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THE RESPONSIBILITIES OF THE BOARD AND THE ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE

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SESSION I: THE ROLE AND MAIN FUNCTIONS OF THE BOARD IN CORPORATE GOVERNANCE

PART B: THE SITUATION IN RUSSIA

COMPANY LAW AND JUDICIAL/ARBITRATION PRACTICES: ROLE AND RESPONSIBILITY OF BOARD OF DIRECTORS IN SUPERVISING MAJOR AND AFFILIATED PARTIES TRANSACTIONS

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[1] The theme of my speech is evident from its title. I will touch upon the law and arbitration court approaches and practices relating to the application and interpretation of the Joint-Stock Company Law provisions regulating the role of Boards of Directors in supervising the effectuation of major transactions, as well as transactions involving material interest.

Evidently, while introducing special regulatory procedures for the two above-mentioned categories of transactions, the lawmakers proceeded from the need to:

- minimize the natural (normal) conflicts of interests between the shareholders and managers of a joint-stock company, on the one hand, and the company and its external creditors, on the other; and
- balance out the interests of the above-mentioned parties.

Let me remind you at this point that the notion of major transaction is defined in Article 78 of the Law on Joint-Stock Companies for the following two categories (groups):

- a transaction or a series of interrelated transactions involving the purchase or alienation, or potential (direct or indirect) alienation, of property worth more than 25 percent of the balance-sheet value of the company's assets as of the date at which the decision to conclude such a transaction is taken, with the exception of transactions effected in the business-as-usual manner; and
- a transaction or a series of transactions involving the placement of ordinary shares, or preferred shares convertible into ordinary ones, that make up more than 25 percent of the company's floating ordinary stock.

As we see, the lawmakers selected the first group based on the value, and the second group based on the number, of shares.

There seems to be no particular need for going into detail about problems related to the definition of the second group of major transactions because:

- such cases are relatively few in law and arbitration court practices; and
- the draft Law «On Amendments and Additions...», expected to be passed by Parliament in the near future, actually places this kind of transactions beyond the sphere of major ones and defines them as business-as-usual transactions.

What should a company's Board of Directors consider in the first place as regards the first group of major transactions?

[1] The views expressed in this paper are those of the author and do not necessarily represent the opinions of the OECD or its member countries. This paper is subject to further revision.

Judicial case analysis shows that the majority of problems in court practices arise in connection with the notion of «the value of property constituting the subject of transaction».

As noted above, such property should be worth more than 25 percent of the balance-sheet value of a company's total assets. Estimates of this balance-sheet value must exclude the company's liabilities, contrary to the procedure for net asset evaluation.

One should also remember that it is the real value of the property constituting the subject of transaction, excluding penalties, interests or forfeits that may be charged for non-fulfillment or partial fulfillment of obligations, which should be taken into account.

Estimates of the value of property that is the subject of a major transaction shall also exclude other civil or legal responsibility measures, such as interest on the use of borrowed funds, as envisaged under Article 395 of the Civil Code.

The size of a major transaction should be determined based on the value of property alienated or purchased in real terms as compared with the figures reported in the latest balance sheet approved by the company.

This provision is not contained in the law; it was established by Section 14 of Joint Resolution #4/8 of April 2, 1997.

Therefore, the parties concerned shall confirm any of their assertions by presenting their balance sheets as per the latest reporting date preceding the date at which the major transaction is concluded.

The Presidium of the Supreme Court of Arbitration has pointed to the need for the relevant documents to be studied thoroughly. Specifically, on February 23, 1999, it ruled to reconsider a case whereby an agreement to mortgage a block of shares had been declared null and void. A lower-standing court had passed the said decision having established that the value of the mortgaged shares exceeded the mortgager's authorized capital. The court should have compared the value of the mortgaged shares with the balance-sheet value of the company's assets, not with the authorized capital, of the mortgager. Actually, the case file contained neither a balance sheet nor any other indication of the balance-sheet value of the company's assets.

Other documents, such as value estimates made by authorized evaluators in accordance with the Law «On Evaluating Activities» of July 29, 1998, may also be presented in court as material proofs.

Where necessary, specifically in the event of contradictory evidence being presented, the conflicting parties may request that the court order an independent evaluation of company assets. However, one should remember that it is one of the rights, not duties, of the court. The latter may choose to consider the contradictory data based on the general rules of evaluation, without ordering an assessment by independent experts.

Another point deserving special attention is that the evaluation of a major transaction versus the balance-sheet value of a company's assets shall be tied to the date at which the go-ahead decision is taken.

That means, among other things, that if, as per the decision date, the value of property to be purchased or alienated was less than, or equal to, 25 percent of the balance-sheet value of a company's total assets, and if the value of its subsequent obligations under the transaction — for example, those related to the non-fulfillment or partial fulfillment of obligations — is found to be in excess of the amount mentioned above, such a transaction shall not be recognized as a major one.

Until recently, the term «property», as applied to a major transaction, used to be interpreted rather loosely in legislation regulating company activities. Currently, most courts rely on Article 128 of the Civil Code for its interpretation, which stipulates that the category of objects of civil rights shall be deemed to cover various material property including money and securities, as well as other assets including property titles.

Proceeding from this understanding, the laws regulating major transactions should be deemed to cover credit agreements and transactions involving cession of incorporeal rights (Article 382), transfer of debt obligations (Article 391), as well as surety and mortgage.

It is not accidental, therefore, that the draft Law, taking current judicial practices into account, unambiguously places credit, loan, mortgage, surety and other similar transactions within the category of major transactions.

And one other problem related to the value of property notion. In line with Article 77 of the Law on Joint-Stock Companies, the value of property constituting the subject of a major transaction shall be estimated by the Board of Directors — exclusively by the Board of Directors, regardless of whether such transaction shall be authorized by the Board of Directors or by the General Meeting of Shareholders. This provision is an imperative one, meaning that:

- no other body of company management may take over the said function (except in cases where the General Meeting is appointed to perform instead of the Board of Directors in accordance with Section 1, Article 64 of the Law on Joint-Stock Companies); and
- the Board may not delegate the relevant powers to anyone at all, whether within or outside the company.

The so-called «first group» of major transactions also mentions «transactions effected in the business-as-usual manner», which is a separate, fairly important case in law-application practices.

The notion of «transactions effected in the business-as-usual manner» is not specified in the law. Section 14 of Joint Resolution #4/8 of April 2, 1997, only says that the norms regulating the effectuation of major transactions shall not apply to business-as-usual transactions (i.e., those involving the purchase of raw or other materials, the sale of end products, etc.) regardless of the value of property purchased or alienated thereunder.

As we see, the Joint Resolution does not make the above-mentioned notion any clearer, providing just a few examples of typical business-as-usual transactions. Since finding an exhaustive definition is actually impossible, the courts have interpreted it with due regard for the specific circumstances of each particular case.

Analysis of judicial practices shows, however, that there is a general criterion based on which one can judge whether or not a certain transaction should be regarded as «major»: any transaction effected by a company within the sphere of its mainline activities should be identified as a «business-as-usual» one. The latter category should be deemed to include, for example, transactions involving loans for the purchase of raw materials, organization of construction, etc.

Now, let us discuss the procedure for effecting major transactions in greater detail. Under the law, a company's Board of Directors is required to give its authorization to any transaction involving property worth 25 to 50 percent of the balance-sheet value of the company's total assets. If the transaction value exceeds 50 percent, or if the Board members fail to reach consensus, the authorization is to be given by the General Meeting of Shareholders. The same is required in the event of a company's having no Board of Directors at all.

The general rule contained in Section 3, Article 68 of the Law on Joint-Stock Companies says that the Board of Directors shall pass its authorization decisions by a simple majority of votes, unless a different procedure is established by current legislation or by internal company regulations.

One such «different procedure» is prescribed by the Law on Joint-Stock Companies, requiring major transactions to be approved by the Boards of Directors unanimously, disregarding the votes of the former Board members.

As far as judicial practices are concerned, the question thus arises as to who should be regarded as a «former» Board member. Having considered one specific case, the Presidium of the Supreme Court of Arbitration ruled that the said formula shall refer to those persons whose official powers have been terminated by the General Meeting of Shareholders. The ruling was based on certain provisions of the Law on Joint-Stock Companies, specifically, on Section 1(4) of Article 48 thereof, which stipulates that the early termination of a Board member's office shall be deemed to be within the exclusive competence of the General Meeting of Shareholders.

Thus, a person shall be considered to stay on the Board of Directors until the General Meeting has decided to terminate his or her official powers.

Until recently, transferring a Board member's vote to other persons was a fairly widespread practice in company activities. That was motivated by the assumption that the Law (Section 3, Article 68) directly banned the transfer of votes only to other members of the Board of Directors. However, it is not to be inferred therefrom that a Board member's vote may be transferred to a third person, for the reasons described below.

A vote in an instrument of corporate law in which, unlike civil law, the principle «Everything that is not banned is allowed» does not work. In corporate law, only that is possible which is provided for by positive regulation. For example, the Law on Joint-Stock Companies provides

for the possibility of transferring a shareholder's vote at a General Meeting, but there is no similar provision in respect of a Board member's vote.

As noted above, as regards the authorization of major transactions, the JSC Law draws a line between the powers of the Board of Directors and those of the General Meeting. It should be stressed that this division is imperative, which means that neither a company's Charter nor any other internal regulations, among them decisions taken by the General Meeting or the Board of Directors, can change these bodies' range of authority in respect of major transactions.

The Law on Joint-Stock Companies only regulates the procedure for the conclusion of major transactions involving the purchase or alienation of material assets. It does not prescribe any rules for effecting major transactions with securities that make up the so-called «second» group of major transactions.

The Federal Securities Commission has taken steps to bridge that gap. Its Standards of Share Issuing While Establishing a Joint-Stock Company, #19 of September 17, 1996, as amended on November 11, 1998, prescribed a decision-making procedure that actually replicated the one approved for the first group of major transactions.

However, the July 4, 2000 decision of the Supreme Court's College of Appeals declared those provisions of the Standards to be at odds with current legislation, and hence null and void.

Therefore, today, the second group of major transactions is regulated by the general rules of decision-making. In other words, regardless of the value of a major transaction involving the placement of shares, the go-ahead decision must be taken by the Board of Directors in accordance with the general rules, i.e., by a majority vote of the Board members who are present at the session considering the transaction in question.

To conclude the major transactions theme, let us discuss the legal consequences that may be entailed by a major transaction effected by a company's General Director or his authorized representative without the consent of the Board of Directors or the General Meeting of Shareholders.

In accordance with the general rules, a major transaction effected in violation of the established norms shall be declared unlawful, null and void, as prescribed by Article 168 of the Civil Code.

However, in accordance with Section 14 of Joint Resolution #4/8 of April 2, 1997, a court of law may find such a transaction to be fully legal if it becomes evident in the course of hearings that it was subsequently approved by the Board of Directors or the General Meeting, whichever was required.

This kind of ruling may contribute to the stability of property turnover and protection of the interests of external creditors of the company concerned.

Judicial practice analysis shows that conflict participants have often referred to the General Meeting's approval of the company's annual report, balance sheet or other similar documents as proofs of a major transaction's authorization. Such reference should be deemed irrelevant.

What is the official procedure for, and form of, approving such a transaction?

Each specific major transaction must be submitted to the Board of Directors or General Meeting for consideration and voting.

For a General Meeting decision to be recognized as valid, the relevant issue must be included in the Meeting's agenda prior to voting, because in accordance with Section 6, Article 49 of the Law on Joint-Stock Companies, a General Meeting may not pass decisions on matters beyond its agenda.

Besides, if the matter under consideration is deemed to be within the competence of the General Meeting of Shareholders (in three above-described events), it may only be decided at the initiative of the Board of Directors, unless the company's Charter establishes a different procedure (see Section 3, Article 49 of the JSC Law).

Just as with major transactions, not a single transaction involving material interest may be effected without the participation of the Board of Directors. This rule applies even to those cases where authorization of such a transaction is deemed to be within the competence of the General Meeting (e.g., an interest-based transaction involving material property worth more than 2 percent of the company's total assets). The Board of Directors must:

- establish the market value of the proposed transaction, as prescribed by Article 77 of the JSC Law; and
- consider the proposed interest-based transaction at a prior Board session, which means that the General Meeting shall be entitled to approve such a transaction only if the latter has been initiated by the Board of Directors.

According to the general rules, all interest-based transactions involving property worth up to 2 percent of a company's total assets shall be effected by decision of the Board of Directors. In other words, all interest-based transactions except those within the exclusive competence of the General Meeting shall be initiated by the Board of Directors, including transactions effected in the business-as-usual manner.

When settling conflicts over nullified transactions involving material interest, most arbitration courts have given priority attention to the following.

The most important thing about interest-based transactions is that one should always assess their likely consequences in terms of possible changes to the company's assets. One must make sure that the value of property to be purchased or alienated as a result of such transactions is not lower than the market value. This means the proposed transaction must provide for an equitable exchange. If this condition fails to be met, the relevant transaction will never be recognized as valid.

As it checked the validity of specific interest-based transactions, the Presidium of the Supreme Arbitration Court has called attention to the following points.

The Presidium stated that a company's Acting General Director, who thus performs as the relevant legal entity's executive manager, shall be deemed to be an interested person if, simultaneously, he is one of the persons mentioned in Article 81 of the Law on Joint-Stock Companies. In the particular case scrutinized by the Presidium, one and the same person performed as the Acting General Director of the seller company and a member of the Board of Directors of the buyer company. The transaction effected between the two companies was identified as one involving material interest.

Also, the Presidium declared that whether or not material interest is involved should be established as per the moment of the relevant transaction's effectuation, not as of the date of establishment of the company concerned. In the case considered by the Presidium, a court of law had declared a transaction null and void because the seller company's General Director had been found to be in possession of 20 percent of the buyer company's voting shares. Subsequently, it became clear that he had owned these shares as per the moment of the buyer company's establishment but was no longer involved with the buyer company as per the transaction date.

Fairly often, courts need to establish the relationship between a major transaction and a transaction involving material interest.

Section 7, Article 83 of the JSC Law stipulates that if an interest-based transaction is at the same time a major transaction involving the purchase or transfer of property, it shall be effected in accordance with the provisions of Chapter X of the said federal law, i.e., the provisions relating to major transactions.

As far as judicial practices are concerned, this requirement is interpreted as follows: if a transaction, or a series of interrelated transactions, displays the signs of both a major transaction and an interest-based transaction, it shall be effected pursuant to the provisions of the JSC Law relating to major transactions.

The draft Law «On Amendments and Additions...» suggests a different formula: if a major transaction is simultaneously a transaction involving material interest, it shall be effected only in accordance with the provisions relating to interest-based transactions. This approach seems to be more justified because the rules of effecting interest-based transactions are generally more stringent than those concerning major transactions.

Finally, one other remark about interest-based transactions. Until recently, some courts found it difficult to justify their decision to declare an interest-based transaction null and void, or else questionable.
Article 84 of the JSC Law stipulates that a transaction involving material interest may be declared null and void. The phrase «may be» suggests that transactions of this kind may also be declared questionable. On the other hand, Article 84 does not specify the parties having the right to claim invalidation of an interest-based transaction. Judicial practice analysis shows that either a shareholder or a company may be recognized as claimants in cases like that.

In conclusion, I would like to make a few remarks about the responsibility of Boards of Directors.

I would be bound to state at once that the problem of an entire Board's responsibility has never arisen in Russian legislation. At best, one can speak of the personal responsibility of individual Board members. In other words, what is currently in effect are the general rules concerning responsibility, established by Article 71 of the JSC Law, which say that a Board member may be held liable for the damages incurred by his company through his guilty actions or inaction.

Compensation for such damages may be claimed from Board members either by the company concerned, or on behalf thereof by a shareholder (shareholders) holding at least 1 percent of the company's floating stock.

At present, arbitration courts decline to consider this category of cases because claims are brought against physical persons. Therefore, it would be difficult to discuss here any specific problems arising in judicial practices in connection with the application of norms regulating the responsibility of Boards of Directors.

Our own experience (including contacts with colleagues in law courts, as well as the content of juridical publications and media reports) prompts us to conclude that matters related to the responsibility of Boards of Directors — both as regards the two groups of transactions considered today, and in general — have largely remained beyond the focus of attention in Russia's courts.

This is deemed to be connected with:

- Financial and legal problems. In each particular case, with due regard for business-as-usual and other specific circumstances, one should draw a line between the actions taken by a Board member and the losses incurred by the company as a result thereof. It is essential to prove that the damage inflicted on the company did actually result from the guilty behavior of the Board member concerned.
- Procedural and legal problems. The claimant must prove in court by all legal means that the Board member concerned did behave guiltily; that the company did suffer damage; and that the said behavior did actually entail that damage.

Summing it all up, one can state with regret that the issue of Board members' responsibility has in many aspects remained an abstract and theoretical problem in Russia's judicial practices.

Hopefully, with time, issues of this kind will be worked out in Russia's legislation and judiciary as thoroughly as in the Western legal systems.