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RECENT DEVELOPMENTS IN RUSSIAN CORPORATE LEGISLATION: WILL NEW NORMS SECURE THE FUTURE FOR SHAREHOLDERS AGREEMENTS?

Evgeniya Berezkina

In summer 2009, Russian legislative authorities amended the federal legislation in order to recognize the validity of agreements among shareholders of Russian joint-stock companies (the Amendments).[1] The Amendments address one of the most controversial issues of Russian corporate practice—the regulation of shareholders agreements in corporations registered in the Russian Federation. Amended legislation is designed to resolve a long-term uncertainty regarding the validity of shareholders agreements and to create a more attractive platform for foreign investment in Russia.[2] The Amendments recognize shareholders agreements as a special contractual type and list general issues which may be addressed in such agreements, basic legal restrictions, and disclosure requirements.

This Article outlines the most important provisions of the Amendments and analyzes the possibility of their successful use in practice. The Article refers to the background of the problem and relevant peculiarities of Russian corporate practice which may affect the application of the Amendments. Until recently, a conservative and formalistic judicial approach to the problem restricted the possibility of contracting around the issues of corporate governance and shareholder relations.[3] The Amendments are aimed to mitigate negative effects of the rigid regulatory regime and underdeveloped practice. However, the effectiveness of the Amendments may be significantly lower than is expected.

Current corporate practice demonstrates unwillingness of equity holders to take the risk of using untested mechanisms offered by the Amendments. Most shareholders agreements are still signed at the off-shore level and subject to non-Russian legislation. Therefore, the question, whether the current regulation of shareholders agreements in Russia is effective and sufficient, appears to be open.

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[1] Sobranie Zakonodatel'stva Rossiiskoi Federatsii [SZ RF] [Russian Federation Collection of Legislation] 2009, No. 23, Item 2770.

[2] Koncepcia Razvitia Zakonodatelstva o Yuridicheskih Licah [Concept of Improvement of Legislation Regarding Legal Entities] March 2009.

[3] Postanovlenie FAS Zapadno-Sibirskogo Okruga [Decision of the Federal Arbitration Court of the Western-Siberian District] March 31, 2006, No. Ф04-2109/2005(14105-A75-11), Ф04-2109/2005(15210-A75-11), Ф04-2109/2005(15015-A75-11), Ф04-2109/2005(14744-A75-11), Ф04-2109/2005(14785-A75-11), case no. A75-3725-Г/04-860/2005 ("Megafon case").

I. BACKGROUND TO SHAREHOLDERS AGREEMENTS IN RUSSIA

Agreements among shareholders are widely used in developed countries as an effective mechanism of regulating relations within a corporation. Until recently, this mechanism was not directly recognized in legislation and was denied by judicial practice. Such an approach was rooted in peculiarities of the Russian corporate practice, which is relatively young and underdeveloped in many aspects. Among its distinctive features, the following can be the mentioned: mainly non-discretionary federal regulation of corporate issues, a significant amount of mandatory provisions, and uncertainty of the judicial practice with respect to issues that are not directly specified in laws and regulations.

These features meant that, until recently, shareholders agreements were under an informal ban imposed by Russian judicial practice. Contractual restrictions on transferring shares, "tag-along" and "drag-along" mechanisms, contractual regulation of voting procedures and board formation, and call options and put options were all considered illegal.[4] Institutional investors traditionally used off-shore legal entities and signed agreements under the foreign law with more flexible corporate legislation. However, this way was not free from concerns, as Russian courts might invalidate such contractual relations as violating the fundamental provisions of Russian law and public order.[5] The Amendments finally recognize shareholders agreements and provide investors with a new tool for structuring their relations with respect to the investment activity in Russia.

II. OVERVIEW OF THE AMENDMENTS

After a few years of negotiations and debates, the Russian legislature altered the federal laws "On Joint-Stock Companies"[6] and "On Securities Market."[7] The Amendments, effective from July 18, 2009, are a part of the general policy of liberalizing the Russian corporate sphere. Last year, the federal law "On Limited Liability Companies"[8] was essentially revised, allowing agreements among the participants of a limited liability company.[9]

Article 31.1 of the Amendments officially recognized a shareholders agreement as a special contractual type: an agreement on the execution of the rights vested in shares, or on peculiarities of the execution of such rights. Following are the basic elements of shareholders agreements.

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[4] Russian legislation does not contain a direct ban on agreements among shareholders. Contractual obligations among shareholders are possible under the general principle of contractual freedom. However, until recently none of the basic acts in the corporate law sphere provided any regulation on shareholders agreements.

[5] In the famous "Megafon case," the Federal Arbitration Court of the Western-Siberian District invalidated the shareholders agreement under Swedish law as a violation of the public policy of the Russian Federation. Megafon case, *supra* note 3.

[6] Federalni Zakon ob Akcionernih Obshestvah [Federal Law On Joint-Stock Companies], Ros. Gaz., Dec. 29, 1995, No. 248.

[7] Sobranie Zakonodatel'stva Rossiiskoi Federatsii [SZ RF] [Russian Federation Collection of Legislation] April 22, 1996, No. 17, Item 1918.

[8] Sobranie Zakonodatel'stva Rossiiskoi Federatsii [SZ RF] [Russian Federation Collection of Legislation] Feb. 16. 1998, No. 7, Item 785.

[9] Federalni Zakon O Vnesenii Izmenii v Chast Pervuyu Grazdanskogo Kodeksa Rossiiskoi Federatsii i Otdel'nie Zakonodatel'nie Akti Rossiiskoi Federatsii [Federal Law On Amendments to the Civil Code of the Russian Federation and Certain Legislative Acts of the Russian Federation], Ros. Gaz., Dec. 31, 2008, No. 267.

Parties of an agreement. Current shareholders of a joint-stock company. The company itself can not be a party to a shareholders agreement.

Form of an agreement. Unlike some common law countries, Russian legislation requires a written form of a shareholders agreement.

Issues within the scope of an agreement:

- Regulation of voting rights and procedures (obligations to vote in a certain way, to exercise coordinated voting, etc.);
- rights to acquire or dispose of shares on predetermined conditions;
- temporary restrictions on selling shares upon the occurrence of certain circumstances;
- other contractual rights and obligations with respect to corporate governance, the company's activity, reorganization, and liquidation of the company.

The list of possible issues within the scope of an agreement is open and depends on the discretion of the parties involved and peculiarities of a corporation.

One of the most controversial issues facing the drafters of the Amendments was an alternative between disclosure and confidentiality of shareholders agreements. As a general rule, corporate and securities laws require disclosure of the material information that can influence the activity of a publicly traded company. At the same time, parties entering an agreement are interested in confidentiality of their relations. The recent Amendments seem to represent a compromise between the two opposing tendencies. General provisions of a shareholders agreement may be confidential. However, disclosure is required if a party to an agreement obtains control over more than 5, 10, 15, 20, 25, 30, 50, or 75 percent of voting rights of a publicly traded company. Russian regulatory authority should be notified about such acquisition in due form and order.[10]

III. ENFORCEMENT AND LIABILITY FOR BREACHES OF SHAREHOLDERS AGREEMENTS

Shareholders agreements are covered by general civil law norms regarding the liability for breaches of contractual obligations. Additionally, an agreement may provide for specific enforcement proceedings and forms of liability.[11]

Difficulties in enforcement of shareholders agreements may significantly blunt the positive effect of the Amendments. Agreements among shareholders may indirectly affect the interests of third parties (joint-stock companies, shareholders not participating in the agreement, creditors, etc.). The Amendments protect non-participating persons in the situations when enforcement of an agreement can infringe upon their interests. A contract entered into in violation of a shareholders agreement can be invalidated only if the other party knew or should have known about the

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[10] Amendments, *supra* note 1, art.32 (5)–(6).
[11] *Id.*, art. 32.1(7).

limitations imposed by the shareholders agreement.[12] Designed to protect third parties, this rule limits defense mechanisms available to the non-breaching participant in an agreement.

Shareholders agreements may regulate business policy issues or fix the unique system of corporate governance and control in a corporation. In such situations, specific performance of an obligation is much more essential than the sum of damages payable to a non-breaching party. The Amendments are ambiguous about the possibility of forcing a party in a shareholders agreement to fulfill its obligations in a judicial proceeding. Additionally, the results of a shareholders meeting cannot be invalidated even if a decision is made in breach of contractual obligations (for example, if a shareholder violates an existing voting agreement).[13]

Monetary forms of liability for contractual delinquency may not always be an effective and sufficient remedy. The Russian legal system does not recognize punitive damages or lost opportunity payments. Even if substantial penalties are fixed in a shareholders agreement, Russian courts have the right to limit the sum payable if the amount is disproportional to the results of a breach.[14] It should be noted that the Russian Ministry of Economic Development actively stands against the restricted interpretation of the Amendments with the aim of preventing potential abuses.[15] However, the question of whether the Amendments establish a substantial basis for enforcement of shareholders agreements is still open.

IV. PROBLEMATIC ISSUES OF THE AMENDMENTS

The Amendments provide for the basic regulation of shareholders agreements in Russia. However, many questions and practical issues are left open. Will foreign investors use mechanisms offered by the Russian legislature or prefer to sign shareholders agreements under foreign laws where the advantages of this instrument have been used for decades and risks are lower? At the moment the answer is unclear. But there are grounds for questioning the effectiveness and sufficiency of the recent legislative changes. Due to the facts described above, the contract enforcement mechanism may not be effective. Courts may limit the monetary penalties stipulated in a shareholders agreement and therefore reduce the protection of a non-breaching party to an agreement. Measures for ensuring specific performance of contractual obligations are not clear.

Potential conflicts between a shareholders agreement and imperative norms of Russian legislation remain a subject of concern. Due to the peculiarities of Russian corporate law, the scope of contractual freedom of shareholders may be limited in comparison to other jurisdictions. For example, the law "On Joint-Stock Companies" requires cumulative voting for the formation of the board of directors and a three-quarters voting threshold for approval of major corporate

[12] *Id.*, art. 32.1(4).

[13] *Id.*, art. 32.1(4).

[14] Grazhdanskii Kodeks RF [GK] [Civil Code] art. 333 (Russ.).

[15] Ministerstvo Ekonomicheskogo Razvitia Rossiiskoi Federatsii, Pismo o Razyasnenii Izmemeni Vnesnnih v Federalni Zakon ob Akcionernih Obshstvah v Chasti Regulirovania Akcionernih Soglasheni [Russian Ministry of Economic Development, Letter Regarding the Interpretation of Amendments to the Federal Law On Joint-Stock Companies] Sept. 14, 2009 No. D06-2643.

decisions.[16] The Amendments do not directly eliminate these mandatory requirements. Contractual obligations inconsistent with such mandatory provisions are invalid. Thus, the possibility of establishing alternative mechanisms (like a higher threshold or the right of a party to appoint a certain number of board members) is questionable.

V. CONCLUSION

The Amendments signify a substantial shift from the restrictions on shareholders agreements to a more flexible and permissive regulatory regime. It is now up to the legal practice to determine the scope and application of the Amendments. However, narrow interpretation of the new norms may discourage investors from applying Russian law to their contractual relations. Mechanisms available in some foreign jurisdictions remain significantly broader. Moreover, lack of judicial practice creates additional risk exposure for market participants. All these factors give grounds to argue that the dispute regarding the future of shareholders agreements in Russia is not resolved.

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[16] *See, e.g.,* Federalni Zakon ob Akcionernih Obshestvah [Federal Law On Joint-Stock Companies], Ros. Gaz., Dec. 29, 1995, No. 248, art.66(4), 32(4), 35(7), 39(3, 4).