CORPORATE COUNSEL ASSOCIATION

THE PRACTICE OF USING SHAREHOLDERS' AGREEMENTS AND THE ISSUES RELATED TO THE RESPONSIBILITY OF THE GOVERNING BODIES, SHAREHOLDERS AND PARTICIPANTS IN JOINT STOCK COMPANIES AND LIMITED LIABILITY COMPANIES

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LEGAL FEATURES OF CORPORATE AGREEMENTS

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I would like to pick up where my colleague, Y.E. Monastyrsky, left off and to dwell, briefly, on a number of practical issues to be encountered by the parties to a shareholders' agreement and share my thoughts on the additional remedies needed to improve security for those parties and to ensure the agreement's performance.

1. Possibility for an agreement governed by foreign law substituting for that subject to Russian law

In spite of some vigorous recent lobbying in favor of shareholder agreements and the inclusion of certain supportive clauses in both the LLC Law and the JSC Law, shareholders still all too often seek to prevent their agreements from being regulated by applicable Russian legislation by having recourse to the following routine stratagems:

a) the launch of a holding venture with the execution of a shareholders' agreement under foreign law for a company relocated to a foreign jurisdiction; or

b) the direct submission of an agreement made by shareholders in a Russian company to foreign law where any such holding venture is impossible.

The desire to make this kind of escape is perfectly understandable, considering that the foreign laws governing such agreements are both elaborate and predictable and that related judicial enforcement practices show welcome consistency. So is there really a place for a shareholders' agreement subordinate to Russian law? The question should be answered in the affirmative, as the standard schemes relying upon foreign legislation may actually prove unacceptable or unduly burdensome in too many a case.

The first of the above devices is too taxing for those Russian corporations which have the status of strategic entities within the meaning of the Federal Law "On Procedures for Foreign Investments in Business Companies of Strategic Significance to the Nation's Defenses and Security", because any transactions towards giving control over such corporations to foreign ventures have to be approved by a state watchdog. Since the range of operations listed in Article 6 of the Federal Law "On Procedures for Foreign Investments" as those which may entail the status of a strategic entity for a company engaging in any such activities is really wide, the holding-venture solution is too troublesome and hence practically unacceptable for many Russian companies.

As far as the second solution is concerned, our invariable advice to clients is to avoid trying it in the light of existing court attitudes (as manifest, for example, in the Megafon and Russian insurance Standard litigation cases both of which have been handled by us) and the position expressed by the President of the Supreme Arbitrazh Court of the Russian Federation, A. Ivanov, in an interview with the Zakon [Law] journal (Issue No. 12 for December 2008) that subordinating shareholders' agreements at Russian companies to any [laws other than those of Russia] contradicts its public policy and is inadmissible.

The relevant judicial precedents and legislative changes suggest that the shareholders will increasingly resort to subordinating their agreements made in accordance with Article 32.1 [of the JSC Law] to Russian legislation.

So what should they keep in mind in the process?

2. Need for prior consent to a shareholders' agreement at a Russian company

The execution of a shareholders' agreement for a Russian company involves the need to observe a number of formalities failure to follow which may expose that instrument to challenges.

2.1. No-objection required from FAS

If putting any of the shareholders in a position to able to actually determine conditions for the company's pursuit of its business, the shareholders' agreement may require a prior no-objection from the Russian Federal Antimonopoly Service by virtue of Articles 28-30 of the Federal Law "On Protection for Competition".

2.2. Approval needed from a state watchdog

A shareholders' agreement is also fully subject to the rules set forth in the Federal Law "On Procedures for Foreign Investments in Business Companies of Strategic Significance to the Nation's Defenses and Security".

If the respective company is strategic within the meaning of that statute, while one of the parties to the agreement is a foreign investor, the arrangements ordinarily made in this kind of agreement may potentially lead to the foreign investor's control over the company and so will call for prior consent from a state watchdog, the special Government Commission, to the execution of the agreement in accordance with Article 7 of the above law. Failure to comply will make the agreement null and void.

3. Possibility for Chapter XI.1 of the JSC Law (including, but not limited to, the requirement of a mandatory share buy-out offer being made) to apply to shareholders' agreements

When it comes to the obligations to be assumed by the parties to a shareholders' agreement with respect to third persons, Article 32.1 [of the JSC Law] only requires them to formally notify the company of the right to dispose of more than 5%, 10%, 15%, 20%, 25%, 30%, 50%, or 75% of the votes carried by its outstanding common shares upon the agreement's execution.

Even though Article 32.1 does not mention any other consequences to follow from the conclusion of the shareholders' agreement, it is imperative to remember that its parties may be subject to the rules of Chapter XI.1 of the JSC Law on mandatory share buy-out offers.

The applicability of such rules is possible because the shareholders' agreement entitles one shareholder to issue binding voting instructions to another shareholder and this is going to turn their relationship into a group of parties within the meaning of Article 9 of the Federal Law "On Protection for Competition" and thus the shareholders themselves into affiliated persons in line with Article 4 of the Federal Law "On Competition and on the Limitation of Monopolistic Operations".

Their affiliation will cause the shareholders' stockholdings to be taken into account together for the purposes of Article 84.2 of the JSC Law, i.e. may result in a duty to make a mandatory share buy-out offer to the company, and a default on that obligation will make the affiliates' combined parcel of shares (if exceeding 30%) unavailable for voting purposes.

Meanwhile, it is unclear which of the shareholders will be under the duty to forward the mandatory offer where several parties to the shareholder agreement have the right to issue binding instructions to the company.

In the absence of relevant judicial practices, it is an open guess right now how the provisions of Article 32.1 of the JSC Law in conjunction with Article 84.2 of the statute will be invoked, but one can rest assured that it is highly likely that the mandatory share buy-out offer rules will apply to the parties to the shareholders' agreement.

One should not forget also that the duty to submit that mandatory offer may come into conflict with certain terms and conditions which are ordinarily recorded in the shareholders' agreement, including, among others, the following:

1) a provision making it impossible to acquire any further shares; and

2) a clause on the share purchase and share sale prices predetermined in the agreement (which will run counter to the procedures for fixing prices during the submission of a mandatory share buy-out offer).

This is why it is advisable when entering into a shareholders' agreement to cause it to record procedures for shareholder networking in the event there arises the obligation to make such mandatory offer, which will take effect under that allocation of shareholder rights and shareholder obligations which the parties to the agreement want to implement.

4. Approval for related party transactions

Since the execution of a shareholders' agreement in a number of cases will give rise to affiliations and entitle certain persons to issue binding instructions, the recognition of any party to the agreement as a related party with a vested interest in a transaction will result in the other parties to the agreement also being seen as related parties with a vested interest – and deprive them of voting rights on the transaction's approval. [One way to deal with the problem is to include a reservation to the effect that no shareholder has the right to issue voting instructions during the approval of related party transactions.]

5. Additional remedies to protect parties to shareholders' agreements and make for their performance

The attractiveness of shareholders' agreements subordinate to Russian law will be constituted in many ways by the ability of such instruments to ensure the parties' compliance with their terms and conditions and a ban on any shareholders' withdrawal from the agreements through any unauthorized share sales (including, but not limited to, such sales contrary to the agreements). As long as a system of penalties for breaches of shareholders' agreements has still to be developed and it remains unclear how the courts will award related statutory compensation, we believe that the parties may rely upon certain additional remedies that would be available at the performance stage (such as irrevocable powers of attorney under the laws of England).

In this connection, we suggest the following practical solution that the parties could employ when making a shareholders' agreement.

They are to pledge their shares to an authoritative third person which will control compliance with the material terms and conditions of the agreement. The respective pledge contract may secure the performance of obligations under the shareholders' agreement such as the undertakings to vote in a certain manner and to refrain from share transfers.

The pledgee could:

a) see to it that any share sales by the parties proceed in full conformity with the agreement; and

b) exercise rights carried by shares on the terms and conditions of the shareholders' agreement. In line with existing court practices, it will be enough for the pledgee's exercise of voting rights at meetings for that power to be recorded in the pledge contract and for the vote transfer to be documented in the respective pledge instructions – without any need for a power of attorney.

Relations with the pledgee can potentially be built on an array of relevant instructions from shareholders, as provided for in the contract. The pledgee holding a shareholding will thus be able to exercise the rights carried by such shares in accordance with the parties' earlier understandings and to prevent any bad-faith performance by the parties to the shareholders' agreement. Considering that commercially, a party to that agreement will occasionally find it more advantageous to breach its terms and conditions despite the threat of resulting compensation (especially as the recovery may never materialize), the appearance of a person interested in the shareholders' agreement being observed and implemented in practice could appreciably lower the risk of any mala-fide conduct by the parties and make shareholders' agreements more attractive.

Because there is no way a person other than a shareholder can be made a party to a shareholders' agreement, we propose that the pledgee should be anyone with even a minimalist parcel of company shares. Considering that the person concerned will obtain a wide choice of rights, it is appropriate for the pledgee to be a commercial entity with a fine reputation on the market.

This arrangement upon being translated into reality on the Russian market may help forge a stable security system to guarantee the shareholders' agreements made, which would enable their parties – through recourse to authoritative third persons – to avoid the principal risks of contractual defaults to the extent connected with voting and the ban on share transfers.