Chapter VIII

DISCUSSIONS ON KEY DIRECTIONS OF CORPORATE LAW DEVELOPMENT IN RUSSIA

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2011 became the year of significant discussions on strategic trends in corporate governance framework in the Russian Federation. They were facilitated by a series of events that occurred during a relatively short period of time. In August 2010, the RF Ministry of Economic Development posted on its official web-site a draft law that envisaged different regulation for public and non-public joint-stock companies, which was aimed at liberalization of Joint-Stock Companies Law.[2] In November 2010, the Council for Civil Law Codification and Improvement under the President of the Russian Federation (hereinafter the Codification Council) published the Draft Amendments to the Russian Civil Code. This Draft proposed, in particular,

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2 National Corporate Governance Report. Issue III, Chapter 7, Moscow, 2010.

an actually new version of Chapter 4 of the Part 1 of the Russian Civil Code, as concerns the general provisions on legal entities, with a number of provisions becoming more stringent even as compared with the current, not very liberal, regulation model.

The Codification Council, the RF Ministry for Economic Development, the RF Ministry of Justice and the Working Group for Establishment of the International Financial Center (hereinafter the IFC Working Group) played the most important part in discussions on these problems, which took place in 2011. The community of judges, the law firms, the academic community and major Russian companies could not afford to stand back from these discussions.

Most issues under discussion can be divided into two large parts. The first of them, which prevails in the Draft Amendments to the Russian Civil Code, touches upon the enhancing of 'law enforcement' focus of the provisions on legal entities, including the provisions on the responsibility of directors and shadow directors, the charter capital, the procedures of registration, reorganization and winding-up of legal entities. The second part includes the proposals such as easing up of the corporate governance regulation in business entities, in particular, and re-allocation of corporate control, regulation of the shareholders' agreements, the articles of association and internal documents of a joint-stock company, its management bodies, and the criteria for public joint-stock companies. The extent to which the freedom of corporate relations participants may be expanded in determining the rules for corporate governance of a company, and the permissible level of liberal reforms have become the most topical issues widely discussed in the professional community and in mass media.

8.1. Proportionality principle in Joint-Stock Companies Law

There was a novelty, almost unfeatured among an array of other changes, in the general provisions on commercial societies in the Draft Amendments to the Russian Civil Code, which was published on November 30, 2011, by the Codification Council. Paragraph 2 of Item 1 of Article 66 of the Russian Civil Code, in the version of the bill, established that '***the scope of rights of business entity's participants is determined pro rata their stakes in the charter capital of the company'.*** Therefore, the Draft promulgated the proportionality principle in corporate relations as a binding one for commercial societies. This rule was phrased as an imperative, which perhaps implied that federal laws on business entities will be aligned with it.

However, this principle is not stated in the applicable versions of federal laws on business entities in such a general form. On the contrary, they envisage a number of deviations from the proportionality principle, first of all, within the framework of differences between common shares and preferred ones.[1] This principle does not work when a related party transactions are approved: it is allowed to establish the so-called 'additional rights' of participants in limited liability companies (LLC), etc. However, the legitimacy of including other deviations from the proportionality principle, which are not envisaged in positive law, into the articles of association of a business entity is doubtful now. Even though the law on business entities makes part of civil law, where the optionality principle seems to be applicable, quite the opposite approach to corporate relations – 'everything not expressly envisaged in law is prohibited' – took shape in law enforcement, first of all, in the court practice. The Russian Civil Code Draft Concept stated unambiguously that it is necessary to increase mandatory corporate rules and procedures and incorporate mandatory unified model of corporate governance in spirit of "one size fits all" 'in general interests of all

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1 In the future, in reviewing the proportionality principle, we will discuss, first of all, the commensurability of voting rights to the contribution to the company's charter capital.

participants in civil transactions, in the interests of the entire society, of the influence of governmental authorities – both as law makers and as judicial power'.[1]

The legal provision proposed by the Codification Council envisaged the fixed proportionality (not subject to cancellation even by other laws, even less so, by the articles of association or an agreement) to the stake in a share capital, not only for voting powers but also for any other powers of the shareholder, such as the right to dividends, the right to information etc. This would mean the revision of many existing legal provisions that envisage other principles of exercising the right of shareholders. For instance, certain shareholders' rights are linked with their holding a stake of certain size (1%, 2%, 10% of the share capital). In this context, the possibility of other than *pro rata* redistribution of any particular shareholders' powers based on a shareholders' agreement looked even more doubtful. In this case, this proposal has not been preceded by discussions in the Russian academic literature and the professional community.

However, after the Draft Amendments to the Russian Civil Code were published and also in connection with promulgation of the bill of the RF Ministry of Economic Development, *On Amending Different Laws to Differentiate Regulation of Public and Non-Public Joint-Stock Companies* (hereinafter, the Bill of the Ministry of Economic Development), which envisages the entirely different approach for non-public joint-stock companies, a spirited debate took place on different sites during 2011. For instance, two discussions of the Bill were conducted by the Expert Group on Corporate Law Expertise and Improvement affiliated with the National Council on Corporate Governance (NCCG). Based on their results, the proposals were adopted to specify provisions of the Bill, while supporting its main goal – easing up of the Joint Stock Company Law, including extension of shareholders' rights to govern the corporate management procedure in many ways. The Bill was also discussed under such angle at governmental meetings devoted to establishment of the International Financial

1 http://www.privlaw.ru/index.php?section_id=83.

Center (hereinafter IFC) in Russia, at the corporate law subgroup of IFC Working Group.

The proponents of the principle of proportionality in corporate relations refer to the global experience and general recognition of this principle in most jurisdictions actively. Is it true? No matter how strange it might seem, this opinion is not supported by the review of foreign law and the corporate governance practice.

8.1.1. Foreign Experience

The corporate control enhancing mechanisms (CEM's) are conventionally classified as follows:

- corporate control re-allocation mechanisms (in particular, shares providing different scope of rights – multi-voting, non-voting and multi-nominal shares);
- control blocking mechanisms (limitations on the number of shares/votes belonging to one shareholder, priority ('golden') shares, qualified majority etc.);
- complementary mechanisms (sophisticated holding entities, depositary receipts, shareholders' agreements) that can be used for different purposes.

The 'one share – one vote' rule emerged as the capital market developed. Before the 20th century, the commensurability of the scope of a corporation participant's rights to his/her stake in the capital was not typical of either European or American companies.

Historically, legal relations between shareholders and companies in continental Europe were based on commercial/civil law that relies on the ***freedom-of-contract principle***. It was only later that shareholders obtained the voting right (e.g. shareholders of Dutch East-Indian Company, established in 1602, received the voting right in 1623 only), which was governed by the Articles of association of each particular company. Corporate law historians say that the 'one share – one vote' rule 'one share, one vote was hardly the norm in the early history of corporations."[1]

1 See, for instance, Randall K. Morck, A history of corporate governance around the world: family business group to professional managers, University of Chicago press, 2005, pp. 662, 663 (authors of the Chapter "Why has there been so little block holding in America?" Marco Becht and J. Bradford DeLong).

This rule appeared in the common law as a presumption (rather than a mandatory rule), in connection with the growth in the number of minority shareholders in the 19th century; later on, its introduction into Articles of associations of the companies established in Continental Europe began. However, up to the second quarter of the 20th century, the 'one shareholder – one vote' rule was more common. Also, starting from the second half of the 19th century, one could come across the multi-stage scales of determining the voting right (for instance, 100 shares provide 1 vote, 100 to 1,000 shares, two votes, 1000+ shares, 3 votes) and the limitation on the maximum number of votes on shares held by one shareholder in corporations' Articles of Association.[1] Moreover, before the beginning of the 20th century, the 'one share – one vote' rule was regarded as unfair and prejudicial to shareholders' interests in continental Europe and the USA.[2] Later on, as the capital market developed, US public companies have gradually shifted to the 'one share – one vote' principle.

It was ever later that it became legitimate to include the 'one share – one vote' rule into the articles of association of a company in France. Meanwhile, the limitation, whereby one shareholder was not entitled to own more than 10 votes, remained in the Commercial Code by the early 20th century. The 'one shareholder – one vote' rule was established in the articles of association of the Prussian-Rhine Railroad, which was approved in 1837. However, the practice of multi-stage scales was recorded among Prussian railway companies as early as in 1858. It was in 1884 that the legitimate right (not a duty!) to include the 'one share – one vote' rule into corporate articles of association sprang up in Germany. However, this provision is believed to have been indicating that any share vests its shareholder with the voting right only (this was aimed at preventing the companies from having shareholders without the voting right). The use of this rule in corporate governance of German companies began much later – early in the 20th century.

The attempt at establishing 'one share – one vote' rule as the unified standard in quasi-regulation was first made in 1925, in NYSE listing rules – as a recommendation to the companies listed at this stock exchange. Researchers believe this trend was largely triggered by the need to standardize the exchange commodity and by the emergence of the professional investors, for whom such rule facilitated gaining control over the target company. As a result of internal competition among stock exchanges, this recommendation was revoked in the 1980's. There were some more attempts at introducing the proportionality principle for listed companies by the securities market regulator (SEC) in the USA The last one was introduction of this principle in 19c-4 SEC Act of 1988, which was cancelled by the District of Columbia Court of Appeal in 1990.

In the postwar history, there was no single trend in amending laws. Nordic countries, France and the Netherlands still provide an option to issue multi-voting shares, though Sweden has restricted the right to include provisions as to issue of multi-voting shares, if one share grants not more than 10 votes, into articles of association. Finland and Italy extended the public companies' rights to introduce control-enhancing mechanisms (CEMs). At the same time, several states, in particular Germany, restrained certain types of deviations from the proportionality principle for public companies late in the 20th century. For instance, the amendments that prohibit public companies to curtail a shareholder's rights by establishing the maximum value of shares belonging to him/her or the multi-stage scale were made to paragraph 134, Federal Republic of Germany's Joint-Stock Companies Law, in 1994. Meanwhile,

1 Eric Hilt, When Did Ownership Separate from Control? Corporate Governance in the Early Nineteenth Century, 68 JOURNAL OF ECONOMIC HISTORY, 645, 660 (2008); Aldo Musacchio, Law Versus Contracts: Shareholder Protections and Ownership Concentration in Brazil, 1890–1950, 82 BUSINESS HISTORY REVIEW, 445, 449 (2008); Aldo Musacchio, Experiments in financial democracy: corporate governance and financial development in Brazil, 1882–1950 (2009); Colleen A. Dunlavy, Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights, 63 WASHINGTON & LEE LEGAL REVIEW 1347, 1354 (2006).

2 See, for instance, Mark J. Roe, Strong managers, weak owners: the political roots of American corporate finance (1994); Colleen A. Dunlavy, From Citizens to Plutocrats: Nineteenth-Century Shareholder Voting Rights and Theories of the Corporation, in constructing corporate America: history, politics, culture 66, 72–86.

shares with different par values may be issued in Germany,[1] which is similar to multi-voting shares in terms of the effect achieved.

According to the OECD report, strict adherence to the proportionality principle is observed in transitional economies that seek to improve perception by foreign investment funds of the corporate governance image in their companies.[2]

Currently, the listing requirements of major stock exchanges in continental Europe (Deutsche Boerse) and the USA (NYSE) allow circulation of shares of the companies having several categories of shares with different voting rights. However, they establish a limitation by prohibiting the issuers to subsequently issue shares, to which a greater scope of rights is attached to dilute the existing shareholders' stakes.

There are still numerous deviations from the proportionality principle in corporate governance practice of European public companies. For instance, the survey conducted by the Association of British Insurers (ABI)[3] concerning voting rights in 300 European major companies suggested that there were deviations from the 'one share – one vote' rule in a third of them.

In 2003, the European Commission made an attempt at establishing the appropriate rule for EU countries' listed companies. The EC-supported survey of national laws of member states as to the permissibility of deviation from the proportionality principle, in particular, from the 'one share – one vote' rule, was held. The aim of the survey was to determine what tools for corporate control re-allocation are used to assess their economic significance, the extent

1 For instance, the par value per share is EUR 1 in one issue and EUR 10, in another one, whereas each of them entitles to one vote, according to the imperative provision of the Joint-Stock Companies Law, paragraphs 23 (3) and 134 (1).

2 "Lack of Proportionality Between Ownership and Control: Overview and Issues for Discussion" Issued by the OECD Steering Group on Corporate Governance, December 2007.

3 Association of British Insurers, Deminor rating, application of the one share-one vote principle in Europe (Mar. 2005), http://www.abi.org.uk/content/contentfilemanager.aspx?contentid=24859.

of their impact on the EU financial market and their role in the institutional investor's decision-making. The survey covered 19 jurisdictions, including 3 jurisdictions outside EU (Australia, Japan, and the USA), as well as 464 European listed companies. The subject of the survey was such corporate control re-allocation tools as multi-voting shares, non-voting preferred shares, shareholders' agreements, 'pyramid' structures, cross-ownership etc.[1]

In December 2007, the European Commission released a report on the assessment of impact of deviations from the proportionality principle, which provided arguments for and against possible efforts aimed at making the proportionality principle binding. Upon comprehensive assessment of the advantages and disadvantages of deviations from the proportionality principle, the authors of the report concluded that ***the current situation (permissibility of using corporate control re-allocation mechanisms) does not require any intervention or settlement***. They made a conclusion that there is no causal relationship between deviation from the proportionality principle and improvement of a company's economic performance, even though the investors do not always approve of the use of corporate control re-allocation tools in a company and favor a greater corporate transparency in making investment decisions.

It is noteworthy that the surveys and the possibility of making the proportionality principle a binding one were only reviewed with respect to listed companies. This question has not even been raised with respect to non-public companies.

OECD followed the European Commission in studying the permissibility of deviations from the proportionality principle and of using CEMs. In December 2007, the OECD Steering Group on Corporate Governance drafted the appropriate report. OECD experts came to the same conclusion as the European Commission did: it is not appropriate

1 COMMISSION STAFF WORKING DOCUMENT "Impact Assessment on the Proportionality between Capital and Control in Listed Companies", Brussels, 12.12.2007, SEC (2007) 1705.

to establish the proportionality principle as the mandatory one for listed companies.[1]

The OECD Steering Group noted in its report that the extensive tools enabling to deviate from the proportionality principle are permitted in laws of the majority of the OECD member states. For instance, most countries with English/US and Roman legal systems allow existence of multi-voting shares, in particular, it is expressly envisaged in law. On the contrary, multi-voting shares are expressly prohibited in countries with the German legal system. However, companies (including listed ones) have such option as shares with different par value, which is equivalent to multi-voting, in arithmetic terms. Even though multi-voting shares are prohibited in Japan, one provision allows companies to establish the 'share units' system in articles of association, determining what number of shares forms one share unit, to which the voting right is attached.

Based on the survey, OECD made a decision not to adopt the recommendations on the proportionality principle and noted that any deviations from this principle did not violate the OECD-approved Corporate Governance Principles, as long as the public company had duly disclosed this. The report comprises four conclusions according to the proportionality principle:

- There is nothing a priori onerous about separating ownership and control.
- The cost of regulating proportionality would be considerable.
- Strengthening corporate governance frameworks is a better alternative.
- Specific problems can be dealt with through carefully targeted regulation.

1 "LACK OF PROPORTIONALITY BETWEEN OWNERSHIP AND CONTROL: OVERVIEW AND ISSUES FOR DISCUSSION." Issued by the OECD Steering Group on Corporate Governance, December 2007.

8.1.2. Arguments for and against proportionality principle

Major Shareholders' Opportunism

The argument of opportunism of the majority shareholder,[1] who, by making use of additional voting rights, will be able to dilute minority shareholders' rights, is one of the principal objections to non-proportional allocation of shareholders' rights in companies' Articles of Association.

However, even if the proportionality principle is complied with, the majority shareholder abusing of his/her power may withdraw assets by entering into the company's transactions with affiliates, to elect himself/herself to management bodies and to fix high remuneration to himself/herself, and otherwise to derive a greater benefit from participation in a JSC than a minority shareholder does. The problems of a majority shareholder's abuses of contractual freedom lead us to a wider range of issues on the extent of contractual freedom and on the ways of protecting minority shareholders. Without dwelling on them, let's note two key points: on the one hand, contractual freedom is a fundamental principle of the market economy, just as private property; but on the other hand, withdrawals from this principle, in particular, to protect weaker participants in civil circulation, appeared and expanded in the history of civil law of continental Europe.

The minority shareholders' problem in corporate governance is resolved in most jurisdictions by creating special remedies for their interests, such as lodging indirect claims against directors or majority shareholders who caused losses to a company, application of the 'piercing the corporate veil' doctrine etc.[2] Meanwhile, as the EU and OECD reviews suggest, the developed jurisdictions neither prohibit nor restrict the corporation shareholders' rights to allocate corporate control other than on the *pro rata* basis, by limiting a small set of practices only. Moreover,

1 La Porta Rafael, Florencio Lopez-de-Silanes and Andrei Shleifer, 1999, Corporate Ownership around the World, JOURNAL OF FINANCE, 54 (2), 471–517; La Porta R., F. Lopez-de-Silanes, A. Schleifer (1998), "Corporate Ownership around the World", Harvard Institute of Economic Research Paper No. 1840.

2 Ibid.

the option of disproportional allocation control power and financial cash flows are frequently used to protect minority shareholders' rights – for instance, by establishing a higher qualified majority for making decisions on certain issues, which reduces the blocking shareholding.[1]

Thus, neither a corporation participant's special rights stipulated in Articles of association nor a greater number of votes attached to a major holding in the corporation where the 'one share – one vote' rule is applicable lead to undoubted abuses in themselves. Meanwhile, to protect minority shareholders' rights, corporate law makes available a set of special remedies, without limiting the range of opportunities available to corporations' participants to agree upon the convenient procedure for exercising their rights and for participation in corporate governance.

Protection of other stakeholders' rights is beyond corporate law and is ensured by other legal measures, such as bankruptcy, stock market, taxes and charges laws.

Shareholders' Participation in Voting and Management of the Company. Principles of Shareholders' Democracy

The proponents of the shareholders' democracy theory proceed from the assumption of the community of shareholders' interests in maximizing a corporation's profit and, on this basis, they regard belonging of a voting right to a shareholder as an absolute value. By defending this point of view consistently, they propose different voting systems[2] that take into account an individual shareholder's preferences to the fullest extent. In their opinion, the proportional voting is in the best interests of shareholders.

However, the assumption of the homogeneity of shareholders' interests is a shortcoming of this theory, even as concerns public corporations. Shareholders' interests may be monetary and non-monetary, long- and

1 Aldo Musacchio, Law Versus Contracts: Shareholder Protection and Ownership Concentration in Brazil, 1890–1950, 82 BUSINESS HISTORY REVIEW 445, 449 (2008).

2 Easterbrook Frank H. and Daniel R. Fischel, 1983, Voting in Corporate Law, JOURNAL OF LAW AND ECONOMICS, 26, quoted after Grant Hayden and Mattew Bodi "The false promise of one share, one vote."

mid-term, etc. The homogeneity of shareholders' interests is conditional upon the following: the company's shares are atomistic and in free circulation; there are no groups of controlling shareholders; decisions are taken by a simple majority of votes. In this case, the 'one share – one vote' rule is actually the most appropriate one for a majority of the corporation participants and may result from the shareholders' consent. But other models may be appropriate in other situations: for instance, unanimity for a closed corporation with a small number of partner participants who run the corporation jointly. Selection of a voting system depends on particular goals of the company's founders, the share capital structure, the number of options under discussion etc.[1]

The thesis of minority shareholders' being inactive and evading from involvement in corporate governance is another objection to the criticism of advocates of shareholders' democracy. This objection also undermines the argument of the shareholders' interests in maximizing the profit being common. Some conservative investors are passive in exercising their voting rights and, if dividends are not paid, they 'vote with their feet'. In this case, division of a shareholder's voting rights and cash flows is likely to enable to preserve the status quo for the majority and minority shareholders whose interests may be just the opposite in a short term.

If decisions as to disproportional allocation of corporate power and cash flows are made by shareholders, when establishing a company, or are introduced in the existing company by unanimous resolution of all shareholders, it is needless to speak about violation of democratic principles.

1 On the problems of non-contradictory social selection and fair aggregation of the voters' preferences, see, for instance, Arrow Kenneth J., (1951b, 2nd ed. 1963). Social Choice and Individual Values. Wiley, New York.

Deviation from the Proportionality Principle and 'Entrenchment' of Management and Majority Shareholder

According to the corporate governance theory, a majority shareholder and hired managers are controlled by market forces, namely, by the risk of a company's takeover and management change. Deviations from the proportionality principle trigger so-called 'entrenching' of the majority shareholder and the management, which become more sensitive to the market signals that discipline them.

The opponents of the mandatory proportionality principle note that the managers' re-election threat creates negative incentives to the entrepreneurial risk taking and limit the decision-making horizon. As concerns the majority shareholders' 'entrenching', the risk of a company's takeover is noted to adversely affect its decisions as to entering the public market. Studies confirm this thesis. To maintain control or ensure management stability, most companies approve different protective measures before IPO (so-called 'poison pills', the staggered board of directors, issue of multi-voting or non-voting shares, prohibition on sale of shares during the first several years after IPO).

'False Bottom' of Corporate Governance

The prevailing opinion among professional portfolio investors and the financial market regulators is that the use of disproportional corporate control allocation tools creates the 'false bottom' of corporate governance that the market 'reads' poorly. A corporate governance model not based on the proportionality principle leads to additional expenses incurred by investors to assess the share value, by the regulator, to determine the share capital structure, by the company's counterparties, to establish powers of the corporate bodies.

The opponents of this standpoint indicate that use of the corporate control re-allocation tools does not necessarily narrow the investors' and the regulator's awareness of the capital structure or make the evaluation of shares more complicated. Some corporate control re-allocation tools, e.g. multi-voting shares, are to be placed upon the same conditions as common ones, i.e. information on the scope of rights attached to them is disclosed and may be taken by the market into account without further difficulties. The above mentioned OECD report notes that multi-voting shares, unlike with shareholders' agreements, do not aggravate the 'information asymmetry'. As concerns other corporate control re-allocation means, the general rules for disclosures on the stock market apply, including disclosures on the persons who dispose of votes attached to the stake determined in the law.

Interests of other stakeholders (counterparties, fiscal authorities) are protected in the rules on representation of a legal entity in circulation via its corporate bodies. The possibility of cancelling a transaction's consequences, if a director exceeds the powers provided to him/her in the company's Articles of Association, has been either lifted or limited substantially in most corporate jurisdictions over the last decade.

Non-pro-rata Allocation of Shareholders' Rights and Stock Market

The surveys devoted to the influence of deviations from the proportionality principle on a company's value failed to prove that there was a direct correlation between inclusion of control re-allocation tools into corporate articles of association and the value of shares.[1]

Being an exchange commodity, a share should have standardized properties. From this point of view,

1 Core John E., Wayne R. Guay and Tjomme O. Rusticus, 2006, Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors Expectations, JOURNAL OF FINANCE, 61, 655–687; Gompers Paul A., Joy Ishii, and Andrew Metrick, 2006. Extreme Governance: An Analysis of Dual-Class Firms in the United States, Harvard Business School, Stanford Graduate School of Business and University of Pennsylvania, The Wharton School; Smart Scott B., Ramabhadran S. Thirumalai, and Chad J. Zutter, 2006. What's in a Vote? The Short- and Long-Run Impact of Dual-Class Equity on IPO Firm Values, Indiana University, Indian School of Business and University of Pittsburg. Another point of view is available at Cronqvist, Henrik and Mattias Nilsson, 2003, Agency Costs of Controlling Minority Shareholders. JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS, 38, 695–719; Giannetti Mariassunta and Andrei Simonov, 2006, Which Investors Fear Expropriation? Evidence from Investors.Portfolio Choices, JOURNAL OF FINANCE, 61, 1507–1547.

any of the issuer's shares should provide the same scope of rights. Portfolio investors and stock exchange regulators have historically sought to unify the rules on rights attached to shares. As a result, they succeeded in elaborating the rules that maintain the majority shareholders' position in the company, while limiting their time-serving. The issuers whose securities are eligible for listing are prevented from issuing shares that provide a greater scope of rights than the earlier issued ones, under penalty of de-listing.

The portfolio investors' surveys held by different organizations (in particular, the European Commission and the Association of British Insurers) suggest that investors are likely to invest into a company where the voting right and the right to dividends are allocated on a proportional basis. The second half of the 20th century saw the struggle of the organizations uniting active shareholders for adherence to this principle.

Meanwhile, researchers conclude that the 'one share – one vote' principle discourages the companies from entering the stock market and atomization of shares.[1] This is due, firstly, to the need to concentrate a large stake of ordinary shares to maintain strategic control (if the stake is not proportional to the voting right, it is possible to reduce the stake, while preserving the shareholder's preferences in voting on strategic issues), and secondly, to the negative expectations of loss of control if the stake reduces. It gets evident by the stock market development: many major corporations were established as family firms and, when entering the market, included the control preservation tools into their articles of association. For instance, the study held by the Harvard University researchers[2] suggest that approx. 60% of the companies starting IPO at NYSE in-

1 Burkart M. and S. Lee (2007), "The One Share – One Vote Debate: A Theoretical Perspective", ECGI, *Finance Working Paper No*. 176/2007; Becht Marco, Patrick Bolton and Ailsa Röell, 2003, "Corporate Governance and Control" in Constantinides George, Milton Harris and Rene Stulz (eds.), Handbook of the Economics of Finance, North-Holland, Amsterdam.

2 Bebchuk Lucian A. and Luigi Zingales, 2000, Ownership Structures and the Decision to Go Public; Morck Randall K. (ed.), Concentrated Corporate Ownership, University of Chicago Press, Chicago and London.

clude the provision on the board of directors that is divided into 'categories' during its election into their articles of association.

In a conflict between portfolio investors and majority owners, the company and its shareholders will be better off by preserving long-term stability in management and by reducing the management control costs.[1] Therefore, the conclusion made by OECD, together with other researchers, seems more correct: the non-commensurability in exercising the voting right is not in itself a risk for minority shareholders if the corporate governance level is high and the proper disclosures are made.

When the proportionality principle was discussed in the EU, they also concluded that the imperative imposed on the listed companies to follow this principle would entail mass delisting and companies' escape from the stock market.

8.1.3. Progress of Discussions and Agreements Reached

As part of the discussion on the Bill of the RF Ministry of Economic Development, two approaches to expanding the options available to participants in joint-stock companies to shape the corporate governance rules were discussed. According to the first approach, the idea was to establish the presumption of optionality of the joint-stock companies law provisions on corporate governance, unless they expressly envisage that the provision is an mandatory or unless the nature of the legal relationship, which this provision is intended to govern, suggests that this provision may be an mandatory only. The proposal was to apply this approach, in particular, to the possibility of deviation from the proportionality principle. Such approach gave rise to criticism on the part of law-enforcers, including judges. If courts will have to make conclusions independently on the nature

1 Bebchuk Lucian A., "Why firms adopt antitakeover arrangements", 152 UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 713–753 (2003); Bebchuk Lucian A. and Oliver Hart, 2001, Takeover Bids vs. Proxy Fights in Contests for Corporate Control, CEPR Discussion Paper, No. 3073, ECGI – Finance Working Paper No. 4; Harris Ellie G., 1990, Anti-takeover Measures, Golden Parachutes, and Target Shareholder Wealth. RAND JOURNAL OF ECONOMICS, 21 (4), 614–625.

of legal relationship and to decide if this nature allows the optionality of governance or else requires the imperative governance, the legal uncertainty would only increase.

As part of the second approach, the idea was to expressly envisage, in a number of laws currently regarded as mandatory ones, the possibility 'to provide for otherwise' in the company's Articles of Association. This would enable to have and apply some specific provisions of the articles of association, in addition to the default rules, and would facilitate the shaping of the legal standpoint for courts and other law-enforcers.

When the Draft Amendments to the Russian Civil Code was reworked, a compromise largely based on the second approach was reached with respect to the proportionality principle. It is proposed that the Civil Code should stipulate, as a general provision, that the scope of powers of a business entity's participants is determined proportionality their stakes in the company's share capital. However, the company's articles of association and a corporate contract may envisage otherwise, provided that the information on availability of such contract is disclosed in the Uniform State Register of Legal Entities. We believe that it would be appropriate to indicate the principal corporate control re-allocation tools and the procedure for their inclusion into the articles of association in the Joint-Stock Companies Law, and also to restrict the use of some of them for public joint-stock companies.

8.2. Approaches to Regulation of Control/ Controlled Status Relations

Corporate control/controlled status relations rely on more or less clear facts. Somebody is able, either directly or via an elaborately built chain of formal or informal relations, to influence someone else's behavior; but in this case the regulations related with them may be quite different and used for different purposes. Regulation of these relations, including the allied institute of affiliation as applicable to business entities, has been traditionally mentioned among key corporate governance problems in Russia, which need to be resolved. This is due to both

economic (highly concentrated share capital) and political (unwillingness of the state to lose control in strategic industries) reasons as well as certain 'cultural' particularities of the Russian business (neglect of minority shareholders' and lenders' interests).

It is the last group of reasons that has regularly become the decisive argument for tightening of legal provisions that limit the majority owners' options or impose additional duties and burdens on them. Out of the provisions adopted in recent years, one can cite:

The definition of control and significant influence in Articles 3 and 5, Federal Law No 57-FZ, On the Procedure for Foreign Investments into Business Entities Strategic for National Defense and Security (largely for political purposes);

Amendments to Article 2, Federal Securities Market Law, made in 2010 by Federal Law No 264-FZ, which introduced a rather broad definition of controlling and controlled persons, in order to ensure transparency of the stock market and to protect the investors' rights;

Amendments to the Bankruptcy Law introduced in 2009 by Federal Law No 79-FZ, as concerns the definition of a debtor's controlling persons for protection of the lenders' interests (in order to eradicate the practice of withdrawing assets of a company with 'shadow directors' on the eve of bankruptcy).

The last mentioned example of special regulation of control/controlled status relations seemed to have become the only example of the positive assessment by virtually all bona fide entrepreneurs, and the professional community. The existing problem was alleviated to a great extent and, largely due to these amendments, Russia's rating in the World Bank's Doing Business List raised by some positions in 2009/2010. However, Law No 57-FZ was perceived by entrepreneurs with a good deal of criticism. Law No 264-FZ also caused mixed feelings among issuers: they were ready to a manifold increase in the scope of disclosed information;[1] however, they were perplexed at the duties

1 Some of them used to disclose such scope of information before, according to the listing requirements of foreign regulators of the financial markets, first of all, the British and the American.

assigned to them – to constantly monitor the structure of holding of its controlled persons and, contrary to the initiators of amendments, did not expect any material improvement of the investment environment on this basis. Some portfolio investments gave a similar assessment.

In addition to already adopted laws, several bills on similar issues have been recently drafted and are actively discussed. This is, first of all, the Draft Amendments to the Russian Civil Code, as drawn up by the Codification Council, in which the notion of control over a legal entity is first introduced into the Civil Code, the provisions on the responsibility of controlling persons are specified; the proposal is made to establish the requirement to disclose beneficiaries of offshore companies. These are also the bills aimed at actual prohibition of 'cross-ownership' by limiting any corporate rights attached to 'quasi-treasury shares'. One can also mention the proposals of FFMS of Russia to extend the range of persons who are obliged to send a mandatory tender offer on the purchase of the company's voting stock (amendments to Chapter XI.1, Joint-Stock Companies Law) and the proposals of the Russian Federal Anti-Monopoly Service as to timing of coming into effect of shareholders' agreements with their publication. The most recent initiative of the anti-monopoly service was rejected when the so-called 'third anti-trust package' was adopted, but it was re-included into the 'fourth package'. Finally, the argument on large-scale abuses by controlling shareholders, as engendered by the contradictory regulation of the affiliation and control/controlled status relations, forms a basis for recent orders of the Russian President and the Russian Government as to the total disclosure of the chains of energy companies' beneficiaries and preventing state-owned companies from contracting with their controlled entities.

All of the mentioned 'law-enforcement' initiatives are likely to be useful for regulators, in terms of ensuring the transparency of the corporate governance structure and financial flows. Perhaps, they upgrade protection of minority shareholders' and lenders' rights to some extent. However, the general economic effect from such innovations is not evident. The dependence between the protection of minority shareholders' rights and the stock market volume

is not strictly linear, as was noted above. At the same time, the practical effect from excessive imperative provisions in corporate law is, rather, negative: businessmen, financial and legal advisors and state officials share the opinion that the number of deals governed by more flexible foreign corporate law has boosted in recent years. Meanwhile, the said trend is true not only for transactions with foreign counterparties but also for contracts negotiated by Russian residents with respect to the assets located in the Russian territory.

Among the conditions that produce the decisive impact on the economic agents' behavior in the Russian environment, one should take into account the following: underdevelopment of institutions and lack of the well-established class of owners; poor protection of ownership and contractual rights; high enforcement costs; dependence on previous development (the key parameters of the corporate ownership structure were pre-determined by the results of the mid-1990's large-scale privatization); excessive paternalism in law that increases the gap between the objectives of encouraging the business effectiveness and of securing social fairness. In this environment, economic entities often conceal their control: they move their businesses to foreign and offshore jurisdictions; use cross- and circular ownership tools etc. It is explained not so much by roguishness of Russian businessmen, which is often mentioned by the proponents of further regulation tightening, as by the normal response of a reasonable person who is doing business where it is more convenient and more profitable to do it. And if we regard the initiatives to tighten the regimentation of corporate relations from this point of view, one can come to unexpected conclusions.

8.2.1. Case 1: Mandatory Tender Offer

Let's show how the Russian legal system is gradually becoming a hostage of approaches initially intended for other economic conditions. The institute of mandatory bid, which used to be fair in systems with a well-developed stock market and diluted ownership, turned into a burdensome duty for majority shareholders when it was 're-planted' in the Russian soil. In the environment when

the average value of a controlling stake reaches 65%–70%,[1] buyers are not in a hurry to cross the threshold of just 30%,[2] which shows their reasonable economic behavior. To ensure that shares are transferred between corporate entities with participation of the state, without 'needless' costs for the latter, amendments to the list of withdrawals from Article 84.2, JSC Law, have already been made twice.[3] Private purchasers became more active users of the indirect control tools, to bypass the mandatory bid provisions. The interpretation of Article 84.2 of the JSC Law to the effect that, for the appropriate duty to arise, it is necessary to actually purchase securities, not just to become entitled to dispose of the votes attached to these shares indirectly (via affiliates, by purchasing stakes in the company holding the issuer's shares, under conditions of the shareholders' agreement etc.) served as an excuse for them.

They often say that 'exceptions confirm a general rule', but when such exceptions become too numerous, they create new rules. Adjustment of the provisions on mandatory bid for all joint-stock companies – namely, aligning of the threshold shareholding that triggers the bid arrangements to the real value of the controlling stake and easing up of the extremely stringent requirements to secure the bid – seem to be a reasonable way out of the situation. However, the amendments to Chapter XI.1 of the Law, as drafted by FFMS of Russia, are largely aimed at tightening the existing regulation. They envisage that the duty to send the mandatory bid should arise both in case of direct and indirect (jointly with controlling and controlled persons) acquisition of the right to dispose of votes on the issuer's

1 To compare: in the UK, from where the mandatory bid rule was exported to European and then Russian nomocracy, most transactions involving change in control are concluded before crossing the 30% threshold.

2 Limitations on prompt corporate decision-making, the costs of sending an offer and securing it with the banker's bond, possibly – agreement of future transactions with anti-trust authorities and bank supervision authorities.

3 A regular amendments that eliminates the duty to send the mandatory bid if shares are transferred from federal ownership into the ownership of the Russian Federation subjects and vice versa, is under discussion now.

shares, and the limitation of the voting right on purchased shares is extended up to the time when a report on the mandatory bid acceptance results is sent to the regulator.

In this case, the notion of 'controlling persons' is used in the meaning envisaged in Article 2 of the Securities Market Law: it is a multitude of variations, which does not almost lend itself to formalization of both permanent and situational control exercised by virtue of direct ownership of shares, being under common control, participation in corporate agreements etc. – a potential bidder does not even know all cases. There is a risk that implementation of such approach (if the current shareholding threshold of 30% is maintained) would not improve the situation for minority shareholders, but would reduce the number of shares in free circulation, because owners, for fear of high expenses caused by such uncertainty, would seek to fully close the company.

Regulation of control/ controlled status relations using economic, not formal, criteria should be accompanied by taking into account the economic pre-requisites for introduction of such regulation.

8.2.2. Case 2: Cross-ownership and 'Quasi-treasury' Shares

Cross-ownership of stakes in corporations (heterarchy) is long-dated as a corporate control re-allocation tool. The popularity of cross-ownership patterns, when a subsidiary holds its parent company's shares and may vote with them, in particular, to the prejudice of minority shareholders' interests, peaked in Russia in the mid-1990's.[1] However, similar situations arise even now, because they are not prohibited by law. The information on cross-ownership of shares must only be disclosed as material facts, and administrative liability is envisaged for breach of the appropriate duty. However, the efficiency of such penalties is often disputed.

The need to introduce regulation of cross-ownership was mentioned, e.g., in the Corporate Law Development Concept up to 2008. In 2011, this issue was discussed

1 "Rings of Shares." – *The Vedomosti,* May 6, 2010.

as part of reworking of the Draft Amendments to the Russian Civil Code as drafted by the Presidential Codification Council. The key issue was the extent of regulatory impact: whether or not to limit exercise of rights attached to quasi-treasury shares and, if so, which particular rights?

According to some judgments, transactions with quasi-treasury shares testify to low-quality corporate governance.[1] The idea about the need in preventing the persons controlled by the company, in the broadest sense (i.e. not only subsidiaries, but also subsidiaries of the subsidiaries and other companies), from exercising any corporate rights attached to their shares and other voting financial instruments of the parent company is very popular with minority shareholders. Meanwhile, an alternative point of view also exists: if actual cross-ownership is disclosed, and shareholders conscientiously take the risks of participating in such a company, it is not required to limit the exercise of rights attached to the appropriate shares.

We did not manage to find any examples of absolute non-acceptance of 'cross-patterns' in the leading foreign jurisdictions. Well, such corporate structure of a company may actually trigger abuses on the part of members of management bodies and controlling persons; therefore, the procedure for exercising of rights by shareholders of the respective companies is specially governed by corporate laws. However, limitation of the voting right attached to quasi-treasury shares is typical of the countries where control over a company is determined by formal attributes and is simpler to detect.

For instance, the US Model Business Corporations Act (MBCA) and corporate laws of US states (e.g., paragraph (c), Article 160, Delaware General Corporations Law) limit the voting right on shares belonging to a corporation, in which another corporation holds the majority of shares, when directors of the former corporation are elected. In the UK, where the voting right attached to quasi-treasury shares is also restricted, the Companies Act (Article 1159) defines control by a formal attribute: through the right to dispose of more than a half of votes or the right to appoint more than a half of the board members.

1 "Offer to Withdraw" – *The Expert,* issue No 6 (740), February 14, 2011.

Unlike English and American corporate statutes, German joint-stock companies law handles a broad definition of the control – 'the possibility of producing the decisive impact'. However, controlled persons that timely disclosed information on cross-shareholding are not limited in their corporate rights in Germany, as soon as they have fulfilled their duty to disclose cross-shareholding (paragraphs 20 and 21, JSC Law).

Shouldn't we take the best of these two approaches': from the Anglo-Saxon system, the prohibition on voting with quasi-treasury shares at the parent company's meetings, and from the continental one, the broad reasons for control initiation? It is not quite correct economically because it is conducive to structural uncertainty and increase *bona fide* agents' costs. Control as an actual ability to determine a legal entity's actions may appear on a case-by-case basis, ad hoc, e.g. as a result of short-term (as part of one meeting of a management body) allocation of voting rights among members of participants in such body. This may result in a situation when even a person holding less than 20% of votes, with the minimum possible quorum, will be recognized as a controlling person in a short term, if shareholders with a greater stake exist.

The minority shareholders' endeavors to limit, in addition to the voting right, other corporate rights on quasi-treasury shares, e.g. rights to dividends or rights to the liquidation quota, are even less reasonable.

Cross-ownership is a powerful tool of disproportional corporate control allocation and, just as any other deviation from the proportionality principle, it cannot be uniquely defined. The original conflict between different interest groups is inherent in these tools, by their nature, and it is unpredictable when and how it will manifest itself. Therefore, any extreme solutions to this problem will be less efficient than an attempt at finding 'the happy mean'.

When the Draft Amendments to the Russian Civil Code were worked on, the following compromise was found: the persons controlled by a legal entity cannot exercise their voting right on their shares in the parent company, however, other corporate rights of holders of 'quasi-treasury shares' are not affected. To ensure stable circulation,

violation of this rule is established not to be a reason for recognizing the controlling business entity's actions with respect to third parties as invalid. The idea also is that this provision would take effect after a two-year transitional period, during which the shareholders will be able to re-format the company's shareholding patterns in line with more stringent requirements.

8.2.3. Case 3: Affiliation and Related Party Transactions for State Shareholder

By participating in circulation via its controlled legal entities, the state pursues, besides private law objectives, a whole range of public law objectives – economic, social, foreign policy ones and others. Naturally, the conflict between these objectives cannot be ruled out. Meanwhile, in terms of civil law, all of the circulation participants are equal, and the provisions that determine participation of legal entities in the relations governed by civil law apply to public legal entities, unless otherwise arises out of law or particular features of these constituents.

The area where public and private interests of the state clash very strongly is the approval of related party transactions. For instance, even if it maintains significant control in a company (privatization of a small stake), a shareholder that is a public legal entity may incur the risks related to transfer to the private shareholders of the option to determine the decisions on approval of the related party transactions (Article 83.4, JSC Law): the risk of situational loss of corporate control (the impossibility to promptly approve of entering into a transaction that is important for implementation of the public legal function) and the risk of minority shareholders' disputing of the transactions entered into in violation of the said procedure.

Naturally, one can hardly presume that minority shareholders would purposefully block entering into transactions, which are important for a company and are aimed at increasing its capitalization or expanding its markets, even if they are related party transactions formally. The majority shareholders' traditional arguments against approval of transactions with minority shareholders are most frequently associated with the unwillingness to follow

the costly approval procedures when their sense is not evident, rather than with the fear of losing corporate control. However, it is impossible to rule out the situation when a transaction that is important for the majority shareholder and for the entire company is not approved by minority shareholders, because the range of transactions that need to be approved under interested party rules can be very wide. Likewise, the risks of the state related to transfer to private shareholders of the option to determine the decisions on approval of related party transactions exist, but do not readily lend themselves to formalization.

Different patterns for involvement of the Russian Federation in the share capitals of joint-stock companies may apply. For instance, the Russian Federation may directly own more than 20% of shares in two OJSCs, and then a transaction between these JSCs will absolutely constitute, de lege lata, a related party transaction, because this article of the JSC Law does not envisage any exceptions for the shareholders – public legal entities, and the term of 'affiliation' is not used to describe this situation. Another situation is also possible: the Russian Federation owns less than 20% in these OJSCs, but they have state-owned shareholders, and the aggregate stake the state may directly or indirectly control exceeds 20%. In this situation the answer to the question as to whether or not this transaction will be approved under the rules of Chapter XI, the JSC Law, depends on the establishment/non-establishment of the affiliation relations by the Russian Federation with legal entities. The law is silent here, and the court practice has not succeeded in elaborating the uniform approach to this issue so far.[1]

To fully eliminate these risks, it is necessary to expressly establish in law that the provisions on affiliation, just as on the special procedure for approval of related

1 Proceeding from 'literal' interpretation, affiliation is possible here. According to the 'systemic' interpretation that prevails in the judicial practice of arbitration appeal courts and arbitration tribunals of federal districts, no affiliation relations arise in these situations, taking into account the particular features of the legal status of the State in circulation. The Supreme Arbitration Court of the Russian Federation has not elaborated any uniform practice on this issue so far.

party transactions, do not apply to legal relations with participation of public legal entities.

This approach is supported by the fact that the provisions on affiliation and on the special transaction approval procedures are intended to settle and prevent the conflict of interests in private law. Administrative law that governs the state property management procedure, the law on civil service and other administrative and criminal law provisions aimed at prevention and settlement of the conflict of interests contain special provisions for settlement of the conflict of interests of the state and its representatives, which arise out of the involvement of legal entities in operations of governmental authorities. The conflict between the strategic interests of the state (economy, foreign trade policy, defense) is also settled at the level of public legal tools – via the system of governmental authorities, approval of the voting directives given to state representatives, and inter-departmental relations.

Therefore, it seems excessive to use private legal tools, such as the affiliation provisions and the approval of related party transactions, in addition to public legal tools for settlement of the conflict of interests between the state and its representatives. Moreover, in the current situation, with numerous legal entities (JSCs, state unitary enterprises etc.) controlled by the state, it would result in significant growth in unreasonable financial costs.

At the proposal of the RF Ministry of Economic Development, the improved definition of affiliates was supported in the course of reworking of the Draft Amendments to the Russian Civil Code. In particular, it envisages that the affiliation does not arise:

- between a public legal entity and its controlled legal entity;
- between legal entities under common control of a public legal entity;
- between legal entities where the public legal entity is able to directly or indirectly dispose of more than 20% of the total number of votes of the participants in each of these legal entities, either independently or jointly with other persons.

The ways of the civil and corporate law evolution are still under discussion. Russia’s long-term economic development depends on whether the law-makers will opt for further reinforcement of the state regulatory function or for easing up the legal framework of business. Excesses in either direction will not obviously be conducive to the confident behavior of the economic entities selecting the Russian jurisdiction. It is only a balanced and wise approach to the corporate relations participants’ rights that would help achieve the economic development and social fairness objectives.