

## **SESSION IV: ENFORCEMENT OF MINORITY SHAREHOLDERS' RIGHTS**

Presentation on  
**OPPORTUNITY TO SEEK LEGAL REDRESS IN RUSSIA**  
by

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### **PROBLEMS RELATED TO PROTECTING THE RIGHTS OF SMALL SHAREHOLDERS<sup>1</sup>**

1. The issue of impending risk to the shareholder, including the risk of losing property, arises at the same time when the joint-stock company is set up (the stocks are placed) and continues to exist throughout the period of its operations. The risk stems from a variety of causes, such as the fact that the joint-stock company depends on exogenous financial, economic and political factors, mismanagement and abuse on the part of the Management of the joint-stock company, the possibility of a decline in the market value of stocks, etc.
2. Corporate conflicts between (a) joint-stock company and shareholders, (b) joint-stock company and its Management, (c) shareholders within the joint-stock company, (d) Management and shareholders, the latter being an intrinsic feature of all joint capital ventures and joint-stock property, are in the nature of the joint-stock company.
3. The objective of legislation and its applications is to ensure a balance between the interests of a joint-stock company and its shareholders.
4. How to guarantee the rights of all shareholders, not only the small ones, how to enable them to enjoy these rights, is not solely a Russian problem. These issues are also acute in the legal systems of other countries. Foreign specialists, in particular, English professors John Case and Aubrey Silberston, from the National Institute of Economics and Socio-economic Research, question in general the possibility for the shareholders to exercise their rights. According to them, in practice the only right the shareholders can actually exercise unhindered is to sell their stocks.
5. The existing opinion that the Russian legislation designed to protect the rights and interests of shareholders is imperfect, is not true. There is a system of legislation applied in the country, which regulates these issues.
6. In many ways the Russian regulations for protecting the rights of shareholders specifying the groundwork for these rights and ways of their protection coincide with the most advanced foreign legislative systems, such as that of Germany. At the same time, this does not mean that the legislation in this sphere does not require improvement and modernisation. The issue of improving the legislation is constantly in the focus of attention of the legislators, as well as other agencies responsible for regulating relations related to the protection of rights and interests of shareholders.
7. Within the past few years a considerable number of normative documents have been approved: the Law for the Protection of Rights and Legitimate Interests of Investors on the Securities Market of March 5, 1999.

<sup>1</sup> 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 revisions.

Decree of the President of the Russian Federation of August 9, 1999 On Adjustments and Amendments to the Decree of the President of the Russian Federation of August 18, 1996 On Measures for the Protection of Rights of Shareholders and Ways of Protecting the Interests of the State as Owner and Shareholder; Resolution of the Federal Securities Commission On the Approval of Regulations for the Proceedings Regarding the Charging of Fines for Breach of Legislation on the Protection of Rights and Legitimate Interests of Investors on the Securities Market, et al.

8. The process of improving legislation will naturally continue. The participants of the market themselves can and should intensify this process and raise its efficiency. It is necessary to "bang on the doors" of the corresponding agencies all the time. The forms of addressing these agencies may be different, from direct appeals to releases in the media on the problems facing shareholders.
9. Some corporate lawyers, especially those working for non-resident companies, try to put down their mistakes and misguided actions to imperfections in the Russian legislation and the biased attitude of courts.
10. Many of the problems could be avoided if the lawyers properly studied statutes and other local normative acts of joint-stock companies, their financial statements and balance sheets prior to the purchase of stocks.
11. There are enough fallacies on the part of the shareholders themselves in monitoring the management of joint-stock companies. The interest in monitoring should be manifest all the time, and not only immediately before the general shareholders' meeting, or ex-post, after the infringement of the shareholders' rights and interests has been identified.
12. Endogenous corporate ways and means of protecting the rights and interests of shareholders within the joint-stock company in practice are not used sufficiently adeptly and in a timely fashion. Here we are talking of mechanisms created by the shareholders themselves to protect their interests and ensure monitoring by shareholders. The legal support for this is sufficiently broad. These measures can include all kinds of checks and balances in statutes and other local normative acts, as well as in contracts signed with the managers. They can also include legitimate incentives for managers and staff and the involvement of professional participants on the securities market in corporate management and control.
13. Another means of protecting shareholders' rights is the administrative method, i.e. protection of the rights and interests of shareholders through executive government agencies. A special focus here should be on the Federal Securities Commission. This agency has vast powers. Within its purview is monitoring of compliance of the issuers with the legislation regulating the securities market.
14. The Federal Commission has the right to issue binding compliance orders to issuers, provide documents to law-enforcement ministries and take cases to court. Thus, the shareholder whose rights have been infringed can bring a complaint to the Federal Commission which, upon professional assessment of the claim, has the right and is obliged to take appropriate measures.
15. Protection through courts occupies a special place among other ways of protection of shareholders' interests. In practical terms, protection through courts is probably the most effective. However, court proceedings should be as a rule seen as an extreme measure, an exceptional form of protection. There are a variety of reasons for this. Let us mention only two:

- first, court proceedings are expensive both for the government and its budget, and for the parties to the trial (stamp duty, costs of hiring lawyers and other expenses);
- second, the court proceedings cannot be conducted "in a rush," it is not in their nature to be completed in an expeditious manner. Court proceedings are encumbered by various requirements of procedure and other constraints. Without compliance with the rules of procedure no justice is possible.

16. Various laws, including the Law on Joint-stock Companies, contain provisions granting to shareholders the right to appeal for the protection of their rights. The latter law in particular stipulates the right of the shareholder to appeal to court if the registry refuses to include into the register a shareholder, a resolution of the general shareholders' meeting, resolution of the Board of Directors to refrain from holding a regular shareholders' meeting, resolution to include certain issues in the agenda of the shareholders' meeting, etc.

17. It is such cases that prevail in courts among cases related to the protection of shareholders' rights. Paragraphs 4, 8-11 of the Joint Resolution of Supreme Court of the Russian Federation and Supreme Arbitration Court of the Russian Federation of April 2, 1997 On Certain Issues Relating to the Application of the Federal Law on Joint-stock Companies are devoted to proceedings on such cases.

18. However, protection of shareholders' rights through courts is not restricted to cases directly specified in laws. Supreme Court of the Russian Federation and Supreme Arbitration Court of the Russian Federation in their joint resolution of July 1, 1996 On Certain Issues Related to the Application of Part 1 of the Civil Code of the Russian Federation provided an explanation to the effect that complaints with the aim of voiding normative acts issued by the Management of legal entities, including decisions of the general shareholders' meeting, Management or other entities within the joint-stock company, can be made in any case, if the above decision infringes the rights and legitimate interests of shareholders.

19. This explanation in principle is based on Article 16 of the Constitution of the Russian Federation, whereby everyone, including shareholders, is guaranteed that their rights and freedoms will be protected.

20. A considerable portion of court proceedings are held on disputes over the protection of rights and interests of shareholders at the time when the authorised capital of a joint-stock company changes, when the joint-stock company purchases its own stocks either for itself or on behalf of the shareholders.

21. Among the means of protecting the rights and interests of shareholders there are provisions of the Law on Joint-stock Companies relating to large-volume transactions and transactions between "interested" parties. Whereas the category of "large-volume transactions" has received a certain definition and is understood in judiciary practices (although here, too, there are certain difficulties, in particular, in the definition of a "transaction effected in the process of regular economic activity"), the application of provisions related to transactions between interested parties causes certain problems in dealing with joint-stock companies.

22. The legislation does not provide a felicitous definition of transactions between interested parties. The definition is complicated and difficult to apply. Here considerable amendments to the legislation are in order.

23. Transactions between interested parties are defined by the Law on Joint-stock Companies as voidable, i.e. it is a transaction which may be declared null and void on grounds stipulated by the law, if it is so adjudicated by the court. However, the above Law does not specify who can be the claimant in such cases. Can shareholders take the case to court? So far the court practice is based on the premise that the joint-stock companies themselves have to be claimants in this category of cases. It appears that amendments are

necessary here as well. It should be stipulated in the legislation that apart from the joint-stock companies the shareholders also can figure as claimants in such cases, provided they jointly own a certain percentage of placed stocks of the joint-stock company.

24. The most important criterion in passing a judgement on transactions between interested parties is the assessment of implications of this transaction in terms of the property of the joint-stock company. This is pointed out in one of the Resolutions of the Presidium of Supreme Arbitration Court on a case, where it was found that the Chairman of the Board of Directors of one of the joint-stock companies acted in the interests of another company, disposing of the property at a clearly understated price.

25. Shareholders are entitled to protect their rights and legitimate interests indirectly, through the protection of the rights and interests of the joint-stock company. The Law on Joint-stock Companies (Article 71) envisages the possibility of lodging indirect (derivative) claims of shareholders against members of the Board of Directors and persons performing the functions of executive bodies within the joint-stock companies (senior executives). They are accountable to the company for the losses caused by their criminal actions (inaction), unless other grounds and the size of liability are specified in special laws.

26. A claim for damages may be brought against the above persons either by the joint-stock company itself or in the interests of the company by a shareholder (shareholders), provided he owns in aggregate no less than 1 percent of placed stocks.

27. The court practice in dealing with disputes where the above Article is applied has not been established so far. This is due to:

- (a) problems in the substantive law. The legislation does not contain a specific list of grounds (facts) on the basis of which the responsibility could be imposed on an executive. In each case, given the regular operations of the company in terms of transactions and other (specific) circumstances, it is necessary to draw a line between the admissible and excessive entrepreneurial risk, which caused the losses for the company. In addition, the behaviour of the persons, who are held responsible for the losses is to be criminal;
- (b) problems in the law of procedure. The claimant must prove in court, using legally admissible means, the fact of criminal illegal behaviour on the part of the executive, the fact that the company incurred losses and the connection between the criminal behaviour and the consequences. To provide convincing proof in such cases is extremely difficult;
- (c) the limited number of such cases, primarily for the reasons specified in (a) and (b).

28. At the same time, the court practices do provide an answer to some of the questions arising during the proceedings on indirect claims. Thus the court practice gives a negative answer to the question whether the shareholder has the right to bring an indirect claim based on facts which took place before he became a shareholder in the given joint-stock company.

29. It appears that the legislation has to be amended so as to make indirect claims a real and effective instrument used to protect the rights of joint-stock companies and shareholders. In particular, the legislation should contain a non-exhaustive list of specific actions taken by executives which serve as grounds to bring a suit for damages.

30. For instance in the FRG, Board members have to pay the damages in case there is a violation of the law committed in the following actions: return of the equity to the shareholders, payment of interest on a loan or a share of profits; underwriting, acceptance as collateral, or withdrawal of own stocks of the joint-stock company or stocks of another company; issuance of stocks before full payment of nominal or higher value; distribution of the property of the joint-stock company; payments resulting in the insolvency of the joint-stock company; payment of bonuses to members of the Supervisory Board; issuance of new shares within the period of the increase of authorised capital over and above the new targeted capital, or before the capital is paid in full.

31. Besides the amendments and adjustments to the existing means of protecting shareholders' rights, new means should be provided for in the legislation. Specifically, the controlling function of inspectors (auditors) should be enhanced. The auditors have to be independent from the executive bodies. The auditors should be obligated to report violations committed by executives not only to shareholders, but also to Government supervisory agencies. Legislation should also envisage the liability of auditors for mistakes made in the course of exercising their duties.