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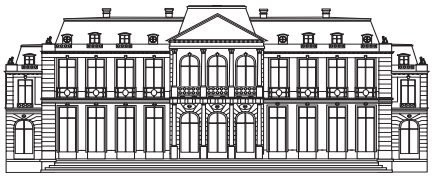

Organisation de Coopération et de Développement Économiques

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the World Bank

Conference on

"CORPORATE GOVERNANCE IN RUSSIA"

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"Review of the implementation of the main company law provisions by the Arbitrazh (commercial) Court: protecting minority shareholders"

Moscow
31 May - 2 June 1999

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1. Introduction

A student of how courts of arbitration treat issues relating to shareholding law, including protection of minority shareholders' interests, should take into account that, being yet in its formative stage, such treatment is not always consistent throughout and that it cannot always provide sufficient grounds for arriving at a conclusion as to what kind of interpretation a court gives to some involved or disputable rule of shareholding law. Federal Law "On Joint-Stock Companies" No.208-ФЗ[2], adopted December 26, 1995, (hereinafter referred to as the Company Law) has up to now had a fairly short effective life (effective date January 1, 1996), and many a dispute has not yet come to a head or has not yet come to court or has not yet been resolved at court. What is more, the courts quite frequently have to rely on the legislation that was in effect before January 1, 1996 (first and foremost, the Provisions on Joint-Stock Companies approved by Regulation of the Council of Ministers of the RSFSR No.601[3], dated December 25, 1990) in situations when the disputes courts are considering, in particular those before a supervisory tribunal, had arisen before the new Company Law came into effect. But though some of the arbitral awards rooted in the antiquated substantive law are of some interest and may have an influence on what shape the practice of arbitration courts will take further on, most of such awards reflect the yesterday of domestic shareholding law. And so far as our subject is concerned, the Provisions on Joint-Stock Companies did not contain a mechanism of any efficiency for the protection of the rights and lawful interests of minority shareholders.

But now such mechanism, at least in theory, is in existence. But if it is to prove practically effective, it requires more than an adequate treatment at court: shareholders themselves should take an active and firm stand to protect their rights and interests in court, using the possibilities provided by law. For the time being minority shareholders do not show themselves very active in this respect. As a rule they do not remember that they can get legal remedy at court in any case other then when they fall victim to chicanery on part of what is known as financial pyramid schemes. In a more or less innocuous situation a rank-and-file shareholder demonstrates an "I-couldn't-care-less" attitude and fails to use the available legal possibilities.

Significantly, most minority shareholders in Russia are individuals (physical persons); many of them came into possession of shares by accident rather than by design, as a result of privatisation. If an individual does not have the legal status of a businessperson, a legal remedy is provided to such individual by a court of general jurisdiction rather than a court of arbitration, and the practice of the former is less accessible to a student; nor for that matter is it the subject of this report.[4] In fact, the very problem of "dual jurisdiction" merits a special consideration. Jurisdiction is divided between courts of general jurisdiction and courts of arbitration in such a way that a dispute may be considered in either jurisdiction depending on the nature of the parties to such dispute. This situation creates what may be termed as a dual

[1] **The views expressed in this paper are those of the author and do not necessarily reflect those of the OECD.**
[2] Anthology of Legislation of the Russian Federation, 1996, No.1, page 1, No.25, page 2956.
[3] Anthology of Regulations of the Government of the Russian Federation, 1991, No.6, page 92.
[4] To be sure, to the best of our knowledge, courts of general jurisdiction hear cases in which minority shareholders seek a legal remedy very infrequently (with the exception of cases related to financial pyramid schemes).

court practice and in certain instances it has resulted in practical problems.[5] In this situation joint rulings by the Plenary Meeting of the Supreme Court and the Plenary Meeting of the Higher Court of Arbitration on the application of civil law and shareholding law are of paramount significance for the formulation of common approaches to be used in court practice. Two such rulings are particularly noteworthy: No.6/8, dated July 1, 1996, "On Certain Issued Relating to the Application of Part One of the Civil Code of the Russian Federation"[6] (further, Ruling No.6-8) and No.4-8, dated April 2, 1997, "On Certain Issues Relating to the Application of the Federal Law "On Joint-Stock Companies"[7] (further, Ruling No.4-8).

Russia's Company Law ("Law On Joint-Stock Companies") contains quite a number of rules a minority shareholder may use to protect his rights and interests. The legal remedies these rules can offer a minority shareholder are as follows:

1. an appeal against a resolution of a general shareholder meeting or another Company governance body;
2. a suit seeking the buyback by the Company of its shares in cases when a shareholder gets a right to demand such buyback under law;
3. recovery in favour of the Company of losses caused by guilty actions of its executives or by another Company or partnership that exercises control over the former Company's actions;
4. a suit seeking the invalidation of a large transaction where such transaction has been performed in breach of rules;
5. a suit seeking the invalidation of a transaction involving a conflict of interests on part of a person (persons) who influences (influence) the Company's conduct of business.

Some of the above legal remedies are used in practice more often than others. Specifically, in all arbitration cases these authors have had access to, we have not come across a single important case instituted by a claim filed for reasons listed in item 2 or 3.

2. Appealing Against Resolutions of General Shareholder Meeting and Other Company Governance Bodies

A right to participate in a general shareholder meeting is one of the fundamental rights a shareholder may rely upon to safeguard his property interests connected with his participation in the joint-stock company. The Company Law spells out fairly detailed rules of procedure for calling and conducting a general meeting, which, if violated, constitute grounds upon which a court may invalidate a resolution adopted at a general meeting in breach of rules. Pursuant to Clause 8 of Article 49 of the Company Law a shareholder may go to court to appeal against a resolution a general shareholder meeting passes in breach of Company Law or other legal acts of the Russian Federation, or in breach of the Company's Charter provided such shareholder did not attend such general shareholder meeting or provided he voted against such resolution and if such resolution infringes upon his rights and lawful interests. It follows from the foregoing that a resolution of a general shareholder meeting may be invalidated, first of all, for formal

[5] For example, in some instances courts of arbitration would refuse to hear a case between two corporations when a beneficiary in such case is an individual. (for instance, the Presidium of the Supreme Court of Arbitration of the of the Russian Federation dismissed a case (Ruling No.2244/96, dated August 27 1996) that had been brought by AOZT Strakhovaya Kompania (Insurance Company) M-GRATA against AOZT Kompania NB Trust seeking the invalidation of an insurance contract – see Vestnik (Gazette) of the Higher Court of Arbitration of the Russian Federation, 1996, No.11).

[6] Bulletin of the Supreme Court of the Russian Federation, 1996, No.9; Vestnik (Gazette) of the Higher Court of Arbitration of the Russian Federation, 1996, No.9.

[7] Bulletin of the Supreme Court of the Russian Federation, 1997, No.5; Vestnik (Gazette) of the Higher Court of Arbitration of the Russian Federation, 1997, No.6.

reasons, i.e., in case of an infraction of procedure for calling and conduction a meeting (for example, when notice of such meeting was not duly given[8]; or if a list of shareholders who may attend the meeting is compiled in breach of rules; or if a meeting passes a resolution in the absence of quorum,[9] etc.), and secondly, if a general meeting passes a resolution on a question on which it is not empowered to decide.[10] Bringing an action, a shareholder may choose between a court of arbitration and a court of general jurisdiction depending on the established case jurisdiction.

It is noteworthy that Law treat appeals against a general meeting's resolutions in any consistent manner. Though proclaiming a right to appeal as a general principle, Law emasculates this rule, saying that "the court, in view of the overall circumstances of the case, may uphold a resolution that is appealed against if the vote of the shareholder [who seeks to have the resolution overruled] could not influence the voting returns, if infractions are not material or if the resolution has not caused such shareholder to incur losses." This rule makes quite a dent in the level of legal protection a majority shareholder has access to – even if only for the simple reason that a minority shareholder's vote does not in most cases make any on the final voting results. Such attitude transforms many imperative rules of the Law that lay down the procedure for calling and conducting a general meeting into what are de-facto discretionary rules. Regrettably, courts of arbitration have been making quite a broad use of this rule even though it is based on the very dangerous conception that laws do not have to be complied with. As a result, the lawgiver himself prompts Company executives, first of all those in major Companies, to neglect the interests of minority shareholders, which results in more and more infractions.

One should keep in mind that a court may only uphold a general meeting's resolution that is appealed against if the infraction of the Company Law that causes the resolution to be appealed against, or that of another legal acts or of the Company Charter is not material. A major violation of law, as per Clause 9 of Regulation No.4/8, makes the appropriate resolution ineffective (in whole or in part) no matter whether such resolution is or is not challenged by any shareholder. Higher courts view the following as material violations: a resolution that oversteps the general meeting's jurisdiction; a resolution passed in the absence of the general meeting's quorum; a resolution taken on a question that is not on the agenda or one that is put on the agenda by the general meeting itself.

One of the most wide-spread infractions in conducting a general meeting is failure to give a shareholder notice of such general meeting -- in fact, it is this kind of meeting that is likely to pass a resolution infringing on the interests of the shareholder who was not notified of such meeting. One characteristic example of such situation is provided by case No.5361/95/35 that was brought by the Spanish Company Cointeco against AOZT Trade/Production Company Trikotazh (AOZT TPF Trikotazh) at the Court of Arbitration of St.-Petersburg and Leningrad Oblast.

AO Cointeco appealed against a resolution of a March 5, 1995, general meeting of AOZT TPF Trikotazh that "struck it [Cointeco] off the list of its shareholders because Cointeco had not paid up its

[8] Pursuant to Article 52 of the Company Law, shareholders shall be notified of a general meeting by mail or in the press; a Company which has more than 1000 holders of voting shares shall send or publish notification no later than 30 days before the meeting date.

[9] The general rule (Article 58 of the Company Law) lays down that a general meeting has the quorum if by the end of the shareholders' registration for participation in a general meeting, holders between them of more than ½ of the Company's distributed voting shares or their representatives have registered for participation. If an original meeting does not take place, a repeat meeting that is called in lieu of the aborted one is valid if by the end of registration for participation in it, holders between them of at least 30 percent of the Company's distributed voting shares or their representatives have registered for participation. The Supreme Court and the Higher Court of Arbitration of the Russian Federation view the absence of statutory quorum as a material violation that makes such general meeting's decision null and void, i.e., treating them as de-facto null transactions (see Clause 9 of Regulation No.4/8).

[10] Pursuant to Clause 3 of Article 48 of the Law, a general shareholder meeting may not consider such issues or pass appropriate resolutions. Correspondingly, a resolution of a general meeting passed in conflict with such meeting's jurisdiction does not have legal force (is null and void), which is expressly specified in Clause 9 of Regulation No.4/8.

share of the Company's chartered capital, which failure to pay is in breach of Clause 17.2 of the [Company] constituent agreement." But Cointeco had not been notified of the general meeting. The AOZT TPF Trikotazh Board of Directors, taking guidance from Clauses 97 and 106 of the Provisions on Joint-Stock Companies that were in effect at the time, presumably did not think it necessary to give notice to its Spanish shareholder.[11] Yet it transpires from the arbitration case materials that the Spanish shareholder had made the payment, which, however, did not arrive at the right address and returned to [Cointeco's] Sberbank account because of inaccurate bankers' essentials. The general meeting did not discuss these circumstances, and the Spanish shareholder was struck off the AOZT TPF Trikotazh register of shareholders. The arbitration court satisfied Cointeco's claim by declaring the general meeting's resolution void.[12] This ruling remedied the infringement on the Spanish shareholder's rights. But generally speaking, this case highlighted a fundamental problem relating to court protection of civil rights, i.e., that a claimant is not always able to formulate his claims fully and correctly. In our case the claims rested on purely formal grounds which did not appear self-sufficient as it remained unclear whether the shares had actually been paid up or whether the payment had been made but it later returned to Sberbank for good reasons. It cannot be ruled out that this vagueness of the claims was the reason why the case went the rounds of four tribunals (each giving a different award). On the other hand it would be quite safe to believe that the challenged resolution of the AOZT TPF Trikotazh general meeting was essentially invalid "on its merits", i.e., irrespective of whether the claimant had or had not fully paid up its shares; in fact, it would have been invalid even if the claimant had been duly notified of the general meeting and if it had attended the general meeting. The concept of "getting struck off the register" is evidently averse to the very nature of a joint-stock company as it is a pooling of capitals, an essentially depersonalised entity. For the same reason no standard shareholding law knows such concept in this particular form. But the crux of the matter lies elsewhere. The general meeting decided that a shareholder should be expelled because of failure on part of such shareholder to meet its obligations relating to payment for shares, which fact is in itself questionable. The consequences of such infraction were spelled out in detail in the Provisions on Joint-Stock Companies saying in Clause 42 that if shares are not paid on time, interest is charged on such unpaid shares in favour of the Company; and then if infraction is not rectified, such unpaid shares are forfeited under the Company Charter. In fact, it does not in any way follow from the Provisions that such infraction leads to the expulsion of a shareholder, much less its expulsion by resolution of a general meeting.

Yet another illustration of how a vague claim may hamper getting redress for infringed-upon rights is provided by an action brought at the Court of Arbitration of Sverdlovsk Oblast by ZAO Firma Link which sought the invalidation of a share issue prospectus and of a corresponding share issue of AOOT Ogneupory that was decided upon at the April 21, 1995, general meeting of AOOT Ogneupory, a manufacturer of refractory materials in the city of Bogdanovichi. Even though the claimant also demanded the invalidation of the AOOT Ogneupory general meeting's resolution that approved the issue prospectus and the increase in the chartered capital, the court of arbitration dismissed these demands, alleging that it did not have jurisdiction over the dispute because an issue prospectus, rather than being an act of an AOOT Ogneupory governance body, is no more than a piece of information concerning a forthcoming

[11] Pursuant to Clause 97 notice of a general meeting is given to all shareholders who have fully paid up their ordinary shares, and Clause 106 permitted a shareholder or his representative to attend a general meeting only on condition such shareholder had made all required payments in connection with his/her shares. Apropos, now and again these rules in the Provisions caused major practical problems. If interpreted literally, these rules make it impossible to call any extraordinary general meeting; for example, an extraordinary general meeting intended to amend the Charter could not be called if all shareholders had only paid up part of the shares even though a spread-out payment is allowed under an annual installment plan pursuant to Clause 38 of the Provisions. This paralyzed the functioning of the general meeting as the Company's highest authority.

[12] Later on the case went to an appellate court that dismissed the claim, then to a court of cassation that upheld it and overruled the appellate court's decision and then to a supervisory tribunal that finally supported the initial award (Ruling of the Presidium of the Higher Court of Arbitration of the Russian Federation No.3421/96, dated February 28, 1997).

securities issue. The court did not examine the facts of the case and failed to note that in actual fact the issue prospectus, through it had been on the general meeting's agenda, had not been approved by the general meeting. An appellate court and a court of cassation upheld the award of the Court of Arbitration of Sverdlovsk Oblast. It was not until the case came to the Presidium of the Higher Court of Arbitration of the Russian Federation that this tribunal decided, in its March 31, 1998, Ruling No.139/98[13] resulting from supervisory proceedings initiated by appeal of Deputy Chairman of the Higher Court of Arbitration of the Russian Federation, that the claim-related materials should be examined on their merits. The Ruling expressly indicated that if need be, the subject of the claim should be clarified.

Now and then courts of arbitration face in their practice the question of how to define a quorum sufficient for holding a general meeting. Ruling No.5167/98, dated September 8, 1998[14], of the Presidium of the Higher Court of Arbitration of the Russian Federation says expressly that whether a general meeting has or does not have a quorum is decided when registration of attendees ends, not when a specific question is put to the vote.[15] This court decision fully corresponds to the letter and the spirit of Article 58 of the Company Law.

In addition to rules that govern appeals against a general meeting's resolutions, the Company Law also contains rules spelling out the conditions on which a Board of Directors' (Observation Council's) resolutions may be declared null and void. Clause 5 of Article 53 allows a court appeal against a Board of Directors' (Observation Council's) refusal to include an issue in a general meeting's agenda or to allow somebody to run for the Company's Board of Directors (Observation Council) or the Auditing Commission (Auditor).[16] Also, Clause 5 of Article 55 allows court appeal against a decision of the Board of Directors (Observation Council) that refuses to call an extraordinary general meeting.[17]

But court practice has been raising the question of whether the above instances are, as law expressly puts it, the only instances that allow resolutions of the Board of Directors (Observation Council) to be appealed against at court, and of whether resolutions of Company executive (collective or one-person) bodies are also appealable. The most exhaustive answer to this question is currently provided by Clause 10 of Ruling No.4/8. The way we see it, the higher tribunals take the flawless position that a decision of a Board of Directors (Observation Council) or a Company (collective or one-person)

[13] Vestnik (Gazette) of the Higher Court of Arbitration of the Russian Federation, 1998, No.6.

[14] Vestnik (Gazette) of the Higher Court of Arbitration of the Russian Federation, 1998, No.12.

[15] This Ruling was passed when Deputy General Prosecutor of the Russian Federation appealed against a July 15, 1997, award of the Court of Arbitration of Moscow Oblast relating to case No.A41-K1-5097/97 that had examined whether the Moscow Oblast Registration Chamber had been right to refuse to register a new Charter of AOZT Reutovskaya Tkatskaya Fabrika (Textile Factory in Reutov). Holders between them of 100 percent of the Company's voting shares – i.e., TOO Textile, 36 percent of the stock, and AO Lyuberetskiye Kovry (Carpets of Lyubertsy), 65 percent - had registered for participation in the general meeting that approved the charter as amended. But though he had registered, the TOO Textile representative left in the middle of the meeting, and the decision that approved the new charter was taken by the vote of the only shareholder that remained at the meeting, AO Lyuberetskiye Kovry. This means that the new charter was upheld by a majority of 65 percent of voting shares while under the law such decision requires a ¾ majority vote of the shareholders participating in a general meeting. The court disagreed with Lyuberetskiye Kovry that claimed that by the time the new charter was put to the vote the other shareholder had left the meeting, so the quorum should be determined based on the vote of the remaining shareholder (i.e., the decision would be viewed as unanimous).

[16] Under Clause 1 of Article 53 within 30 days of the end of a financial year (unless the Company's Charter allows a lengthier period) holders between them of not less than 2 percent of the Company's voting shares may propose not more than two items to the agenda of the Company's annual general meeting and nominate candidates to the Company's Board of Directors (Observation Council) provided the number of their nominees does not exceed the number of members of the Board of Directors (Observation Council).

[17] Under Clause 1 of the same article the following may demand the calling of an extraordinary general meeting: the Company's Auditing Commission, Auditor and holders between them of at least 10 percent of the Company's voting shares.

executive body may be challenged at court by filing a demand to have it declared null and void both when law expressly allows an appeal and when law makes no mention of such possibility if such decision does not comply with the Law or other normative legal acts and infringes upon a shareholder's rights and lawful interests. In such cases the Company is the defendant.[18] This opinion builds on and amplifies Clause 8 of Ruling No.6/8 which says that courts have jurisdiction over claims seeking the invalidation of resolutions of a Company's general meeting, Board of Directors or other Company bodies that infringe upon a shareholder's statutory rights. This opinion is of major importance in the protection of interests of a minority shareholder as earlier (in particular before the Company Law took effect) courts often dismissed such claims, alleging that arbitration courts did not have jurisdiction over such claims. [19]

3. Claims Demanding Company Buyback of Its Shares

One of the more important safeguards law gives a minority shareholder is the right to choose between continuing to hold his/her share in the Company and leaving the Company with a fair compensation. The standard way for a shareholder to leave the Company is to sell his/her shares to the other shareholders or on the free market. However, a situation may arise in which a shareholder cannot take this course of action while further participation in the Company becomes non-profitable for such shareholder for reasons beyond his/her control.

The Company Law envisages two situations in which a shareholder may demand that the Company buy back all or part of his/her voting shares:

1). when the Company is reorganised or where its general meeting decides to make a large transaction, if the shareholder votes against the reorganisation or large transaction resolution or if he/she does not participate in a vote on those issues;
2) where the Company's charter is amended or modified in such a manner as to restrict the shareholder's rights if the shareholder votes against the amendment or modification or if he does not vote on the issue.

The shareholder demands that the Company buy back his/her shares, and these shares must be bought back at a fair market price as determined by an independent auditor.

As has been noted above, a practical treatment of this group of cases by arbitration courts has yet to assume a definitive form. However, the higher tribunals have already made clear their general attitude toward this issue in Ruling No.4/8. Clause 15 of the Ruling sets forth that if a Company refuses or evades the buyback of shares as laid down by Articles 75 and 76 of the Law (that enumerate the cases where buyback is mandatory, procedures and deadlines), a shareholder may file a claim at court to seek a mandatory share buyback. A court considering such cases should keep in mind that the list of grounds under Article 75 of the Law that allow a shareholder to demand the buyback of his/her shares by the Company is exhaustive. The demand of a buyback of shares by the Company under article 75 of the Law

[18] Based on this general position, the Presidium of the Supreme Court of Arbitration also clarified that it is possible to challenge at court a resolution of a Company's Board of Directors (Observation Council) concerning property valuation (including valuation of shares) that is passed under Article 77 of the Company Law if such resolution is passed in breach of Law (item 12 of Information Letter No.33, dated April 21, 1998, "Review of Practice of Resolution of Disputes Relating to Transactions Involving Distribution and Circulation of Shares" - Vestnik (Gazette) of the Higher Court of Arbitration of the Russian Federation, 1998, No 6.

[19] For example, on September 4, 1995, the Court of Arbitration of Samara Oblast dismissed Samaraagrobank's claim seeking the invalidation of a number of resolutions of an AOOT Zavod Imeni A.A.Tarasova (Tarasov Works) general meeting - Vestnik (Gazette) of the Higher Court of Arbitration of the Russian Federation, 1997, No.2.

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may be made by a holder of ordinary shares and a holder of preference shares if pursuant to Article 32 (Clauses 3-5) and Article 49 (Clause 1) of the Law such holder is entitled to voting rights at a general meeting. A court decision that obligates a Company to buy back its shares shall indicate the number and type (category) of shares to be bought back[20].

4. Recovery in Favour of Company of Losses Caused by Guilty Actions of its Executives or by Another Company or Partnership That Exercises Control over the Former Company's Actions

Where a Company incurs losses caused by guilty actions of its executives or by another partnership or Company that controls the former Company's actions, it is of paramount importance to give the Company shareholders a right to representation in court because in such cases the persons who normally have this right under law are unlikely to undertake the steps necessary for ensuring the protection of Company interests, which interests in such cases are common with those of minority shareholders. Therefore the Company Law, relying on Article 53 of the Civil Code, says that holders between them of not less than 1 percent of ordinary shares may go to court to recover losses that have been caused to the Company by guilty actions of a member of the Board of Directors (Observation Council), a one-person executive body, a member of a collective executive body or a manager (managing organisation).

Similarly, a subsidiary's members may seek a recovery of losses caused to such subsidiary by its parent Company or partnership. Significantly, law does not require a subsidiary's shareholders to have any of the parent company's shares to be able to lay a claim to the parent company. This means that any of a subsidiary's shareholders may lay such a claim. It is of note however that it is quite difficult in practice to utilise the rule that makes a parent company liable for the losses it causes to its subsidiary. The problem is that, in departure from Article 105 of the Civil Code of Russian Federation, Article 6 of the Company Law says that a parent company is only liable if its actions demonstrate guilt in the form of direct design. As is known, proving design is always difficult – and proving design on part of a legal entity is next to impossible. So it is of utmost importance for courts to see eye to eye on approaches toward the resolution of this legal collision. [21] ***In our opinion, Article 105 of the Civil Code must have priority in this class of cases as this Article does not tie a parent company's liability to proved design in its actions. This construction follows from Clause 2 of Article 3 of the Civil Code of the Russian Federation, saying that civil law-related rules in other legislation must be in keeping with the Civil Code. And the rule of Article 6 of Company Law is apparently in conflict with Article 105 of the Civil Code.***

[20] Company Law lays down another situation in which shareholders may sell their shares. Under Article 80 of the Law, a person who buys on its own or with its affiliated persons 30 percent or more of a Company's distributed ordinary shares, shall offer to buy the Company's shares from the Company's other shareholders. To be sure, a Company charter or a resolution of a general meeting may waive such responsibility (and such major shareholder does not vote on this issue). Also, under this article and its mechanism for the protection of minor shareholders' interests, minor shareholders may not demand that their shares be bought. So if a major shareholder fails to offer to buy the other shareholders' packages, the only disadvantage for such major shareholder is that he/she may not use more than 30 percent of his voting shares of the Company when voting at a general meeting.

[21] Regulation No.4/8 does not give a direct reply to this question. Clause 12 of this document is vague on attitude of higher-level courts toward this collision. But as the Regulation, as well as the Civil Code of the Russian Federation, only mentions guilt as basis for a parent company's liability, saying nothing of design, the Supreme Court and the Higher Court of Arbitration presumably lean toward a broader construction of a basis for a parent's company's liability in keeping with that provided by the Civil Code.

Regrettably, it is yet unclear what position arbitration courts take on this class of causes (both regarding the recovery of losses caused to a company by a member of its Board of Directors or Observation Council or executive body and regarding the recovery of losses caused to a subsidiary).

5. Suits Seeking the Invalidation of Large Transaction

The Company Law's rule that prescribes a distinct procedure for the execution of what is known as "a large transaction" is novel in Russian law, and one of disputable value too, as it can jeopardise the stability of business in which companies constitute major players. Pursuant to Article 79 of the Company Law a Company may only execute a large transaction by a resolution of the Board of Directors (Observation Council) supporting such transaction unanimously if the value of property changing hands in such transaction is 25 to 50 percent of the book value of the Company's assets as of the date of passage of such resolution; or by a resolution of a general meeting if the value of property changing hands in such transaction is more than 50 percent of the book value of the Company's assets as of the date of passage of such resolution. If the Board of Directors (Observation Board) fails to take a unanimous resolution on a transaction in which the value of property that changes hands is 25 to 50 percent of the book value of the Company's assets, this question is delegated to the general meeting that is thus given authority to support or reject such transaction.

The definition of a large transaction in Article 78 of the Law is so vague and ambivalent from the conceptual viewpoint[22] that in actual fact a bona-fide creditor may never be absolutely confident that a specific transaction such bona-fide creditor is involved into is not a large transaction. But the thorniest problem is that the Law does not define the consequences of an infraction of the procedure for the execution of a large transaction, so courts have started automatically to treat large transactions executed in breach of established procedure as null under Article 168 of the Civil Code. Aware of the danger of this practice, the Supreme Court and the Higher Court of Arbitration attempted to tone down their position in Clause 14 of Ruling No.4/8. But in our opinion the attempt did not meet with unqualified success. Having recognised that a large transaction that is executed in breach of established procedure is invalid, they pointed out that the court may find that such transaction has legal force and creates for the Company appropriate rights and obligations if the court finds while hearing such dispute that the challenged transaction was consequently approved by the Board of Directors (Observation Council) or the general meeting. Regrettably, the higher tribunals have not specified the reasons for such construction. Presumably, they took guidance in the general rule in Article 168 of the Civil Code that governs null transactions, and also allowed a partial use by analogy of Article 183 of the Civil Code that says that a transaction executed by an unauthorised person may be subsequently approved. As a result, courts have created a distinct type of null transactions the defects of which may be remedied by a post-facto approval of such transactions. It is apparent however that civil law does not know such transactions. Therefore, in this Ruling the courts went beyond what constitutes court construction of law as such; what they in reality did amounted to an attempt to lay down a new legal rule. So it is quite doubtful that the application of such construction is reasonable. It is also noteworthy that in contrast to the Corporation Law, the Company Law expressly explains the consequences of large transactions provided they are executed in breach of established procedures. Pursuant to Article 46 of this Law such large transaction may be declared null by a claim of the Company or its member. This means that the Company Law introduced special grounds for voidability of transactions. We would venture to suggest that even before the Company Law is appropriately amended, the treatment of large transactions by courts of arbitration may follow the route charted by the Company Law even through such analogy is less than fully justified.

Today most disputes relating to large transactions that are being heard at courts of arbitration result from transactions made by joint-stock companies that were set up through privatisation. Such joint-

[22] The centerpiece of this definition is the following awkward formula: "a transaction or several related transactions involving a purchase or sale, or a possibility, directly or indirectly, of purchase or sale of property by a Company."

stock companies act on the basis of the Model Charter of Open Joint-Stock Company as approved by Decree No.721[23]; Clause 6 of this Decree says that a general meeting has exclusive power to take a decision concerning the pledge, lease, sale, exchange or other alienation of the Company's real estate or other assets; the composition of such real estate or other assets is laid down by constituent documents if the size of the transaction or the value of the property that changes hands is in excess of 10 percent of the Company's assets. While assessing the circumstances of such transactions, a court usually presumes that when making a transaction with a joint-stock company established in the process of privatisation, the contracting party should have knowledge of the requirements of the Model Charter and, therefore, is liable for any unfavourable consequences of an infraction of the proper procedure for making such transactions.[24]

Significantly, in some cases such approach appears overly formalistic because a company that is established through privatisation often does not appear to have any distinction from a joint-stock company that is established in a different manner. It is common knowledge that a "privatised" company's special status is in no way indicated in its business correspondence or its bankers' essentials. For example, just how could AOOT Sapozhok's contracting party know that AOOT Sapozhok had been a government enterprise? It does not appear proper to automatically impose on a contracting party the burden of finding out how the company [such contracting party plans to enter into an agreement with] was set up or what its specific status is. When such disputes are heard in court, it would be right to assess the claimant's evidence on a priority basis and in view of whether the contracting party was familiarised with the Company's charter or whether the contracting party was advised that the Company operated pursuant to a Model Charter, i.e., an examiner of circumstances of such disputes should not base his opinion on purely formal criteria.

6. Suits Seeking the Invalidation of a Transaction Involving a Conflict of Interest on Part of a Person (Persons) Who Influence the Company's Affairs.

The Company Law sets forth a special procedure for the execution of transactions involving conflict of interests on part of persons who influence the Company's corporate policy.

Pursuant to Article 81 of the Law, the following may be recognised as persons who take an interest in the execution of a transaction by the Company: a member of the Company's Board of Directors (Observation Council); an officer of another management body in the Company; a shareholder (shareholders) who owns (own) between itself and its affiliated person (persons) 20 percent or more Company voting shares provided the abovementioned persons, their spouses, parents, children, brothers, sisters and all their affiliated persons who:

are a party to such transaction or participate in it as a representative or intermediary;

own 20 percent or more voting shares (stakes, stock) of the corporation that is a party to the transaction or that participates in it as a representative or intermediary;

[23] Anthology of Acts of the President and Government of the Russian Federation, 1992, No.1, Article 3; No.21, Article 1731.

[24] See, for example, Ruling No.3326/96, dated March 4, 1997, of the Presidium of the Higher Court of Arbitration of the Russian Federation regarding the action Sberbank (Savings Bank) of the Russian Federation brought against AOOT Sapozhok (Vestnik (Gazette) of the Higher Court of Arbitration of the Russian Federation, 1997, No.6) and Ruling No.7470/95, dated February 13, 1996, of the Presidium of the Higher Court of Arbitration of the Russian Federation regarding the action AOOT Lukhovitsky Vodstroi brought against the Moscow Industrial Bank and the Tourist/Sports Club Paganel (Vestnik (Gazette) of the Higher Court of Arbitration of the Russian Federation, 1996, No. 4).

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are officers in the management body of a corporation that is a party to the transaction or that participates in it as a representative or intermediary.

A resolution that the Company will nevertheless execute a transaction even though such transaction involves a conflict of interest on part of one of the above persons is taken by the Company's Board of Directors (Observation Council) on condition that the interested directors do not vote on the resolution. But in two cases such resolution is voted on at the general meeting: 1) if the amount paid in the transaction and the value of property that is the subject of the transaction is higher than 2 percent of the Company's assets; 2) if the transaction and/or several related transactions constitute a distribution of the Company's voting shares or other securities convertible into voting shares, and the volume of such distribution is in excess of 2 percent of the Company's previously-distributed voting shares.

As we see, the wording of the conflict of interests rule of the Law is as vague and awkward as that of the large transaction rule, which certainly does not contribute to an efficient application of this law. But in contrast to the large transaction rule the conflict-of-interests rule sets forth the consequences of failure to comply with the established procedure for the execution of such transactions. Pursuant to Article 84, such transaction may be declared null, i.e., it is voidable. To be sure, the Law fails to specify who may file a claim, which is the rule for voidable transactions. So in most cases a claim is made by the Company itself when such Company finds itself involved in a questionable transaction, not its shareholders. It stands to reason that this is only the case when the person who is interested in a transaction is not the prospective claimant's one-person executive body.

Consequences for the Company's property that are likely to take place for the Company if a conflict-of-interests transaction is executed are the most important criterion that is used when it is decided whether a conflict-of-interests transaction should be executed. The same criterion of property consequences is applied by courts to qualify disputed relationships.[25]

[25] See, for example, Ruling No.757/96, dated July 2, 1996, of the Presidium of the Higher Court of Arbitration relative to the AOOT Systema case when it was found that chairman of the AOOT Systema Board of Directors had acted in the interests of another corporation when he sold AOOT Systema assets at prices that were deliberately understated (Vestnik (Gazette) of the Higher Court of Arbitration of the Russian Federation, 1996, No.10).
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