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## *SHAREHOLDER RIGHTS, EQUITABLE TREATMENT AND THE ROLE OF THE STATE*

*Outline for the Case Study on Share Dilution*

By

**Dr. Irina Paliashvili,  
President of the Russian-Ukrainian Legal Group, P.A.  
Washington, Kiev, Moscow**

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### 1. Case Description

The case described below is a hypothetical one, which, however, is based on several share dilution cases that our firm has handled for various clients in the course of the last several years. For convenience, the international client whose shares were diluted will be referred to as “**the Client**”, the Ukrainian company in which the Client owned the shares in question will be referred to as “**the Company**”, the Offshore intermediary that sold these shares to the Client will be referred to as “**the Offshore Intermediary**” and the two outside Registrars that consecutively held the Company Shareholders Registry will be referred to, in chronological order, as “**Registrar 1**” and “**Registrar 2**”.

A few years back, the Client bought from the Offshore Intermediary 25% shares (we will use the percentage of the Authorized Fund rather than the actual number of shares for convenience) of the Company in two installments: a 15% Installment and a 10% Installment. The shares were issued in a non-documentary form. The Client carried out all necessary paperwork and formalization procedures and separately registered each Installment in the Company Shareholders Registry, which at that time was held by Registrar 1.

The Client missed the first General Shareholders Meeting (“GSM”) it was entitled to participate in, but came to the next one. At this GSM the Client found out that the number of its shares recorded in the GSM documents was not 25%, but 15%. The Company management and Registrar 1 assured the Client that it was a purely technical mistake, which would be corrected next time. The Client believed them and did not undertake any formal measures.

When the Client came for the next GSM, the number of its shares recorded in the GSM documents was not even 15%, but 5%. The Company management again was extremely apologetic and assured the Client that it was a purely technical mistake, which would be corrected next time. The Client again did not undertake any immediate formal measures because it had a good relationship with the management (which, the Client believed, did a very good job in developing the Company) and did not want to ruin this relationship.

It should be also noted that the Client had not received any dividends from the Company profits since it purchased Company shares, which the Client believed was normal since the Company was growing and claimed that all its profits were reinvested in the Company.

However, sometime after the second GSM, the Client grew suspicious and contacted us. The Client still believed that nothing wrong really happened, but just wanted to double-check the status of its shares. By the time we got involved, Registrar 1 had been liquidated (meaning that there was no legal successor) and the Company had hired a new Registrar 2. It should be noted that, although there was no legal connection between Registrar 1 and Registrar 2, apparently Registrar 2 was owned and managed directly or indirectly by the same individuals as Registrar 1. It also had the same employees.

The first thing we did was to request from Registrar 2 the excerpts from the Client's individual account in the Company Shareholders Registry to see what the current status of the Client's shares was. After many delays and appeals to the Registrar and the Company Management, we received a response and documents certifying that the Client owned only 5%. Registrar 2 alleged that:

- In the first 15% Installment the Client actually bought 5% and not 15%. To this end, Registrar 2 provided what seemed to be an original of the transfer order, signed by the Client's representative that indicated only 5%. This "original" later was certified by the Ukrainian Forensic Institute as a fake document, with both the Client representative's signature and its corporate seal having been forged. The Client, on the other hand, had in its possession a real original of the same document indicating 15%.
- As to the second 10% Installment, Registrar 2 alleged that the Client actually sold all of its 10% back to the Offshore Intermediary. To this end, Registrar 2 provided a copy of the share-purchase contract, which had been signed on behalf of the Client by an individual who was totally unknown to the Client and for this obvious reason had never been authorized by the Client to perform any activities with the Client's shares. There were a number of other features in the contract indicating that it had been forged. The same individual who signed the Contract later recorded this Contract with Registrar 1, on the basis of which the respective entries were made in the Company Shareholders Registry. It should be noted that these documents were accepted by Registrar 1 despite the fact that they were submitted by an unauthorized individual, while the authorized representative was on the record with Registrar 1.

When we requested a number of other documents from Registrar 2, we received a letter stating that all other documents had probably been lost by Registrar 1 and that Registrar 2 had no responsibility whatsoever in this case since it was not a legal successor to Registrar 1.

At the same time, the Client learned that the Authorized Capital of the Company had been increased, which further diluted the Client's shares from 5% to 2%, and that sometime later a consolidated majority packet of the Company's shares (owned by various shareholders) had been offered for sale to a single buyer.

In resolving this case, we used a combination of remedies, described in section 2 (Available Remedies) below, and eventually, after two years of successful litigation in and outside Ukraine, and other legal and political remedies, this case was settled to the Client's full satisfaction. The practical lessons from this case are described in section 3 below.

## **2. Available Remedies**

Our experience shows that there is usually no single remedy, no magic wand, for resolving a share-dilution case. In virtually every case that we either worked on or heard about, a combination of remedies was used by shareholders whose shares had been diluted in one way or another. Even such a serious remedy as successful litigation, in most cases, was only a strong argument in the hands of the injured party, but not the final solution.

Obviously, which remedies are chosen and how they are combined depends on the particular circumstances of each case, and there are numerous considerations in choosing the right strategy.

Generally the following legal remedies are available to the injured party:

- Litigation in local Ukrainian courts;
- Litigation in courts outside Ukraine;
- Filing complaints with the Securities Commission;
- Filing complaints with the Antimonopoly Committee (to prevent it from granting antimonopoly clearance for further acquisition of the diluted shares);
- Initiating criminal investigation.

A couple of measures that may be a good supplement to legal remedies are independent forensic testing of documents and private investigation.

Of all of the above legal remedies, only courts (litigation) have the actual authority to restore violated rights. All other government agencies have authority to stop the violation, impose penalties, etc.

With regards to the first two legal remedies, it should be noted that we specifically refer to litigation in courts (in or outside Ukraine) and not to international arbitration, since, in most cases, a violation of shareholders' rights does not stem from any particular international contract (which often provide for dispute resolution through international arbitration) and is not a contractual dispute. It should be also noted that litigation outside Ukraine is only recommended either if the country of litigation has a treaty with Ukraine providing for the mutual recognition and enforcement of court decisions, or if the defendant has assets in the country of litigation.

Finally, speaking about all above legal remedies, and litigation in particular, it should be noted that obtaining a favorable court (Securities Commission, AMC) decision does mean winning the battle, but often is very far from winning the war. The major problem still remains, which is that of enforcement. There are many examples of an injured party, favorable court decision in hand, spending tremendous time and resources trying to enforce the decision, to no avail.

In addition to legal remedies, there are a number of other measures (loosely referred to as "political remedies") that an injured party may resort to. They are not so well defined as legal remedies, but mostly amount to preventing the parties involved in dilution from enjoying the benefits of their activities. For example, in most cases such parties do not intend to acquire the

diluted shares themselves, to resell them. In this case, it may be possible to inform potential buyers that the shares offered for sale are the subject of a legal conflict (litigation, etc.). Another example is that some Ukrainian companies are planning IPOs at various stock exchanges around the world, or ADRs, which would be good opportunity for the injured party to report its case. It is also possible to appeal to various shareholder rights- protection organizations. (Unfortunately these are still rudimentary in Ukraine, whereas in Russia such organizations are well developed, quite vocal and often successful in protecting shareholders rights.) Finally, we know of many situations in which an injured party has appealed to its government or embassy, and the interference on the part of the foreign government was quite effective.

### **3. Practical Lessons**

#### **Red Flags**

Based on the above case study and other relevant experience, shareholders should watch out for the following red flags:

- The relationship between the company management and the Registrar is too close.
- All kinds of “technical mistakes” appear in various documents, especially the GSM documents.
- Dividends are not paid at all, or the amount of dividends paid does not correspond to the number of shares owned.
- The Company management or the Registrar fails to provide requested documents in a timely manner.
- The corporate procedures (especially as to calling, conducting, and voting at a GSM) are not properly observed.
- Shareholder representatives are denied access to corporate documents or to the GSM on all kinds of bogus grounds (“we lost your POA”, the site of the GSM is changed at the last minute without prior notification, shareholder representatives are told that the GSM was cancelled or postponed when it actually took place, etc.)

#### **Prevention**

It is absolutely clear to us that, in quite a few cases, a more careful due diligence, a consistent follow-up, a more transparent and legally sound transaction, and earlier detection of the problem would help to avoid costly and time-consuming legal conflict. In most cases, any shareholder rights violations require an immediate reaction, because during the time wasted by the shareholder (in believing bogus explanations, relying on good trust between him and the company management, not wanting to act unless something more serious happens, etc.), his shares are being sold and re-sold many times and it will thus become more and more difficult to restore the violated rights. Some of the prevention tactics are self-evident from the above “red flags”; others are supplemental, but in general we advise that the following measures always be taken by shareholders:

- Properly follow all procedures and formalities, since even a small omission could result in considerable damage in the future
- Keep all your documents in perfect order – for example, all POAs must be up to date, properly notarized, legalized, translated, etc.
- Safely keep all original documents in one place and notarized copies of all original documents in another place.
- Carefully read all correspondence from the Company and the Registrar, and always mail your official correspondence by certified mail, return receipt requested (and keep the receipts).
- Immediately file formal complaints regarding any violations of your shareholder rights and corporate procedures (especially GSM procedures such as registration, quorum, voting, etc.).
- Closely monitor the company's activities, including in the press (we know of cases in which a shareholder found about the dilution of its shares from the press).
- If entitled to participate in the governing bodies of the company (Supervisory Council), take this participation very seriously – always send an authorized representative, and follow up on the activities of the governing body between its sessions.