legal significance” or declaratory judgment¹³⁹ should be filed with an arbitration court at the location or place of residence of the plaintiff, except for applications relating to the legal status of immovable property, which are filed with a court at the location of the property;
- An application challenging a bailiff’s decisions or actions (omissions) should be filed with an arbitration court at the location of the bailiff;
- An application related to a dispute between Russian legal entities that have activities or property on the territory of a foreign country should be filed with an arbitration court at the place of state registration of the defendant on the territory of the Russian Federation; and
- A counterclaim may be filed only with the same court as the original action.¹⁴⁰

If an arbitration court admits a case in violation of venue rules, the case should be transferred to the appropriate arbitration court.¹⁴¹ That court must try any

¹³⁷ Arbitration Procedure Code, Article 37.

¹³⁸ Arbitration Procedure Code, Article 38.

¹³⁹ The closest U.S. legal equivalent to “an application for establishing circumstances of legal significance” is “declaratory judgment”.

¹⁴⁰ There are some other rules for the definition of an exclusive jurisdiction; however, they are not relevant to corporate relations and disputes in this field.

¹⁴¹ Arbitration Procedure Code, Article 39, Clause 2, Paragraph 3.

claim accepted by an arbitration court in accordance with venue rules, even if in the future the claim falls under the jurisdiction of another court.¹⁴²

It should be noted that there are no special rules for determining the venue of an action filed against a company. These actions are filed with a court in accordance with the Arbitration Procedure Code rules.

Company Practices in Russia: Problems arise when companies are located far from shareholders (or from their place of registration). Traveling to a distant court and staying there throughout the litigation can be expensive. Another way for shareholders to protect their rights is to file an action by registered letter and inform the court that a trial may be held in absentia.¹⁴³

The Civil Procedure Code rules for determining the venue of actions are largely similar to the Arbitration Procedure Code rules.¹⁴⁴

2. Provisional Remedies

a) General Provisions

The Arbitration Procedure Code provides for temporary measures aimed at securing a claim or the property interests of the plaintiff (provisional remedies). Provisional remedies may be granted upon application of an interested person at any stage of the proceedings if failure to do so impedes (or renders impossible) the execution of a court decision, or when the execution of a decision may take place abroad, and to prevent inflicting damages on the plaintiff.¹⁴⁵ Provisional remedies must be proportionate to the damages sought in the claim.¹⁴⁶ When applying for a protective measure, the plaintiff must prove that the remedy is necessary to secure the execution of a court decision.

Since the Arbitration Procedure Code does not contain any special rules for the application of provisional remedies in companies, the general rules provided

¹⁴² Arbitration Procedure Code, Article 39, Clause 1.

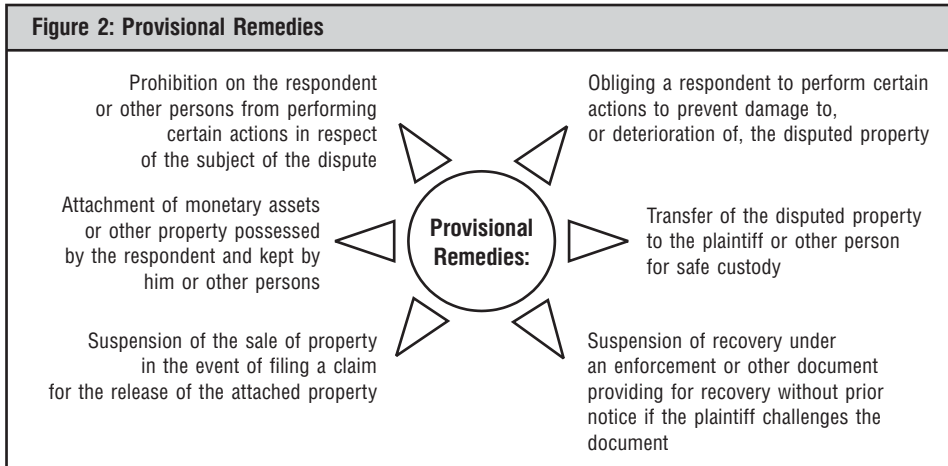
¹⁴³ Arbitration Procedure Code, Article 156, Clause 2.

¹⁴⁴ Arbitration Procedure Code, Articles 23 — 33.

¹⁴⁵ Arbitration Procedure Code, Article 90, Clause 2.

¹⁴⁶ Arbitration Procedure Code, Article 91, Clause 2.

by Chapter 8 of the Arbitration Procedure Code apply. However, the Supreme Arbitration Court has interpreted provisions regarding provisional remedies as discussed, which are shown in Figure 2.¹⁴⁷



Source: IFC, March 2004

An arbitration court has the right to grant any other protective measure it finds necessary, or several remedies simultaneously.

The plaintiff may apply for provisional remedies at any stage of the proceedings before the adoption of a court decision that concludes consideration of the case.¹⁴⁸ This application must be filed with the same court that is hearing the main case. The arbitration court must consider the application the day after its receipt at the latest, without notification of the parties.¹⁴⁹ An arbitration court order imposing provisional remedies is subject to immediate execution.¹⁵⁰ Copies of the court order to grant provisional remedies must be sent to the parties in the case on the day after its issue at the latest.¹⁵¹

¹⁴⁷ Arbitration Procedure Code, Article 91.

¹⁴⁸ Arbitration Procedure Code, Article 92, Clause 1.

¹⁴⁹ Arbitration Procedure Code, Article 93, Clause 1.

¹⁵⁰ Arbitration Procedure Code, Article 96, Clause 1.

¹⁵¹ Arbitration Procedure Code, Article 93, Clause 6.

Company Practices in Russia: A company against which provisional remedies have been taken sometimes learns of this only when its property (bank accounts, securities, etc.) has already been attached and its activities paralyzed. Unscrupulous plaintiffs often abuse provisional remedies by initiating suits aimed at receiving specific provisional remedies, especially during hostile takeovers.

b) Preliminary Provisional Remedies

Besides provisional remedies, the Arbitration Procedure Code provides for the application of preliminary provisional remedies, which, unlike ordinary provisional remedies, are applied before filing an action.¹⁵² An application for these remedies may be filed not only with the arbitration court that has, or will have, jurisdiction in respect of the main claim, but also with the arbitration court at the location of:

- The plaintiff; or
- Monetary assets or other property in respect of which the plaintiff is seeking provisional remedies; or
- The alleged violation of the plaintiff's rights.

Except for the special provisions embodied in the Arbitration Procedure Code, preliminary provisional remedies are regulated by the same rules as ordinary provisional remedies.

If the person who has applied for the preliminary provisional remedies does not file an action within the period defined in the court order on the imposition of such measures (not more than 15 days), the preliminary provisional remedies are revoked by the court.¹⁵³

c) Protection of Defendant Rights

Provisional remedies may result in the violation of a defendant's rights and legitimate interests. To protect the defendant, an arbitration court may, upon the application of the defendant or on its own initiative, demand that the plaintiff agree to hold the defendant harmless against possible losses (plaintiff's security bond).¹⁵⁴

¹⁵² Arbitration Procedure Code, Article 99.

¹⁵³ Arbitration Procedure Code, Article 99, Clause 5.

¹⁵⁴ Arbitration Procedure Code, Article 94.

If an arbitration court decides to demand a plaintiff's bond, the order should be issued, at the latest, on the day after the date when the court receives the application for provisional remedies. In this event, the court will not consider an application for provisional remedies until confirmation that the defendant's interests have been secured. The amount of the security should be established within the limits of the claim of the plaintiff and may not be less than half of the claim. The Arbitration Procedure Code also allows a defendant to apply for the reimbursement of damages incurred because of provisional remedies.

An order dissolving a protective measure may be issued conditional upon the defendant paying a security bond into the court's account equal to the plaintiff's claim (defendant's security bond).¹⁵⁵ Thus, a defendant may file a motion to replace a protective measure with the temporary payment of a sum of money. However, the decision whether to grant this motion is at the court's discretion.

d) Protection Against Abusive Use of Provisional Remedies

One downside associated with the application of provisional remedies is the potential for abuse by unscrupulous plaintiffs in the course of hostile takeovers.

Company Practices in Russia: The Arbitration Procedure Code does not provide an exhaustive list of protective measures; a court may use any protective measure it finds reasonable. For example:

- Shares may be seized and later sold through the Federal Property Fund;
- Movable and immovable property may be attached;
- The register may be seized and removed by the bailiff;
- Supply agreements may be frozen;
- Implementation of decisions may be suspended; and
- Governing bodies may be ordered to stop their activities.

As a result, company activities may potentially be paralyzed, its property confiscated, and management could be transferred to the plaintiff.

Although the Arbitration Procedure Code allows a defendant to apply for reimbursement of losses incurred due to provisional remedies, an application may be filed only after the arbitration court's decision dismissing the claim takes effect.¹⁵⁶ However, if a plaintiff withdraws the claim, no such decision will be

¹⁵⁵ Arbitration Procedure Code, Article 94, Clause 2.

¹⁵⁶ Arbitration Procedure Code, Article 98.

rendered¹⁵⁷ and, therefore, a defendant would not have the right to apply for reimbursement of losses.¹⁵⁸ As a result, plaintiffs often file frivolous claims to obtain a court order on provisional remedies. After a period, the plaintiff withdraws its claim and thus makes itself immune from liability for the defendant's losses. Since the arbitration court does not have to provide for the plaintiff's security bond, the plaintiff does not have to reimburse the losses borne by the defendant because of such provisional remedies. These losses may be significant enough to bankrupt even large companies.

To compensate for the lack of clear definitions in the law, and to offset the abuse of provisional remedies, the Plenum of the Supreme Arbitration Court has adopted a resolution dealing with this issue (Resolution 11).¹⁵⁹ Although it does not solve all problems associated with provisional remedies, Resolution 11 is extremely important, since it may become an effective deterrent to abuse during hostile takeovers. The most important provisions of Resolution 11 include:

- Provisional remedies must conform to the protection sought in the claim, i.e. they should:¹⁶⁰
 - Directly relate to the subject of the dispute;
 - Be proportionate to the protection sought; and
 - Be necessary and sufficient to ensure the execution of a judicial decision or to prevent damage which the plaintiff may incur.

¹⁵⁷ In this case, a court order on the termination of proceedings is issued. Arbitration Procedure Code, Article 151.

¹⁵⁸ An arbitration court may not accept withdrawal of a claim if it contravenes the law or violates the rights of other persons (Arbitration Procedure Code, Article 49, Clause 5). Thus, an arbitration court may not accept renunciation of a claim in these cases. A respondent whose interests have suffered due to the application of protective measures should oppose the plaintiff's intent to withdraw its claim on the basis of the Arbitration Procedure Code, Article 49, Clause 5.

¹⁵⁹ The Plenum of the Supreme Arbitration Court Resolution No. 11 on the Practice of the Review by Arbitration Courts of Requests for Prohibition of Convocation of the General Meeting of Shareholders as a Protective Measure (Resolution No. 11), 9 June 2003.

¹⁶⁰ Resolution No. 11, Section 1.

- A prohibition to hold a General Meeting of Shareholders (GMS) may not be used as a protective measure.
- Since the GMS is the highest governing body of the company, a prohibition effectively prevents the company from carrying on its business. A prohibition of a GMS is contrary to the purpose of provisional remedies, which are intended to protect plaintiff's interests and not to deprive another person of the ability or right to carry on its lawful activities.¹⁶¹
- The court may not grant any protective measure that amounts to a prohibition of a GMS (i.e. the Supreme Arbitration Court has sought to prevent evasion of Resolution 11 by arbitration courts). For example, no court may interfere in:¹⁶²
 - Calling a GMS;
 - Preparing the shareholders list;
 - Providing premises for the GMS;
 - Sending voting ballots; and
 - Summarizing the results of voting on agenda items.

However, a court may prohibit a GMS from taking decisions on certain items if they are the subject-matter of the case or directly relate to it. A court may also prohibit a company, its bodies or separate shareholders from acting upon a GMS decision in respect of certain matters.¹⁶³

In any case, when deciding whether a protective measure should be applied, the court must make sure that it would not hinder or render impossible the execution of the court decision in case of satisfaction of the claim. If a plaintiff requests a protective measure because a failure by the court to grant such measure would cause material damages, he should prove the likelihood of damages, its amount, its connection with the object of the dispute, and the necessity and sufficiency of the protective measure to prevent damages.¹⁶⁴

¹⁶¹ Resolution No. 11, Section 2, Paragraph 2.

¹⁶² Resolution No. 11, Section 2, Paragraph 4.

¹⁶³ Resolution No. 11, Section 3.

¹⁶⁴ Resolution No. 11, Section 4, Paragraph 2.

When granting provisional remedies, the court should take into consideration that such measures not stop (or significantly impede) the company activities or result in violation of legislation by a company.

Best Practices: The Supreme Arbitration Court has issued an Information Letter on provisional remedies. Although the provisions of this Information Letter are only recommendations, they are important for the protection of shareholder rights. Its most important provisions are:¹⁶⁵

- An attachment of securities means the prohibition for a defendant to dispose of these securities, including the prohibition of all transactions with the securities, even if these transactions do not result in the transfer of rights in these securities. The transfer of attached securities to a nominee is also prohibited.
- When an arbitration court applies provisional remedies, it should explicitly define the nature and scope of the remedies. For example, the attachment of shares does not automatically mean that a shareholder may not vote these shares at a GMS nor does it suspend the right to receive dividends. Thus, if an order of an arbitration court on provisional remedies does not expressly state that a shareholder may not participate in the governance of a company or that a person may not accrue any income on the attached securities, the owner of the attached securities retains these rights.
- When applying a protective measure, only an arbitration court may impose limitations on shareholder rights. A bailiff in executing a court order for application of provisional remedies may only enforce it in exact accordance with its text.¹⁶⁶ A bailiff may not impose any other limitations, except for those expressly stipulated in an order.
- The voting shares owned by a shareholder, whom an arbitration court prohibited from voting at the GMS shall, nonetheless, be counted for a quorum purposes.

¹⁶⁵ Information Letter No. 72, the Supreme Arbitration Court, on the Review of Arbitration Courts Practice in Application of Protective Measures in Lawsuits concerning the Circulation of Securities, 24 June 2003, Sections 1, 2, 4, 5, 6 and 7.

¹⁶⁶ Law on Executive Procedure, Article 51, Clause 2, provides that when executing a court decision, a bailiff may define the scope, manner, and periods of legal restraints on the right to use attached property. However, since an order for application of protective measures is not a decision (an act that adjudicates a case on its merits), a bailiff may not impose any additional legal restraints on the right to use the attached property.

- If an arbitration court attaches the securities of a defendant as a protective measure, the attachment shall not prevent another arbitration court from attaching the same securities in connection with another claim for the nullification of a purchase agreement involving the securities.
- If securities of a defendant are attached by an arbitration court as a protective measure in connection with a claim for the nullification of a purchase agreement, the securities may also be attached pursuant to an enforcement order issued in another case.
- If shares owned by the defendant are irrelevant to the issue and are part of assets upon which the production activity of the company is dependent, these shares may be attached only when the defendant has no other assets that may be attached.
- When attaching securities as a protective measure, an arbitration court should indicate the exact title and number of the attached securities in the writ of execution. A bailiff may not select securities to be attached at his discretion.
- When securities are the subject of a claim, the possibility of their disposal is a valid ground for their attachment as a protective measure.

e) Application of Provisional Remedies by Courts of General Jurisdiction

Courts of general jurisdiction may sometimes try corporate cases. Consequently, courts of general jurisdiction may also issue provisional remedies. In this case, Civil Procedure Code provisions apply.¹⁶⁷

The grounds for application of provisional remedies and the list of remedies are generally the same as established by the Arbitration Procedure Code.¹⁶⁸

It should be remembered that Resolution 11 issued by the Supreme Arbitration Court is not legally binding for courts of general jurisdiction. Although Resolution 11 interprets the provisions of the Arbitration Procedure Code that relate to provisional remedies, some judges of courts of general jurisdiction may not accept any references to it. The Supreme Court issued the clarification on the application of provisional remedies in corporate disputes in Resolution 2, according to which

¹⁶⁷ Civil Procedure Code, Chapter 13.

¹⁶⁸ See Section B.2.a of this Chapter. Although the Civil Procedure Code allows the court to provide for the plaintiff's security bond, it does not contain any specific provisions on the amount of such security, terms, and other conditions of its application.

the prohibition to hold a GMS may not be used as a protective measure because it violates the Constitution, which grants the right of peaceful assembly to every citizen of the Russian Federation.

3. Statute of Limitations

If a claim is filed after the expiration of a limitations period established by law, a court may consider the case and pass acts (orders on provisional remedies, decisions, resolutions, etc.) only when the defendant does not object to the admission of the case by the court.

A general limitations period of three years from the moment when a plaintiff learned, or should have learned, of the violation of his right, is found in the Civil Code.¹⁶⁹ To declare a voidable transaction invalid and apply consequences of its invalidity, a one year limitation period is established from the date of the cessation of the coercion or threat under which the transaction was made, or from the moment when the plaintiff learned, or should have learned, about other circumstances which are grounds for the nullification of the transaction.¹⁷⁰ To apply the nullification consequences of a transaction void from inception (*ab initio*), the Civil Code establishes a limitations period of ten years from the beginning of the execution of the transaction.¹⁷¹

The Company Law provides for a special limitation period for suits seeking to invalidate a GMS decision. Any such decision may be contested within six months of the moment when the shareholder first knew about, or should have known about, the GMS.¹⁷² Clearly, if a decision taken by the GMS is invalidated and that particular GMS had the election of the General Director on its agenda, then there is a significant risk that all transactions he made on behalf of the company could be invalidated as well. This risk was reduced when a shorter limitation period was established on 1 January 2002.

4. Types of Claims

Legislation does not identify types of claims and thus does not establish any special rules for their consideration. All claims, notwithstanding the remedy sought

¹⁶⁹ CC, Articles 196 and 200.

¹⁷⁰ CC, Article 181, Clause 2.

¹⁷¹ CC, Article 181, Clause 1.

¹⁷² LJSC, Article 49, Clause 7.

by the plaintiff, are filed with the court in accordance with the general rules of jurisdiction established in the Arbitration and Civil Procedure Codes. However, the following types of claims regarding companies can be distinguished in theory:

- Claims to appeal decisions of the company's governing bodies;
- Claims to compel governing bodies to carry out certain actions or to refrain from certain actions;
- Claims to reimburse the damages caused by actions of company officials and claims against the company for damages; and
- Claims regarding corporate transactions.

5. Administrative Procedures in Arbitration Courts

Besides the above mentioned cases (which arise from private-law relations), certain cases in the field of corporate governance arise from administrative and other public-law relations (public cases). Administrative bodies may consider some of these cases,¹⁷³ while others fall under the jurisdiction of arbitration courts.

Arbitration courts try such public cases as challenges to the normative and non-normative acts of state bodies and the actions thereof, some administrative offences (other than those falling under the jurisdiction of the FCSM and other executive bodies), and challenges of decisions of state bodies on administrative liability. It should be noted that arbitration courts have jurisdiction only in public cases that relate to business and economic activities.

Those public cases that fall under the jurisdiction of arbitration courts are tried in accordance with the general rules of arbitration procedure (including the rules on jurisdiction), unless the Arbitration Procedure Code provides otherwise.¹⁷⁴

a) Appealing Legal Acts and Actions of State Bodies and Officials

Legal acts may be appealed in arbitration courts only if they affect the plaintiff's rights and legal interests in the field of business or other economic activities.

Challenges to normative legal acts¹⁷⁵ of the President, the Russian Government, and federal executive bodies fall under the exclusive jurisdiction of the Supreme

¹⁷³ See Section D of this Chapter.

¹⁷⁴ Arbitration Procedure Code, Article 189, Clause 1.

¹⁷⁵ Arbitration Procedure Code, Chapter 23.

Arbitration Court.¹⁷⁶ Since the FCSM is a federal executive body, its normative acts may be challenged only in the Supreme Arbitration Court, which, in this case, is the court of first instance. Non-normative (individual) acts¹⁷⁷ of the President, the Government, State Duma, and Federation Council also fall under the exclusive jurisdiction of the Supreme Arbitration Court.¹⁷⁸ However, non-normative legal acts of federal and local executive bodies (including non-normative rulings and orders of the FCSM) should be challenged in an arbitration court at the location of the body or official whose act is being challenged.

Filing of an appeal does not suspend the operation of the contested legal act during dispute resolution proceedings.¹⁷⁹ On the other hand, a court may suspend the operation of the non-normative legal act at the request of the applicant.¹⁸⁰

Cases of this type must (as a rule) be concluded within two months from the filing of an application with the arbitration court.¹⁸¹

b) Arbitration Court Authority over Administrative Offences

Arbitration courts may hold legal entities and individual entrepreneurs administratively liable for offences under the jurisdiction of arbitration courts. In corporate relations, arbitration courts may try such offences as improper management of a legal entity and performing transactions and other actions in transgression of authority.¹⁸²

An application shall be filed with the arbitration court at the offender's location or place of residence¹⁸³ by the regulatory body that has such authority.¹⁸⁴ The administrative hearing must (as a rule) be completed within 15 days after an application has been filed. If necessary, this term may be extended for one month.¹⁸⁵

¹⁷⁶ Arbitration Procedure Code, Article 34, Clause 2.

¹⁷⁷ Arbitration Procedure Code, Chapter 24.

¹⁷⁸ Arbitration Procedure Code, Article 34, Clause 2, Paragraphs 1 and 2.

¹⁷⁹ Arbitration Procedure Code, Article 193, Clause 3.

¹⁸⁰ Arbitration Procedure Code, Article 199, Clause 3.

¹⁸¹ Arbitration Procedure Code, Article 194, Clause 1; Article 200, Clause 1.

¹⁸² See Section D.2.b of this Chapter.

¹⁸³ Arbitration Procedure Code, Article 203.

¹⁸⁴ Arbitration Procedure Code, Article 202, Clause 2.

¹⁸⁵ Arbitration Procedure Code, Article 205, Clause 1 and 2.

Any decision of a regulatory body on administrative liability may be appealed to the arbitration court at the applicant's location or place of residence.¹⁸⁶ The right to challenge decisions of regulatory bodies on administrative liability is an important measure to protect one's rights and legal interests.

Such cases must be decided (as a rule) within ten days of the filing of an application.¹⁸⁷ Another important rule is that the burden of proof of an administrative violation is on the regulatory body.

The 2002 Code of Administrative Offences provides for a new administrative sanction — disqualification of managers. A disqualified manager may not hold any managerial office in any legal entity within the period of disqualification (from six months to three years).¹⁸⁸ Among other things, this person may not be a General Director or a Supervisory Board member. Only a court of general jurisdiction or an arbitration court may apply this sanction.

The Code of Administrative Offences stipulates the following situations when this sanction may be applied:

- 1) In case of repeated violations of labor legislation by the manager.¹⁸⁹ These cases are tried by magistrates (the judges of the lower level of courts of general jurisdiction);¹⁹⁰
- 2) In cases of improper management of a legal entity and of performing transactions and other actions in transgression of authority.¹⁹¹ Only arbitration courts have jurisdiction in respect of these offences;¹⁹²
- 3) In case of filing of documents containing knowingly false statements with the state bodies responsible for state registration of legal entities.¹⁹³ This offence falls within a magistrate's jurisdiction.¹⁹⁴

¹⁸⁶ Arbitration Procedure Code, Article 208, Clause 1.

¹⁸⁷ Arbitration Procedure Code, Article 210, Clause 1.

¹⁸⁸ Code of Administrative Offences, Article 3.11.

¹⁸⁹ Code of Administrative Offences, Article 5.27, Clause 2.

¹⁹⁰ Code of Administrative Offences, Article 23.1, Clause 1.

¹⁹¹ Code of Administrative Offences, Article 14.21; Article 14.22.

¹⁹² Code of Administrative Offences, Article 23.1, Clause 3.

¹⁹³ Code of Administrative Offences, Article 14.25, Clause 4.

¹⁹⁴ Code of Administrative Offences, Article 23.1, Clause 1.

Company Practices in Russia: Director/manager disqualification is quite often used in the course of hostile takeovers as a means to “behead” a company, or to remove a person from the Supervisory Board. In fact, the more power is concentrated in the hands of a General Director, the more dangerous this sanction becomes. In practice, corporate raiders usually seek to apply Clause 2 of the Article 5.27 of the Code of Administrative Offences, since violations of labor law are (relatively) easy to prove and such violations are tried by courts of general jurisdiction, which may make companies even more vulnerable to the abuse of this sanction.

6. Enforcement Authority of the Prosecutor’s Office and Criminal Liability of Directors and Managers

Other parties besides courts have enforcement powers. One such body is the Prosecutor’s Office (prokuratura), which may be involved in both civil and criminal litigation in the field of corporate governance.

a) The Prosecutor’s Office in Civil Litigation

The Arbitration Procedure and Civil Procedure Codes provide for specific rules that govern the Prosecutor’s Office’s rights and enforcement capabilities in cases considered in arbitration courts and courts of general jurisdiction.

A prosecutor is entitled to file a claim for invalidation of transactions made by legal entities with an arbitration court, including companies the authorized capital of which includes an interest of the Russian Federation, its political subdivisions, or municipalities. A prosecutor applying to an arbitration court has the procedural rights, and discharges the procedural duties, of the plaintiff.¹⁹⁵

Prosecutors are not generally authorized to participate in suits among shareholders, companies and their management. Prosecutors have the right to file an application to protect the rights, freedoms, and lawful interests of citizens, or an indefinite group of persons, or of the interests of the Russian Federation.¹⁹⁶ The prosecutor can file an application only if the citizen cannot apply to the court personally because of poor health, age, incapacity, or other valid reasons.

¹⁹⁵ Arbitration Procedure Code, Article 52.

¹⁹⁶ Civil Procedure Code, Article 45.

A prosecutor has the right to initiate administrative proceedings if he discovers the fact of an administrative violation.

Moreover, a prosecutor has the right to file an action with an arbitration court for the invalidation of a legal act in the field of business and other economic activities, if the prosecutor deems this act illegal.

Company Practices in Russia: There are some recorded cases of prosecutors filing cases to defend shareholder interests. However, it has become a matter of policy that the Prosecutor's Office generally does not become involved in corporate disputes.

With the adoption of the new Arbitration Procedure and Civil Procedure Codes, the role of the prosecutor in civil litigation has diminished significantly. In the past, the Prosecutor General and his deputies had the right to file general supervision appeals. Today this right has been given to the parties involved in a dispute. As for the prosecutors, they may file supervision appeals only within the scope of their competence established by the relevant articles of the Arbitration Procedure and Civil Procedure Codes.

b) Prosecutor's Office in Criminal Litigation

Besides being involved in civil and commercial litigation, the Prosecutor's Office has an important role in criminal litigation.

Current Russian legislation does not provide for the criminal liability of legal entities. Only individuals, including managers, directors, and shareholders, can be subject to such liability. To enforce their rights, criminal offence victims should address their claims to the Prosecutor's Office or to the police. All criminal cases are considered in courts of general jurisdiction.

Criminal offences are listed in the Criminal Code. Other laws and secondary legislation cannot criminalize any actions. The following groups of criminal offences relate to corporate governance:¹⁹⁷

- Offences related to the disclosure of information, such as the illegal receipt and disclosure of information classified as a commercial, tax, or banking

¹⁹⁷ Criminal Procedure Code, Article 151, Clause 2, Paragraph 2 provides that police investigators investigate these offences.

secret,¹⁹⁸ and refusal to provide information when required to do so by legislation;¹⁹⁹

- Offences related to the issuance of securities;²⁰⁰
- Offences in the field of bankruptcy, such as illegal actions in the course of bankruptcy,²⁰¹ deliberate bankruptcy,²⁰² and fictitious bankruptcy;²⁰³ and
- Offences related to the abuse of authority by management²⁰⁴ and commercial bribery.²⁰⁵

It should be noted that investigators have the right to conduct searches and seize documents and other evidence (including correspondence) while investigating a criminal case.

Company Practices in Russia: The “cooperation” of law-enforcement bodies, and especially the assistance of investigators, is often sought by corporate raiders in the course of illegal takeover campaigns.

Although criminal offences related to corporate governance are investigated by investigators of the Ministry of the Interior (i.e. police investigators), the role of the prosecutor’s office is nevertheless significant.

One of the most important enforcement rights of the prosecutor is the right to give consent to initiate a criminal prosecution (or to start prosecution, in certain circumstances) when the actions of an individual constitute a crime.²⁰⁶ After an investigation is finished, a prosecutor must examine the bill of indictment presented by an investigator and either endorse it and refer the case to court, or

¹⁹⁸ Criminal Code, Article 183. Illegally procured information is often used by executive bodies when making decisions.

¹⁹⁹ Criminal code, Article 185.1.

²⁰⁰ Criminal Code, Article 185.

²⁰¹ Criminal Code, Article 195. Illegal bankruptcy schemes are often used in the practice of hostile takeovers both by the attackers and the attacked.

²⁰² Criminal Code, Article 196.

²⁰³ Criminal Code, Article 197.

²⁰⁴ Criminal Code, Article 201. Abuse of authority refers to extraordinary and related party transactions.

²⁰⁵ Criminal Code, Article 204.

²⁰⁶ Criminal Procedure Code, Article 20, Clause 4.

cancel the prosecution.²⁰⁷ Another important authority the prosecutor is vested with is his right and duty to prosecute a case.²⁰⁸ In other words, a prosecutor appears in court on behalf of the state to pursue a charge against an offender. The prosecutor's participation is necessary in almost every criminal case.

Criminal prosecution is an effective tool for the protection of shareholders' rights. Sometimes the simple threat of criminal prosecution may lead to the cessation of illegal actions.

7. Execution of Court Acts and the Role of Bailiffs

After a court renders its judgment, it becomes binding on the parties in the case. A bailiff service executes court decisions. The Law on Bailiffs and the Law on Execution Procedure vest bailiffs with extensive enforcement powers in order to provide for timely, complete, and proper execution.²⁰⁹ Some of these powers are significant as they relate to the seizure of company property (including securities), transfer of management, etc.

The demands of bailiffs are binding on all bodies, organizations, officials, and citizens on the territory of the Russian Federation. Non-fulfillment of a bailiff's demands (or interfering with a bailiff's duties) may result in liability.²¹⁰

Bailiffs act on the basis of execution orders, i.e. writs of execution issued by courts, court orders, decisions of bodies authorized to consider administrative offences, etc. The majority of execution orders are issued by courts, either because of a court decision or as a protective measure to secure the interests of the plaintiff. Bailiffs are obliged (as a rule) to execute court orders within three days.²¹¹

The Law on Execution Procedure establishes an open list of compulsory execution measures, including attachment of the debtor's property and seizure of certain objects for transfer to a creditor. The bailiff can execute any order included in the writ of execution.²¹²

²⁰⁷ Criminal Procedure Code, Article 221.

²⁰⁸ Criminal Procedure Code, Article 246.

²⁰⁹ Law on Bailiffs, Article 12.

²¹⁰ Law on Bailiffs, Article 14.

²¹¹ Law on Execution Procedure, Article 9, Clause 2.

²¹² Law on Execution Procedure, Article 45.

Generally, bailiffs perform executive actions at the location of the debtor or its property. However, a bailiff may perform executive actions on territory outside his district if needed.²¹³

Company Practices in Russia: Bailiffs who are involved in hostile takeover attempts often abuse their right to execute actions outside their district. In order to make enforcement procedures more effective, it is important to prevent the abuse of bailiff authorities. Formal procedural guarantees against abuses do, however, exist. For example, bailiffs should use their rights and fulfill their obligations according to the law, and not permit the infringement of the rights and legal interests of citizens and organizations when carrying out their activities.²¹⁴

As a rule, executive actions should be performed within two months from the date when the bailiff receives a court order. In some cases, orders are subject to immediate execution.²¹⁵

Damages inflicted by a bailiff upon citizens and organizations are subject to compensation in conformity with the civil legislation of the Russian Federation. The actions of bailiffs, including the issuance of orders to start an executive action, may be appealed to the respective court within 10 days.²¹⁶

C. Alternative Dispute Resolution

An alternative to enforcement by judicial authorities is private commercial arbitration. In general, arbitration is believed to be cheaper and faster than going through the courts.

Company Practices in Russia: Arbitration is frequently used in Russia as a means of alternative dispute resolution. However, due to unclear wording of the Arbitration Procedure Code, Article 33, there is a strong tendency to avoid the use of commercial arbitration as a means to resolve corporate disputes.

²¹³ Law on Execution Procedure, Article 11.

²¹⁴ Law on Bailiffs, Article 13.

²¹⁵ Law on Execution Procedure, Article 13.

²¹⁶ Law on Execution Procedure, Article 9.

Arbitration is not prohibited by law. However, arbitral decisions will be revoked if it is found that an arbitration tribunal lacks jurisdiction to try the case.²¹⁷ The Arbitration Procedure Code states that disputes between shareholders and companies fall under the “special jurisdiction” of arbitration courts.²¹⁸ Actually, the precise meaning of the phrase “special jurisdiction” is (as yet) unclear. Although Article 33 does not state that arbitration tribunals²¹⁹ may not resolve corporate disputes, the words “special jurisdiction” may be interpreted in this way.

To transfer a dispute to the arbitration tribunal, an arbitration agreement normally must be concluded between parties. An arbitration agreement is a contract that empowers a private tribunal to try a case while depriving the state court of its jurisdiction. An arbitration agreement may be incorporated in a contract (in this case it is called an arbitration clause), or it may be concluded as a separate agreement in addition to an existing contract, or as an agreement between the parties to a dispute before judgment is reached by a state court.

Company Practices in Russia: In practice, using arbitration clauses in corporate contracts appears to be limited:

An arbitration clause may be included in the text of a contract for the sale and purchase of shares. However, standard stock exchange contracts do not normally include arbitration clauses.

Nevertheless, the Law on the Securities Market states that disputes between stock exchange participants, and between stock exchange participants and their customers may be resolved by arbitration tribunals.²²⁰ This could be interpreted to allow exchanges to include arbitration clauses in standard stock exchange contracts, thus permitting arbitration. As for disputes between issuers and registrars, an arbitration clause may be included in a contract with a registrar.

Another means of alternative dispute resolution is mediation, in other words, the settlement of disputes with the assistance of a (professional) mediator. A me-

²¹⁷ Arbitration Procedure Code, Article 233, Clause 3, Paragraph 1.

²¹⁸ Arbitration Procedure Code, Article 33.

²¹⁹ Note: Arbitral tribunals (treteiskie sudi) are not the same as arbitration courts. Arbitration courts in Russia have nothing in common with what is usually meant under this term in other countries and in international commercial practice. These are state courts that deal with business and other economic matters. In the present text, the term “arbitration tribunals” is used to distinguish private commercial arbitration institutions from state arbitration courts.

²²⁰ Law On Securities Market, Article 15.

diator does not adjudicate the issues in dispute or force a compromise; only the parties, of their own will, may achieve a settlement. Any corporate dispute may be solved by means of mediation. A contractual settlement reached by means of mediation has the same legal nature as any other valid agreement and is enforceable by filing an action with an arbitration court. On the other hand, settlements reached between the parties in the course of proceedings in an arbitration court and affirmed by the court may be enforced by means of a writ of execution issued by a court.

D. Enforcement by Regulators and Administrative Authorities

In addition to judicial authorities and private commercial arbitration, some regulators and administrative authorities may also be involved in corporate governance enforcement.

1. Enforcement by the Federal Commission for the Securities Markets

The principal regulator dealing with corporate governance enforcement is the FCSM. The FCSM has significant powers over companies, registrars, and other participants of the securities market.

Most of the FCSM enforcement powers are embodied in the Law on the Securities Market. They are summarized below and discussed in detail in other parts of this Manual.

a) Authority over Professional Participants of the Securities Market

Professional participants of the securities market are legal entities that engage in the following activities: broker's activities, dealer's activities, securities management, clearing, depositary activities, keeping registers of securities' owners, and organization of trade on the securities market.²²¹ Only entities engaged in these activities are considered professional participants of the securities market.

The FCSM has the authority to suspend or revoke licenses of professional participants of the securities market in the event they violate securities legislation.²²² This authority, however, may be misused. For example, the revocation of an Ex-

²²¹ Law on the Securities Market, Chapter 2.

²²² Law on the Securities Market, Article 42, Clause 6.

ternal Registrar's license causes the shareholder register to be transferred to another Registrar. In some cases, the new Registrar (if acting unfairly or unprofessionally) may make changes to the shareholder register that may violate shareholder rights and hinder management in exercising its rights.

Company Practices in Russia: The transfer of shareholder registers from one External Registrar to another through the revocation of the Registrar's license by the FCSM, though possibly illegal, is a sought-after tool by "corporate raiders" in the course of hostile takeovers. Companies should, therefore, attempt to engage the services of Registrars with the proper investment of time and resources to ensure that the company contracts for the services of a Registrar who is as competent and user-friendly as possible.

In addition, the FCSM has the right to give orders to professional participants of the securities market including Registrars. These orders are binding unless reversed by the FCSM or by a court.

b) Right to Seek the Liquidation of a Company

The FCSM has the authority to bring an action to an arbitration court to liquidate any legal entity that breaches the provisions of securities legislation, and to impose penalties on such entities.²²³

c) Right to Assist Other Law-Enforcement Agencies

The FCSM can send materials to law-enforcement agencies and file suits with a court of law or arbitration court on matters within the FCSM's scope of authority (including the nullification of securities transactions).²²⁴ In this case, the FCSM can protect shareholders and help resolve governance-related disputes. If any actions of the issuer's officers are based in criminal law, the FCSM submits its findings to the Prosecutor's Office.²²⁵

d) Right to Apply Administrative Liability

The FCSM has the right to hear allegations of certain administrative offences committed in the securities market. Most of these offences relate directly or in-

²²³ Law On the Securities Market, Article 42, Clause 20.

²²⁴ Law On the Securities Market, Article 44, Clause 8.

²²⁵ Law On the Securities Market, Article 51, Clause 3.

directly to the protection of shareholder rights. The FCSM has authority to consider the following groups of offences:

- Offences on information filing and disclosure,²²⁶ and the use of insider information;²²⁷
- Violations such as the prevention of an investor from exercising his rights to manage a company;²²⁸ and
- Offences in the course of securities transactions such as the violation of the rules for keeping the shareholder register,²²⁹ and refusal to transfer the shareholder register to a Registrar.²³⁰

e) Additional Powers of the Federal Commission for the Securities Markets

The Law on the Protection of Rights and Legitimate Interests of Investors in the Securities Market (Investor Protection Law) bestows additional enforcement powers on the FCSM. The FCSM can be joined as a party to court proceedings in pursuance of its duties and to protect rights of individual investors and interests of the state.²³¹

The FCSM may intervene in company actions by filing a claim with a court:²³¹

- To protect governmental, public, civic, or investor interests;
- To liquidate a legal entity or terminate operations of an individual entrepreneur engaged in professional activities in the securities market without a license (this applies to all licensed professional participants of the securities market, including stock exchanges, brokers/dealers, registrars, nominal holders of securities, and depositories);
- To cancel share issues;
- To invalidate a securities transaction; and
- As otherwise provided for by law.

²²⁶ Code of Administrative Offences, Article 15.19. Good corporate governance provides for the full and timely disclosure of information to shareholders and investors as required by both the law and a company's by-laws. Non-disclosure of information leaves shareholders and potential investors in the company unable to make informed investment decisions or learn about the real state of operations of the company.

²²⁷ Code of Administrative Offences, Article 15.21.

²²⁸ Code of Administrative Offences, Article 15.20.

²²⁹ Code of Administrative Offences, Article 15.22.

²³⁰ Code of Administrative Offences, Article 15.23.

²³¹ Investor Protection Law, Article 14, Clause 1.

²³² Investor Protection Law, Article 14, Clause 2.

2. Enforcement by Other Regulatory Bodies

Almost every regulatory body has enforcement powers although most do not directly relate to corporate governance.

a) Antimonopoly Ministry

Some regulators play a very important role in monitoring business. One of most significant roles in this field belongs to the Ministry of Antimonopoly Policy and Entrepreneurship Support (MAP). Certain actions of market participants require MAP's preliminary consent, and some other actions require subsequent notification.²³³ In order to ensure the enforcement of antimonopoly legislation, MAP may issue an order providing for the compulsory division of a company,²³⁴ and file a claim to an arbitration court for the liquidation of a company.²³⁵

b) Other Regulatory Bodies

Besides regulatory offences dealt with by the FCSM, there are a number of other offences provided for in the Code on Administrative Offences that can be raised by shareholders whose rights were violated by management actions. These are the following:

- Improper management of a legal entity, that is, the use of managing powers contrary to the legitimate interests of the legal entity and/or legitimate creditor interests, which results in a decrease in the organization's own capital, and/or damages.²³⁶ This offence is tried by courts on the grounds of reports drawn up by the Federal Financial Rehabilitation Service.²³⁷
- Performing transactions or other actions in transgression of authorities.²³⁸ This offence is also tried by courts on the grounds of reports drawn up by the Federal Financial Rehabilitation Service.²³⁹

²³³ Antimonopoly Law, Articles 17 and 18.

²³⁴ Antimonopoly Law, Article 19, Clause 1.

²³⁵ Antimonopoly Law, Article 6, Clause 5.

²³⁶ Code of Administrative Offences, Article 14.21.

²³⁷ Code of Administrative Offences, Article 23.1, Clause 1; Article 28.3, Clause 2, Paragraph 10.

²³⁸ Code of Administrative Offences, Article 14.22.

²³⁹ Code of Administrative Offences, Article 23.1, Clause 1; Article 28.3, Clause 2, Paragraph 10.

- A gross violation of bookkeeping rules, violation of procedures for keeping accounting documents, and the filing of incorrect accounting reports. Violations are deemed gross in case of a 10% misstatement of the amounts of taxes and fees to be paid, or in cases of a 10% misstatement on any line item on an accounting form.²⁴⁰ These offences are tried based on reports drawn up by the tax authorities.²⁴¹

The Ministry of the Interior is responsible for the investigation of criminal offences in the field of corporate relations.²⁴²

E. Stock Exchanges and Self-Regulatory Bodies

In addition to enforcement by judicial and regulatory authorities, stock exchanges and self-regulatory organizations may sanction corporate misconduct. Specific sanctions involve suspension of trading and de-listing of securities.

1. Listing Rules

At present, Russian stock exchanges do not play a significant role in enforcement of corporate governance rights when compared with analogous institutions in the U.S., U.K., and other countries. Moreover, they do not have detailed corporate governance guidelines or rules that could affect Supervisory Board structure, committees, or other governance aspects.

Best Practices: The New York Stock Exchange (NYSE) provides listing rules that cover board structures, committees, and disclosure and audit requirements, among many other issues. New NYSE corporate governance rules demand that:

- Boards have a majority of independent directors;
- Nominating, corporate governance, and compensation committees be composed entirely of independent directors;
- Companies adopt and disclose corporate governance guidelines;

²⁴⁰ Code of Administrative Offences, Article 15.11.

²⁴¹ Code of Administrative Offences, Article 23.1, Clause 1; Article 28.3, Clause 2, Paragraph 5.

²⁴² See Section B.6 of this Chapter.

- Companies adopt and disclose a code of business conduct and ethics for directors, officers, and employees, and promptly disclose any waivers of the code for directors or officers; and
- Foreign issuers disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.

For companies that repeatedly or blatantly violate NYSE listing standards, suspension and de-listing remain the ultimate penalties. However, suspending trading or de-listing a company may be harmful to the very shareholders that the NYSE listing standards seek to protect. Therefore, for most violations, the NYSE will issue a public reprimand.

Some Russian stock exchanges, however, require issuers to either comply with the FCSM Code or their own company codes.

For example, the Russian Trading System (RTS) provides for several types of listings, two of which (Level A, Tier 1 Quotation and Level A, Tier 2 Quotation) require compliance with the FCSM Code. Companies receive a Level A, Tier 1 rating if they produce accounting statements according to US GAAP or International Financial Reporting Standards (IFRS) and document compliance with the FCSM Code.²⁴³ In order for companies to receive a Level A, Tier 2 rating, they only need document compliance with the FCSM Code's Chapter 7 on information disclosure.

The Moscow Interbank Currency Exchange (MICEX) listing rules are similar. In order for the issuer to list its securities on Quotation Level A, Tier 1, an issuer should "comply with the requirements of the FCSM Code or requirements of their own code enacted in accordance with that Code." This requirement is easier to implement, and many issuers prefer to enact their own codes. In order to list on Quotation Level A, Tier 2, the issuer must simply comply with the information disclosure requirements in Chapter 7 of the FCSM Code.

Many Russian issuers have raised concerns about the vagueness of the RTS and MICEX listing requirements. It is expected that RTS and MICEX will issue clarifications describing the format and contents of their compliance documents.

²⁴³ RTS Listing Rules, Articles 5.2.4, 5.2.6, 5.3.4.

Company Practices in Russia: Like the NYSE, the RTS and MICEX can de-list securities in case of violation of the listing rules.²⁴⁴ In practice however, no issuers have (yet) been de-listed. Major stock exchanges may themselves have a conflict of interest as pseudo-regulatory bodies since they stand to lose clients if they are too rigorous in applying sanctions. The perception is that exchanges may relax their standards rather than lose companies to competing exchanges.

It is important to note that there is a fundamental difference between NYSE listing rules and RTS and MICEX rules. NYSE listing standards are requirements by the stock exchange rather than a reference to a non-binding code. When Russian companies develop codes, they are not obliged to follow the recommendations of the FCSM Code. Accordingly, Russian issuers have considerably more freedom than their NYSE counterparts.

2. Self-Regulatory Organizations

Most countries with developed securities markets have self-regulatory organizations (SROs) that play an important role in enforcing professional behavior among market participants.

At present, there is only one SRO of professional market participants in Russia possessing an official permission of the FCSM — the Professional Association of Registrars and Depositories (PARTAD). The National Association of Participants of the Securities Market (NAUFOR) has not been re-registered by the FCSM.

Other professional organizations, for example associations of accountants and auditors, institutes of directors (such as the Independent Directors Association and Russian Institute of Directors), institutes of corporate secretaries, and institutes for internal auditors could also eventually play leadership roles in the future in regulating their respective professions, and consequently specific corporate governance matters, as is the case in many OECD countries.

F. Public Pressure

Though shareholder activism is just emerging in Russia, shareholders and the public can exert considerable influence over companies. The mass media plays an

²⁴⁴ RTS Listing Rules, section 3.

important role in publicizing conflicts. In Russia, the first successful shareholder campaigns have already produced enormous publicity. In the case of RAO United Energy System (RAO UES) for example, the Russian and foreign media have played a significant role in the strengthening the position of shareholders against management.

1. Non-Governmental Organizations

NGOs can help shareholders exercise their rights.

a) The Russian Investor Protection Association

In April 2000, the Russian Investor Protection Association (IPA) was formed with the assistance of the World Bank. The goal of IPA is to combine investor efforts in defense of minority shareholders. IPA members include sizeable domestic and international investors with considerable experience in the Russian market. Besides being a well-established center of shareholder activism, IPA helps enforce member rights in court.

Public associations of individuals who are investing in securities are entitled to protect the rights and interests of investors and, in particular, may apply to court to protect the rights and interests of investors in accordance with procedural legislation of the Russian Federation.²⁴⁵ The law does not explicitly state whether claims should be filed with the court of general jurisdiction or with the arbitration court.

b) The Russian Union of Industrialists and Entrepreneurs

In 2002, the Russian Union of Industrialists and Entrepreneurs (RSPP) established a tribunal on corporate ethics to resolve conflicts that involve alleged ethics violations by its members. Although the tribunal may consider member violations, most of its cases in 2003 addressed hostile takeovers.

The Rules for Consideration of Disputes by the Russian Union of Industrialists Commission on Corporate Ethics (the Rules) govern procedural aspects of applications to the court, selection of arbiters, jurisdiction, evidence, sanctions, and other issues. The Rules are to be amended and clarified following consideration of pilot cases by the tribunal. The tribunal will consider whether companies

²⁴⁵ Law on Protection of Rights and Interests of Investors in Securities Markets, Article 18.

violated the charter of the RSPP, the Rules, the Declaration of Principles of Activities of the Russian Union of Industrialists, or the FCSM Code.

The RSPP tribunal has the authority to issue recommendations to parties guilty of ethical standard violations, recommend their exclusion from the RSPP, and include them on a list of undependable business partners.

2. Shareholder Activism

Shareholder activism is not yet a Russian tradition. Most shareholder initiatives have come from foreign investors with experience in their home jurisdictions. Yet activism is an effective way of asserting shareholder rights. In an environment where the court system is often perceived to be ineffective, investors may achieve more tangible results than the judiciary.

While some investors have enough wherewithal to assert themselves against corporate powerhouses, many are too small. One way for small shareholders to protect their rights is to pool their efforts. The RAO UES case, presented as Mini-case 1, is the best example of shareholder activism to date. It is perhaps the only example of a successful assertion of minority shareholder interests against a large company in which a controlling stake is held by the state.

Mini-Case 1: Minority Shareholders vs. RAO Unified Energy Systems

In 2000, minority shareholders of RAO UES, owning approximately 10% of voting shares of the company, joined in an effort to call an Extraordinary General Meeting of Shareholders (EGM) to assert their right to participate in a planned RAO UES restructuring on fair and transparent terms.

Investors, led by several major foreign investment banks and hedge funds, proposed the following items for the EGM agenda:

- To prohibit the Supervisory Board, Executive Board, and their respective chairmen from approving or carrying out any restructuring plan involving changes to the capital structure of RAO UES and its subsidiaries, as well as other entities without the approval of $\frac{3}{4}$ -majority of voting shares at the GMS;
- To lower the number of votes required to approve the early termination of the Chairman of the Executive Board;
- To require that most transactions with the assets of RAO UES and its subsidiaries (including subsidiaries of such subsidiaries), and the liquidation

and reorganization of subsidiaries, would be subject to shareholder approval; and

- To remove the Chairman of the Executive Board and call for the election of a new Chairman.

The EGM was not held due to a decision by the state, which owns a controlling block of shares.

However, shareholders succeeded in creating a working group with managers and the state aimed at protecting shareholders interests, and improving transparency in Russian power sector reform. In 2001–2003, most of the proposals were approved as charter amendments.

Despite the fact that shareholders failed, the case is the most successful in the history of the Russian securities market to date.

G. Self-Enforcement

1. The Federal Commission for the Securities Market's Code of Corporate Conduct

The FCSM Code introduces a high standard of corporate governance to Russian businesses. Like many foreign codes, the FCSM Code is voluntary. The chief incentives for complying with the FCSM Code are the “comply or explain” policies of stock exchanges, public pressure, and market forces.

All market participants can, in one way or another, contribute to the application of the FCSM Code's standards. Law firms, accountants, and investment banks (foreign and domestic) can advise their corporate clients on the value of adhering to recognized standards for good corporate governance. Compliance can be encouraged by: introducing a system of reporting to shareholders and the markets; making stock exchange listings contingent upon filing compliance statements; promoting openness in relations between companies and public organizations; and incorporating the FCSM Code's recommendations into company charters and by-laws.

Company Practices in Russia: General business customs are an independent, enforceable source of law.²⁴⁶ A general business custom is defined as “an established rule of behavior which is not stipulated by existing legislation, but is widely used in certain areas of business operations, regardless of whether it is actually documented.” To become a general business custom, a recommendation of the FCSM Code would need to:

- Become an established rule of behavior (have a sustainable and relatively fixed content);
- Be widely applied in corporate governance as practiced by companies; and
- Be judicially recognized as a general business custom.

It should be noted that, in practice, general business customs are also used in the field of international trade and merchant shipping. It is impossible to predict which articles of the FCSM Code might, with time, be incorporated into general business customs. This will only become clear when companies begin to use the FCSM Code more widely.

The FCSM Code may also be implemented as the result of one or more large institutional investors, either Russian or foreign, making its adoption a precondition for investment in a company. The FCSM Code embodies standards of good corporate governance that emphasize the protection of minority shareholder rights, the importance of transparency in corporate decision-making, and the accountability of directors and managers to shareholders — all values of particular importance to institutional investors.

The Russian state, acting as an investor/shareholder, also has a potential interest in the FCSM Code by virtue of these same values and may require that the companies in which it holds shares adopt the FCSM Code and make its provisions legally binding in their day-to-day business.

Alternatively, some of the FCSM Code’s recommendations may, with time, find their way into legislation and regulations.

²⁴⁶ CC, Article 5.

2. Self-Enforcement Through Internally Established Procedures

Charters and other company by-laws are legally binding, and viewed by courts as quasi-sources of law governing the operations of companies in addition to the Company Law and securities legislation. Incorporation of the provisions of the FCSM Code into corporate charters and by-laws makes them binding on a company's business and, thus, enforceable in courts.

The Company Law includes numerous discretionary standards and definitions allowing companies to include in their charters (and other by-laws) detailed rules that are not provided for by existing legislation. Examples include modification of the quorum required for approval of certain transactions, the option to apply procedures for approval of an extraordinary transaction to other transactions, special procedures for dismissing managers, and the introduction of rules and procedures governing the operations of governing bodies above and beyond those stipulated by legislation. It is important, however, that charters and by-laws not contradict legislation.

Best Practices: Making amendments to the existing by-laws and/or development of new by-laws with the above list is not the only method to make recommendations of the FCSM Code binding. Companies may also develop their own governance codes based on the FCSM Code. A number of large companies have already done so.

It is advisable that, in creating their company-level corporate governance codes, companies should adhere to the rules of the FCSM Code and use its definitions and wording as appropriate. At the same time, companies may reflect in their codes any special requirements based on their operations. Another possibility is to develop codes that are binding for all companies within a holding structure (group of companies). Companies may have their codes approved by the GMS or by resolution of the Supervisory Board.

The preparation of codes of conduct by each company should be accompanied by appropriate amendments to their charters and by-laws. Only then will it be possible to speak of an adequate, all-encompassing transformation of the corporate governance policies of each individual company.

3. Internal Dispute Resolution

The FCSM Code contains a number of recommendations dealing with extra-judicial resolution of corporate conflicts. The term “corporate conflict” means a dispute between a governing body of the company and a shareholder, and a dispute between shareholders, if it affects the interests of the company.²⁴⁷

It is reasonable for conflicts to be resolved by the Supervisory Board.²⁴⁸ For this purpose, the Supervisory Board may create a special corporate conflict resolution committee, which may be a permanent or an ad hoc committee. It is important that those tasked with conflict resolution be completely independent from the matters to be considered.

To identify corporate conflicts at the earliest possible stage, and to ensure that they receive due attention from the company, its officers and employees, it is good practice that the Corporate Secretary of the company register inquiries, letters and demands filed by shareholders, conduct their preliminary evaluation, and forward them to the corporate body which is most competent at resolving each particular conflict.²⁴⁹ The powers of corporate bodies with respect to consideration and resolution of corporate conflicts should be clearly delineated. At the same time, their common task is to find a lawful and reasonable solution that is in the interests of the company.

With the consent of the shareholders involved in a corporate conflict, corporate bodies may participate in negotiations between the shareholders, provide them with available information and documents related to the conflict, explain provisions of the Company Law and company charter and by-laws, provide shareholders with advice and recommendations, prepare draft conflict resolution documents to be signed by the shareholders, and — acting on behalf of the company and within their respective scope of competence — assume obligations before shareholders to the extent that this may be conclusive to the resolution of the conflict.²⁵⁰

The conflict may be resolved by signing an agreement between the shareholder(s) and the company. This agreement may take the form of a resolution of the relevant governing body. To ensure the objectivity of conflict resolution,

²⁴⁷ FCSM's Code of Corporate Conduct (FCSM Code), Chapter 10, Section 1.1.1.

²⁴⁸ FCSM Code, Chapter 10, Section 2.1.2.

²⁴⁹ FCSM Code, Chapter 10, Section 1.1.2.

²⁵⁰ FCSM Code, Chapter 10, Section 3.1.2.

Chapter 17. Enforcement and Remedies

none of the interested persons should participate in the resolution process. For instance, if the interests of the General Director are, or may be, affected by the conflict, it should be referred for resolution to the Supervisory Board or to its conflict resolution committee. If the conflict affects the interests of a Supervisory Board member, that member should not participate in the resolution process. Naturally, consideration of a corporate dispute by governing bodies does not preclude judicial recourse.

FOR NOTES

FOR NOTES

FOR NOTES

FOR NOTES

FOR NOTES
