Tilburg Law School

Master's Thesis – Research Master in Law

The Enforcement of Shareholders' Agreements

Comparative Analysis of English and Russian Law

(Final version)

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ABSTRACT: Private actors in 'following' countries usually encounter with the problems of enforcing well-developed and effective 'Western-style' contracting techniques. A common response is the structuring of transactions according to foreign law. This pattern of development fully applies to the shareholders' agreements of Russian companies. Additional costs related with the use of foreign law and national sovereignty concerns compelled Russian legislature to act by introducing rules on shareholders' agreements into corporate legislation. Yet, even after the amendments the popularity of English law among the shareholders of Russian companies remains widespread. The comparative analysis of the new Russian rules on shareholders' agreements and of the English model shows that both jurisdictions share similar problems of enforcement of the agreements. Therefore, other factors, such as the general mandatory nature of Russian corporate legislation, the quality of Russian courts, legal uncertainty, the interests of law firms, and unfavorable court practice on certain contract law concepts, count for shunning Russian law by private actors. The thesis also uses economic reasoning and the results of the comparative analysis to offer a general framework that can be used for the interpretation of the shareholders' agreements by the courts.

Contents

I. INTRODUCTION

Despite numerous legal reforms of the last decades, the development of legal rules was and continues to be one of the central problems in Russia and in other 'following' countries. This problem is intensified by the fact that the development of corporate sector is generally quick, as globalization, international competition, open markets, and arbitration between regulatory regimes allow businesses to learn, borrow and use directly foreign practices. Partially because 'Western-style' contracting techniques are well-developed and effective, there are strong incentives and temptation for private actors from 'following' countries and their consultants to adopt foreign practices. A common feature in these countries is that new business practices, sometimes even new fragmented statutory rules as well, encounter with enforcement issues in local courts.[1]

In a relatively short period after the adoption of basic laws on different business forms, companies in Russia started to use shareholders' agreements (SAs) which were not regulated by the domestic laws. These agreements provide for the detailed regulation of relations between shareholders in cases when legislative provisions are deemed not sufficient or not appropriate. From an economic perspective – given dynamic moral hazard and uncertainty – SAs allow pursuing efficiency-driven *ex ante* decisions with regard to investments in the firm by enhancing certainty in relations and mitigating relational-specific moral hazard issues.[2] Contractual arrangements of shareholders in companies and joint ventures can also induce the parties to negotiate and continue relations if deadlock situations arise.[3] Finally, SAs give an opportunity to engage in an efficiency-based choice between rules and standards to better informed participants of corporate relations rather than to legislatures.[4]

The new practice of Russian private actors – which was borrowed from foreign jurisdictions – was encountered with enforcement problems in the national commercial courts, as some of the provisions of SAs were considered void due to their incompatibility with the basic requirements of the laws and the internal documents of companies. This situation in effect, turned SAs governed by Russian law into nothing more than gentlemen's agreement between its parties. The result was widespread use of other functionally equivalent instruments that achieved similar outcomes, and shift to foreign law by governing agreements according to foreign law.

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[1] For the issues related with the enforcement of shareholders' agreements in Ukraine *see* Timur Bondaryev & Markian Malskyy, 'Recent Developments Concerning Dispute Resolution of Shareholder Agreements in Ukraine: For Better or For Worse?' (2008:3) STOCKHOLM INT'L ARB. REV. 83. The pitfalls of implementing U.S. venture capital contracting techniques in South Korea are described in Eugene Kim, 'Venture Capital Contracting under the Korean Commercial Code: Adopting U.S. Techniques in South Korean Transactions' (2004) 13 PAC. RIM L. & POL'Y J. 439. Brazilian legislation also causes problems for private equity and venture capital contracting structures (Cinthia Daniela Bertan Ribeiro, 'Financial Contracting Choices in Brazil: Does the Brazilian Legal Environment Allow Private Equity Groups to Enter into Complex Contractual Arrangements with Brazilian Companies?' (2007) 13 LAW & BUS. REV. AM. 355.).

[2] Gilles Chemla, Michael A. Habib & Alexander Ljungqvist, 'An Analysis of Shareholder Agreements' (2007) 5 J. EUR. ECON. ASSOC. 93, 94, 116.

[3] Joseph A. McCahery & Erik P.M. Vermeulen, *Corporate Governance of Non-Listed Companies* (OUP 2008), 149 (however, these contractual arrangements are difficult to devise *ex ante* due to information asymmetries; another issue is the valuation of shares for the purposes of buy/sell-out clauses).

[4] The problems of collective decision-making and agency relationships inherent to public legislatures make the choice of contractual structures (precise rules versus standards) by legislatures less efficient, than the choice made by better informed participants of corporate relations (Louis Kaplow, 'Rules Versus Standards: An Economic Analysis' (1992) 42 DUKE L. J. 557, 608–11.).

Yet, the new practices created additional costs for private actors, firstly in the form of tax obligations, obtaining foreign legal services, and litigation in foreign jurisdictions and international arbitration courts. Secondly, in cases where the assets of the involved parties were in Russia, the enforcement of the judgments of foreign courts and arbitrators led to more problems related with the recognition of the judgments by Russian courts. Moreover, the very fact that the legal restrictions could be easily circumvented by using substitute techniques necessitated legislative action. Additional concerns were related with the loss of national sovereignty over the regulation of corporate transactions and adjudication of disputes, and with the interests of local law firms, which had conceded the large part of the market of legal services in the field of corporate law to foreign law firms.

In late 2008 and in the summer of 2009 the legislature answered to the problem by amending the Federal Laws on Limited Liability Companies (the Law on LLCs) and on Joint Stock Companies (the Law on JSCs) and introducing the concept of SAs in Russian law. However, anecdotal evidence suggests that the use of foreign law (especially English law) for governing SAs remains widespread. This raises two questions. First, is the new Russian model of shareholders' agreements different from the analogous concept used in English law? And second, if the two models do not have significant differences, what other factors can explain the refusal to use Russian rules for governing shareholders' agreements and instead opting for English law?

The objective of the comparative analysis in this study is to demonstrate possible similarities and differences of Russian and U.K. approaches towards SAs by comparing the treatment of the main 'controversial' provisions of SAs (from the perspective of their enforcement in Russian commercial courts) in the two jurisdictions, and to define a general framework that can be used by Russian commercial courts to interpret statutory rules on SAs by using the results of the comparative study. To strengthen the normative dimension of legal comparisons, the study also applies economic reasoning to construct the general framework.

The object of the thesis is the ways Russian and English law deal with the relations which arise in connection with the agreements between the shareholders of companies with regard to the internal governance of the companies, and the exercise of the shareholders' rights over the shares and certified by the shares. The sources of the comparative analysis are multilayered. The first layer includes legal rules on shareholders' agreements. As common law plays significant role in regulating contracts in the U.K., and statutory rules obtain their meaning during their interpretation by courts, both statutory and case law are studied (though Russian case law on shareholders' agreements remains scarce and is almost absent after the amendments of the legislation with regard to SAs). The second layer is the legal context of the rules: other rules, institutions and fields of law that affect the application of the rules. The third layer is non-legal context: institutional, social and historical factors that affect the development and application of the legal rules.

The choice of English law for comparison is based on the claimed widespread use of the latter as a governing law for SAs related with Russian companies. In particular, a recent survey by a leading Russian law firm demonstrated that more than half of the examined Russian companies do not trust to Russian law, and govern by Russian law not more than 10 percent of their significant transactions. Such transactions as M&A, shareholders' agreements, project financing,

joint ventures, and debt restructuring are usually structured according to foreign, and mainly English law.[5]

In a comparative analysis it is a challenge to define a neutral research question. Similarly, one of the main methodological problems of this study was the definition of SAs in abstract non-legal terms, as such agreements contain different provisions. For the purposes of this thesis an SA is an agreement concerning the internal governance of the company, rights certified by the shares, and/or concerning special rules on issuing and transferring shares. Still, the definition is not fully neutral, as it is based on legal terms, such as internal governance, rights certified by shares, transfer and issuance of shares. However, as the concept has been borrowed by Russian private actors from abroad, rather than developed domestically, the agreements have similar meaning in both jurisdictions. This similarity allows establishing a common basis and clear scope for comparison.

The thesis shows that both jurisdictions share significant similarities in the way they deal with the main issues of the enforcement of SAs (relation with mandatory statutory rules and articles of association, the participation of the company in its shareholders' agreement, specific performance of the provisions of SAs, external effects of a breach of SAs). Yet, narrow focus on the main questions of the treatment of SAs by courts is misleading, as such focus shows only a part of a big picture. The rules on SAs should be examined within the framework of corporate and contract law in general.

The general mandatory nature of Russian corporate law as compared with U.K. company law, uncertainty with regard to the interpretation of the new rules by Russian courts, and well-developed supplementary techniques and contract case law in the U.K. make SAs governed by English law more convenient, and hence probably more demanded. Possibly other factors such as the interests of legal advisers, network effects, and the popularity of English law and the English language in international commercial transactions do matter as well for the choice of the governing law of SAs. However, the development of case law oriented towards the balancing of the rights and interests of the involved parties from the perspective of the offered framework can contribute to the structuring of more agreements according to Russian law.

The thesis will proceed according to the following structure. First, brief historical background on the development of the concept of SAs in Russian corporate practice and corporate law will be provided. This historical excursus can be helpful for understanding the following parts of the thesis. In the following part, to answer the first research question the thesis will describe the main 'controversial' provisions used by Russian corporate sector in SAs and will analyze their legality and enforcement according to the new approach of Russian law and of English law. The third part will use the results of the comparative analysis to explain the widespread use of English law by the shareholders of Russian companies. Finally, the results of the analysis will be used to define a general framework that can be used by Russian courts to interpret the new provisions on SAs introduced in the Law on JSCs and the Law on LLCs.

[5] *Vedomosti* (by Dmitry Afanasiev), 'Sovereignty on 10%', June 27, 2012 (*in Russian*). *See also* Hiroshi Oda, 'Shareholders' Agreements in Russia' (2010) 21 INT'L CO. & COMMERC. L. REV. 359.

II. THE RISE OF SHAREHOLDERS' AGREEMENTS IN RUSSIAN CORPORATE PRACTICE

SAs are one of the most famous 'private legal transplants' in Russian corporate practice. They were borrowed by private actors from foreign practice[6] and used without special legal regulation and case law.[7] However, the judgments of the courts in *Megafon* case, which involved the first SA dealt by Russian courts, rang a bell for Russian companies, shareholders and their consultants. The courts declared the agreement between the major shareholders of Russian mobile operator *Megafon* void.[8] In its resolution the Federal Commercial Court of West-Siberian Region stated that agreements between shareholders cannot contradict the national legislation and the founding documents (articles of association) of companies.

In particular, the courts declared void the clauses of the SA that did not comply with the mandatory rules of the Law on JSCs, such as the clauses changing the terms for convening general and extraordinary meetings of shareholders, the terms of notification about general meetings, requirements on the quorum for general meetings, the questions that are the exceptional competence of the general meeting of shareholders, the rules of electing board members and managers, the clauses restricting voting rights on the general meetings of shareholders, the clauses establishing pre-emption rights for buying shares in an open joint-stock company, as well as non-competition clauses imposing obligations for the shareholders.[9]

In fact, the only provision of SAs which did not cause significant problems with regard to legality, was voting agreements.[10] However, these clauses were considered as not effective on the enforcement stage. According to Art. 49 of the Law on JSCs, a resolution of the general meeting of shareholders can be disputed, if the resolution has been adopted with the violation of legal rules and the company's articles of association. Therefore, breaching obligations enshrined in an SA cannot be a legal ground for overturning the resolution of the general meeting of shareholders. Enforceability of specific performance of obligations (court injunction to vote in specific way) was not available as well. The only available remedies in such cases could be found in the law on obligations, namely by claiming damages or penalties.[11]

As a general response to the problems with the legality and enforceability of SAs, Russian corporate practice shifted to the laws of foreign jurisdictions. To avoid international private law

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[6] *See e.g.*, Igor Ostapets & Aleksei Konovalov, 'Shareholders' Agreements in the Practice of Joint Ventures with Russian Participation' (2006:1-2) SLIYANIYA I POGLOSCHENIYA 50 (*in Russian*).

[7] *See e.g.*, Iliya Nikiforov & Iliya Bulgakov, 'Shareholders' Agreements in Russian Practice: Is There an Alternative?' (2006:11) KORPORATIVNIY YURIST 27 (*in Russian*).

[8] Resolution of the Federal Commercial Court of West-Siberian Region of March 31, 2006, No. F04-2109/2005(14105-A75-11), F04-2109/2005(15210-A75-11), F04-2109/2005(15015-A75-11), F04-2109/2005(14744-A75-11), F04-2109/2005(14785-A75-11). The cassation court by its resolution upheld the judgments of the lower first instance and appellate courts. The judgments were not reviewed by the Supreme Commercial Court of the Russian Federation.

[9] *Ibid.*

[10] Ostapets & Konovalov, 'Shareholders' Agreements in the Practice of Joint Ventures with Russian Participation' (2006:1-2) SLIYANIYA I POGLOSCHENIYA 50, 51; Nikiforov & Bulgakov, 'Shareholders' Agreements in Russian Practice: Is There an Alternative?' (2006:11) KORPORATIVNIY YURIST 27, 28.

[11] In fact, the last two remedies could be ineffective as well. Damage claims are encountered with practical difficulties of proving the size of damages, while penalty clauses usually were enforced by courts in a decreased amount. For more detail on penalty clauses *see infra* notes 102-109 and accompanying text.

restrictions on the *lex societatis* and public policy concerns in Russian courts,[12] instead of governing shareholders' agreements of Russian companies by foreign law, shareholders usually established special purpose vehicles in foreign jurisdictions and entered into agreements at the level of these foreign entities (usually under English law)[13]. Foreign legal entities were acting as an additional layer between beneficiary shareholders and Russian companies, holding the shares of the latter.

To cope with the developments in corporate practice the legislator decided to act[14] and the Law on JSCs was amended in June 2009.[15] According to the amendments (Art. 32.1(1)), an SA is an agreement concerning the exercise of rights certified by shares, and/or concerning special rules of exercising rights over the shares.[16] By this agreement parties are bound to exercise rights certified by the shares and/or rights to the shares in a specific manner, and/or refrain from the exercise of such rights. Then the paragraph continues by listing the scope of an agreement, indicating that shareholders' agreements may provide for the obligation of the parties to:

- vote in a certain way at the general meeting of shareholders;
- agree on a variant of voting with other shareholders;
- acquire or dispose of shares at a pre-determined price and/or with occurrence of a certain event;
- refrain from disposing of shares until the occurrence of a certain event;

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[12] In *Megafon* case the Federal Commercial Court of West-Siberian Region refused to enforce the shareholders' agreement by referring, *inter alia*, to Art. 1202 (relations of a legal entity with its participants shall be regulated by the law applicable to the legal entity) and Art. 1193 (foreign law rules chosen by parties shall not be applied, if the consequences of their application would obviously contradict the public policy of the Russian Federation) of the Civil Code of the Russian Federation (Resolution of the Federal Commercial Court of West-Siberian Region of March 31, 2006).

[13] *See e.g.*, Ostapets & Konovalov, 'Shareholders' Agreements in the Practice of Joint Ventures with Russian Participation' (2006:1-2) SLIYANIYA I POGLOSCHENIYA 50, 54. Using foreign law for governing transactions with underlying Russian assets is not limited to SAs only. In an article on law and globalization *The Economist* indirectly pointed to the phenomenon of applying foreign law by two companies from the same country by stating that a global lawyer's work, among other things, can include *"writing a contract under English law between two companies in Russia"* (*The Economist*, 'Not entirely free, your honour', July 31, 2010.). Even state controlled companies and banks in Russia acknowledge that their important agreements are governed by foreign law and disputes are considered by foreign courts (*Vedomosti* (by Dmitriy Kazmin & Philip Sterkin), 'Lawyers are losing the market', Januray 27, 2011 (*in Russian*).). *The Financial Times* speculates that more than half of cases in the commercial division of the London's High Court are related to Russia or other former Soviet republics (*Financial Times* (by Catherine Belton, Caroline Binham & Neil Buckley), 'Oligarchs in London', October 8, 2011.). One of the leading Russian corporate law practitioners (Andrei Goltsblat of *Goltsblat BLP*) recently in his blog described Russia as a state of law where *"English law and Stockholm arbitration are triumphed"*.

[14] In the U.S., although SAs are practiced in close corporations, the development of case law started with hostile attitude towards such agreements by courts (Harwell Wells, 'The Rise of the Close Corporation and the Making of Corporation Law' (2008) 5 BERKELEY BUS. L. J. 263, 297-304.). Apparently, in 'following' countries unenforceability of popular contractual mechanisms is more likely to result in legislative changes, as private party pressure, regulatory competition and the fact that such mechanisms have been at least tested in other jurisdictions make a strong case for action by legislatures.

[15] Federal Law of the Russian Federation No. 115-FZ of June 3, 2009 on Amending the Federal Law on Joint Stock Companies and Article 30 of the Federal Law on Securities Market. For more details on the history of the legal reform *see* Oda, 'Shareholders' Agreements in Russia' (2010) 21 INT'L CO. & COMMERC. L. REV. 359, 361-4.

[16] Rights over shares are related with the transfer of shares (purchase, sale, assignment of shares, other property rights), while rights certified by shares are those rights which are derived from the shares and can be exercised by their holders (for instance, voting rights, dividend rights, information rights).

- carry out in an agreed manner other activities related to the management of the company, its business, reorganization, and liquidation.

The article sets two important limitations on SAs. First, SAs cannot bind its parties to vote according to the indications of the managing bodies of a company, whose shares are concerned by the agreement (Art. 32.1(2)). And second, an SA is binding only for its parties (Art. 32.1(4)). The latter has two implications as well: agreements with third parties which result in the breaches of an SA cannot be declared void on a mere ground of breaching the SA;[17] and a breach of an SA cannot serve as a ground for invalidating the decisions and resolutions of the governing bodies of the company.

Further, the amendments provide that SAs can define measures for securing the fulfillment of the obligations, and civil law remedies for non-performance or improper performance of the obligations.[18] Such remedies can be compensation of damages, penalty clauses, payment of a compensation for breaching an SA (in a fixed amount or in an amount which shall be defined according to an SA)[19], as well as other remedies available in contract law (such as actions concerning the validity of contracts and contract termination).[20] Another measure aimed at strengthening the effectiveness of contractual arrangements of shareholders is conditional share buy-sell clauses.

Shortly before the amendments of the Law on JSCs, the legislature introduced to the Law on LLCs almost similar rules on the agreements between the participants of limited liability companies. Art. 8(3) of the Law on LLCs contains only general information about the issues that can be included in the SAs of the participants of LLCs. In contrast to the amendments to the Law on JSCs, it does not specify further limits for the agreements, nor does it provide any guidelines for the enforcement of SAs. The wording of Art. 8(1) is almost similar to the definition of SAs contained in Art. 32.1(1) of the Law on JSCs.[21] This abstract wording in effect serves the aim of confirming the legality of SAs in principle, and leaves much room for future judicial interpretation.

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[17] The only exclusion when courts can invalidate agreements with third parties is when the third party was aware or should have been fully aware about the limitations set by the SA. Such claims can be brought by the interested parties of the SA. The plaintiff also bears the burden of proof, which significantly complicates court action, as SAs are – as a matter of practice – generally confidential. Courts have to define a practice when third parties can be deemed to be aware about the provisions of a confidential SA.

[18] Art. 32.1(7), Law on JSCs.

[19] Art. 32.1(7) of the Law on JSCs does not use the term "liquidated damages" due to the principle of full compensation of damages of Russian civil law. However, the offered remedy of compensation probably will serve as the functional equivalent of liquidated damages in Russian law, allowing the parties of SAs to make a choice between the specific performance of their obligations and the payment of compensation/damages.

[20] Due to differences in English and Russian contract law the list of remedies in several cases does not overlap. English law offers such remedies as injunctions, specific performance, damages, rescission (and damages) for misrepresentation or a breach of a fundamental term of the SA, termination.

[21] *See above* note 16 and accompanying text. For a brief description of Art. 8(1) and its legislative history *see* Oda, 'Shareholders' Agreements in Russia' (2010) 21 INT'L CO. & COMMERC. L. REV. 359, 362-3.

III. Comparative Analysis of the Enforceability of the Provisions of Shareholders' Agreements under Russian and English Law

The issues raised in Russian scarce case law on SAs[22] and in scholarly legal articles on the use of SAs in Russia[23] allow singling out the following 'controversial' issues with regard to the enforcement of SAs:

- non-compliance of the terms of SAs with mandatory laws and the provisions of the internal documents of companies (company by-laws);
- the effect of breaches of SAs on company decisions (resolutions) and on transactions with third parties;
- the right of a company to be a party in an SA between its shareholders;
- claiming specific performance of an SA in court/using court injunctions for the specific performance of SAs.

In the remaining of this section these questions are used as a basis for the comparative analysis of English and Russian law on SAs.

1. Contradictions between Mandatory Laws and Company By-laws, and Shareholders' Agreements

Russian case law on SAs is clear on the priority of mandatory legal rules and the provisions of the articles of association over SAs. Those provisions of SAs which do not comply with mandatory legal requirements and are in conflict with the provisions of the articles of

[22] Resolution of the Federal Commercial Court of West-Siberian Region of March 31, 2006 (declaring illegal the provisions of the SA deviating from mandatory rules of the Law on JSCs and company by-laws); Decision of the Commercial Court of Moscow of December 26, 2006, No. A40-62048/06-81-343 (the SA was considered void, as its provisions were in contradiction with mandatory rules of the Civil Code, the Law on JSCs and the provisions of the articles of association of the company; the court also stated that the provision of the agreement establishing its priority over the articles of association was illegal); Decision of the Commercial Court of Moscow of March 13, 2008, No. A40-68771/07-81-413 (a mandatory statutory rule cannot be altered by the agreement of shareholders; although the defendant also raised the question of relations between the SA and the articles of association, the court refrained from expressing its position on the issue).

[23] *See e.g.*, Ostapets & Konovalov, 'Shareholders' Agreements in the Practice of Joint Ventures with Russian Participation' (2006:1-2) Sliyaniya i pogloscheniya 50, 51, 54 (for the contradictions between mandatory rules and the provisions of SAs, the availability of specific performance of the agreements and default event clauses, and the effect of the breaches of SAs on corporate acts); Evgeny Levinsky, 'Use of a Shareholder Agreement Model in Russia' (2006:10) Zakon 123, 128-9 (*in Russian*) and Alexander Ivanov & Nadezhda Lebedeva, 'Shareholders' Agreements: A Step Forward or Running in Place?' (2008:9) Korporativniy yurist 50, 51-3 (*in Russian*) (explaining the impossibility of specific performance of SAs according to Russian law and showing the limits of penalty clauses); Oda, 'Shareholders' Agreements in Russia' (2010) 21 Int'l Co. & Commerc. L. Rev. 359, 364, 366-8 (with regard to the disposal and acquisition of shares as a means to secure obligations arising out of an SA, the participation of the company itself in the SA, the enforceability of an SA against the company, the effect of the breach of an SA on transactions with third parties and on the decisions of corporate bodies, the availability of specific performance of SAs); Dmitry Stepanov, 'LLC Shareholders Agreement' (2010:12) Review of the Supreme Commercial Court of the Russian Federation 65, 66-74, 78-9, 87, 90 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1752471> (*in Russian*) (discussing the contradictions between SAs on the one hand and statutory rules and articles of association on the other, participation of the company in its shareholders' agreement, specific performance of SAs, possible results of breaching an SA on corporate acts and transactions with third parties).

association are void, and thus do not create any legal consequences. In *Megafon* case the court listed all mandatory provisions of the Law on JSCs and the provisions of the articles of association of *Megafon OJSC* that were in conflict with the SA – such as quorum rules for general and extraordinary shareholder meetings and board of directors, rules on notification of shareholders, cumulative voting rules for the formation of the board, rules on the election of the board chairman, rules on the exclusive competence of the meeting of shareholders and board.[24] Similar approach was adopted by the Commercial Court of Moscow in *Russian Standard Insurance* case.[25]

This approach was confirmed by the courts in a simulated dispute involving an SA between the participants of an LLC.[26] The Commercial Court of Moscow confirmed the priority of mandatory legal rules and articles of association over the provisions of SAs by stating that an agreement serves the aim of providing more details with regard to the allocation of the rights of the participants of LLCs (rather than substitute the articles of association of the company).[27]

The priority of mandatory rules over the provisions of shareholders' agreements in Russian law is also supported in legal scholarship published after the introduction of the rules on shareholders' agreements into the Law on JSCs.[28]

The relation between the articles of association and an SA is a controversial issue in English law too. The usual recommendation of legal advisers is to adjust the provisions of the articles of association with the provisions of an SA.[29] Sometimes SAs provide for the obligation of the parties to amend the articles of association in line with the provisions of the agreement. In such cases SAs in effect describe in more detail the mechanisms of the realization of the rights and liabilities provided in the company's articles. These detailed provisions are less vulnerable from the perspective of their enforcement in courts. Moreover, in addition to contractual remedies

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[24] Resolution of the Federal Commercial Court of West-Siberian Region of March 31, 2006.

[25] Decision of the Commercial Court of Moscow of December 26, 2006 (in contravention of the statute and the articles of association of the insurance company, the SA, for instance, provided for different number of the board members, differing procedures for the appointment of the company CEO and the election of the board members).

[26] The dispute between the participants of *Verniy Znak LLC* was simulated by legal practitioners in order to clarify the position of courts on the amendments on SAs. The participants of the LLC entered into an SA and included in it provisions which were in contradiction with the statute and the by-laws of the company. In particular, the parties tested the possibility of the participation of the company in the agreement, restricting the right to sell shares, depriving a party of voting rights as a result of breaching the agreement (*Vedomosti* (by Yuliya Govorun & Philip Sterkin), 'An Experiment for the Precedent', March 3, 2010 (*in Russian*); Dmitry Dmitriev, 'A Relevant Example of Disputing An LLC Shareholders' Agreement' (2010:1-2) SLIYANIYA I POGLOSCHENIYA 66 (*in Russian*).).

[27] Decision of the Commercial Court of Moscow of November 24, 2010, No. A40-140918/09-132-894. The position of the trial court was confirmed by the appellate court (Resolution of the Ninth Appellate Commercial Court of February 17, 2011, No. A40-140918/09-132-894.). The cassation court, however, pointed only to the inconsistencies of the agreement with mandatory statutory rules (Resolution of the Federal Commercial Court of Moscow Region of May 30, 2011, No. A40-140918/09-132-894.). The Supreme Commercial Court refused to consider the case.

[28] *See e.g.*, Igor Korneev & Victoria Arutyunyan, 'Shareholders' agreement: Execution, Content and Performance' (2010:1) KORPORATIVNIY YURIST 32, 33 (*in Russian*).

[29] *See e.g.*, Christopher Rose, 'Don't be the Second Little Pig' (2007, October) INT'L FIN. L. REV. 32, 33. The main benefit of the integration of the provisions of an SA into the articles of association is that while a breach of an SA entitles to contractual remedies, a breach of the company's articles can be a ground for the invalidation of the action itself. At the same time this strategy encounters with informational disadvantages, as SAs usually are confidential, while the company's articles are available for the public.

they entitle to using corporate law remedies – such as the invalidation of corporate resolutions. Some agreements also establish their precedence for the shareholders over the articles of association.

An example of a case where the court gave priority to the contractual obligations over the articles of association is *British Murac Syndicate Ltd. v Alperton Rubber Company Ltd*.[30] According to the agreement between the plaintiff and the defendant, as long as the plaintiff held a certain number of shares in the defendant, it would have the right to appoint two directors. Similar provision was included in the articles of association of the defendant company. After the defendant refused to accept the nomination by the plaintiff and intended to alter the articles to remove the right of nomination, the court granted an injunction to restrain the alteration of the articles of association for the purpose of committing the breach of the contractual obligations.[31]

Later cases in effect changed this approach – in *Southern Foundries (1926) Ltd. v Shirlaw* the court held that alterations of the articles of association did not constitute a breach of contractual obligations of the company, but the exercise of the power under the altered articles, in contravention of the terms of the contractual obligations, did constitute a breach. Therefore, no injunction could be granted to prevent the alteration of the articles of association.[32] This approach implied that by its contractual obligations a company did not undertake to refrain from altering its articles, but rather to pay damages in a case the articles were altered. The articles of association were entrenched indirectly by placing a financial premium on their alteration.[33]

However, in *Russell v Northern Bank Development Corporation Ltd.* the House of Lords established a different rule. Any contractual obligation undertaken by a company not to alter its articles is invalid.[34] As the House of Lord did not make any reference to the *dicta* in *Southern Foundries (1926) Ltd. v Shirlaw*, it can be presumed that the case is overruled.[35] Yet, the House of Lords distinguished between the agreements between the company and the shareholders on the one hand, and the agreement between the shareholders on the other. In opposition to a direct undertaking by a company not to alter its articles, the court established the validity of personal contractual obligations of shareholders that can in effect prevent alterations of the articles of association – like the agreement of shareholders to vote unanimously for such alterations.[36] Hence, contradictions between the provisions of SAs and articles of associations do not invalidate the former, and at least lead to the obligation of a defaulting party to indemnify damages.

Case law on the relation between SAs and mandatory statutory provisions is clearer. The rules on the duties of company directors who also own the shares of the company demonstrate this relation. Contractual arrangements of such shareholders (directors) cannot fetter their

[30] [1915] 2 Ch. 186.
[31] [1915] 2 Ch. 186, 193-5.
[32] [1940] A.C. 701, 740-1. This approach was followed in *Cumbrian Newspapers Group Ltd. v Cumberland & Westmorland Herald Newspaper & Printing Co. Ltd.* ([1987] 1 Ch. 1, 24.).
[33] Clare M.S. McGlynn, 'The Constitution of the Company: Mandatory Statutory Provisions v Private Agreements' (1994) 10 COMP. LAW. 301, 302.
[34] [1992] 1 W.L.R. 588, 593.
[35] McGlynn, 'The Constitution of the Company: Mandatory Statutory Provisions v Private Agreements' (1994) 10 COMP. LAW. 301, 303.
[36] [1992] 1 W.L.R. 588, 594-5.

statutory general duties in the capacity of the company directors (*e.g.* duty to promote the success of the company, duty to exercise independent judgment).[37] In *Kregor v Hollins* the court established a rule that directors must not fetter their discretion (independent judgment).[38] For example, a director cannot agree in an SA to vote in a particular way in the interests of a creditor or other shareholder.

The priority of mandatory statutory rules over the provisions of SAs also follows from the long established principle in case law, which prescribes a company to forgo its statutory right to alter its articles of association. Any provision that limits the power of a company to alter its articles is invalid on the ground that it is contrary to the statute.[39]

Voting agreements can be viewed as exceptions which actually can alter statutory provisions on the required minimum voting thresholds. Common law acknowledges the freedom of shareholders to enter into contracts that prescribe the way they will exercise their votes.[40] At the same time the law bans provisions in the articles of association that restrict the company's statutory power to alter the articles or its share capital by a special resolution. For instance, the articles cannot provide for a unanimous vote by shareholders in such cases, as special resolutions require only 75% majority vote.[41] As is shown below in more details, the court banned a company to participate in an alternative undertaking (outside the articles of association) with a similar effect as well. However, the court refused to invalidate the agreement as regard to the shareholders of the company.[42]

Due to the subtle distinction established in *Russell*, the similar effect can be achieved by the means of an SA which does not include the company as a party. For instance, the agreement between shareholders to vote unanimously for a resolution to change the articles of association is a substitute mechanism which prevents the company from changing its articles of association by the statutory 75% majority voting requirement. In other words, the provisions of the statute on altering the company's articles with special resolution were considered as mandatory with respect to the company's obligations. But the same provisions were treated as enabling with regard to the personal undertakings of shareholders.[43]

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[37] Companies Act 2006, s. 170-177.

[38] *Kregor v Hollins* [1913] 109 L.T. 225, 228 (if a director has to promote the interests of a shareholder who nominated him, rather than the interests of the whole body of shareholders which are in conflict, then the agreement is unlawful). The standard was softened in *Fulham Football Club Ltd. v Cabra Estates plc* – directors can bind themselves to act in a particular manner in the future, if they properly, in the exercise of their discretion, enter into contractual arrangements that as a whole are for the substantial benefit of the company ([1992] B.C.C. 863, 876.).

[39] *Walker v London Tramways* [1879] 12 Ch.D. 705; *Allen v Gold Reefs of West Africa Ltd.* [1900] 1 Ch. 656, 671; *Southern Foundries (1926) Ltd. v Shirlaw* [1940] A.C. 701, 739.

[40] Eilis Ferran, 'The Decision of the House of Lords in Russell v. Northern Bank Development Corporation Limited' (1994) 53 CAMBRIDGE L. J. 343, 345 (with references to case law). Judge Judson of the Supreme Court of Canada acknowledged that voting arrangements are *"not prohibited either by law, by good morals or public order"* (*Ringuet et al. v Bergeron* [1960] S.C.R. 672, 684.).

[41] Companies Act 2006, s. 283.

[42] *See infra* the discussion of *Russell v Northern Bank Development Corporation Ltd*.

[43] Peter Jaffey, 'Contractual Obligations of the Company in General Meeting' (1996) 16 LEGAL STUD. 27, 35. McGlynn analyzed the judgment of the House of Lords within the framework of contractual freedom in corporate law and state interference. The court attempted to balance both approaches – *"on the one hand upholding the statutory power, on the other validating the shareholders' agreement"* (McGlynn, 'The

However, the claim that voting agreements can alter mandatory statutory rules is probably too ambitious. Before *Russell* courts acknowledged the possibility of altering voting threshold requirements also by the articles of association of small 'partnership-like' companies. In *Bushell v Faith* the House of Lords considered valid a provision of the articles of association which in effect prevented the removal of a director without his consent, although statutory rules provided for the right of a company to remove a director by a simple majority vote, "*notwithstanding anything in its articles*" (Companies Act 1948, s. 184).[44] The decision of the court was based on the reasoning that the Companies Act specified the type of the resolution required (ordinary resolution), yet companies and shareholders are free in allocating voting rights for such resolutions.[45] Therefore, in the light of *Bushell v Faith* the definition of required voting thresholds for specific matters by SAs is interference in the provisions of the articles of association, rather than in statutory provisions.[46]

To ensure consistent approach in relations between the provisions of SAs and the articles of association a disclosure requirement has been introduced by the Companies Act 2006.[47] When the provisions of an SA in effect materially change the company's governance and affect statutory rules and the provisions of the articles of association (on voting, appointment of directors, transfer of shares, etc.) the agreement requires disclosure.[48] Sections 17 and 29 of the Companies Act 2006 regard such agreements as a company's constitution (on a par with the company's articles) and require their submission to the registrar (Companies House). In particular, the following agreements between shareholders require disclosure:

a) agreements between all shareholders of a company which have an effect that, if not so agreed to, would require a passage of a special resolution (for instance, agreements that effectively alter the articles of association);
b) agreements between all shareholders of a class of shares of a company which have an effect that, if not so agreed to, would require voting by a particular majority;

Constitution of the Company: Mandatory Statutory Provisions v Private Agreements' (1994) 10 COMP. LAW. 301, 303-4, 306.).

[44] *Bushell v Faith* [1970] A.C. 1099.

[45] [1970] A.C. 1099, 1110-1. The same reasoning was used by the Court of Appeal (*Bushell v Faith* [1969] 2 Ch. 438, 448.). The position of the courts in *Bushell v Faith* is highly criticized in scholarly literature (Ferran, 'The Decision of the House of Lords in Russell v. Northern Bank Development Corporation Limited' (1994) 53 CAMBRIDGE L. J. 343, 346-7 (with references to the scholarly literature).).

[46] At the same time, it should be admitted that *Bushell v Faith* and *Russell* contain contradictory implications, as the first tolerates distinctions from statutory powers in the company's articles of small businesses, while the second allows such distinctions only as a personal agreement of shareholders which does not involve the company itself. In *Russell* the court assumed the mandatory nature of the statutory provisions and refrained from discussing the possible extent of their enabling nature. For the discussion of the nature of the provisions of the Companies Act on the alterations of the articles of association (mandatory or enabling) *see* Peter Jaffey, 'Restraining the Exercise of Corporate Statutory Powers' (1994) 9 DENNING L. J. 67, 68-77.

[47] It is worth mentioning that a liberal view in English scholarship arguing for maximum contractual freedom in SAs (including with regard to the participation of the company in its shareholders' agreement) criticized the decision in *Russell* as well. However, in accord with liberal views the solution was seen in lifting the restrictions set on companies to bind themselves by their shareholders' agreements (Ferran, 'The Decision of the House of Lords in Russell v. Northern Bank Development Corporation Limited' (1994) 53 CAMBRIDGE L. J. 343, 362.).

[48] Mads Andenæs & Junko Ueda, 'Shareholders' Agreements: Some EU and English Law Perspectives' (2007:3) TSUKUBA L. J. 135, 137.

c) any agreement that effectively binds all shareholders of a class of shares though not agreed to by all those shareholders.[49]

A provision of an SA providing for its precedence over the articles of association can be considered as changing the nature of the agreement, and hence will trigger the requirement of its disclosure.

In conclusion, both Russian and English law are clear on the priority of mandatory statutory rules over the provisions of SAs. With regard to the relation between the company by-laws and SAs, Russian law has the same approach: in case of conflicts the provisions of SAs are void. In contrary to this, in English law the conflicts between the company articles and SAs do not invalidate the latter. But such conflicts – more particularly in cases where they have external effects for non-participating shareholders and/or third parties – in effect change the status of SAs by rendering them into a company constitution and leading to their registration and disclosure.

2. External Effects of a Breach of Shareholders' Agreements

As mentioned above, the amendments of Russian law directly rule out any effect of breaches of SAs on the decisions and resolutions of the corporate bodies of the involved company, as well as on the transactions with third parties.[50] The restrictions follow from the clear demarcation between the contractual relations of the parties to an SA and the relations of a shareholder with a company. They can be explained by the aim of limiting the external effects of SAs given their confidential nature. The provisions of SAs in general do not create effects for non-participating shareholders, for the company itself, its contractors, and personal creditors of shareholders. To create such external effects, similar provisions should be included in the articles of association.

In English law the analysis of SAs within the contractual context shows that unlike the articles of association,[51] SAs create personal obligations between their immediate parties only. They do not become a 'constitution' of the company (in analogy with the articles of association), and they are not binding on the transferees of the parties to it or upon new or non-assenting shareholders.[52] Similarly, the contractual nature of SAs implies that such agreements do not affect transactions with third parties and company resolutions.

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[49] Companies Act 2006, s. 29(1). The interpretation of Section 29 by the courts can be broader and might require the disclosure of SAs in other cases as well (Anna Ovcharova & Ekaterina Sjostrand, 'Law and Practice of Shareholders Agreements under Russian and English Law: Comparative Analysis' (2009:12) SLIYANIYA I POGLOSCHENIYA 68, 73 (*in Russian*).).

[50] *See above* note 17 and accompanying text.

[51] English law treats the articles of association as a contract between the company and a member in respect of her rights and liabilities as a shareholder. However, it is a matter of debate whether this 'contract' extends to the relations between shareholders. While the older authorities support the view that the rights and liabilities of shareholders as shareholders may be enforced by or against the shareholders only through the company, more recent authorities support the direct enforcement of the articles of associations by shareholders against other shareholders (Andenæs & Ueda, 'Shareholders' Agreements: Some EU and English Law Perspectives' (2007:3) TSUKUBA L. J. 135, 138-9.).

[52] Andenæs & Ueda, 'Shareholders' Agreements: Some EU and English Law Perspectives' (2007:3) TSUKUBA L. J. 135, 138-40; Len Sealy & Sarah Worthington, *Cases and Materials in Company Law* (8th edn, OUP 2008) 230.

Few exceptions are possible when SAs exceed the bounds of the contractual context, the main one being the unanimous shareholders' agreements in private limited companies.[53] Case law equated unanimous informal agreements of all shareholders with a resolution of a general meeting.[54] The requirement of disclosure of unanimous SAs of the Companies Act 2006 renders them into a company's constitution.[55] In these cases it comes without any surprise that SAs create external effects for companies' acts and third party transactions. For instance, an action breaching a company's constitution, such as a transfer of shares to a third party in breach of restrictions, is invalid.

To sum up, both Russian and English law set strict limits on the external effects of SAs, conditioning such effects on the availability of information. But Russian law permits external effects of SAs for third party transactions only, while English law makes a step further allowing external effects for company resolutions as well. At the same time, possible effects of SAs on company resolutions in Russian law should not be ruled out, as the courts still have to express their opinion on this matter, more particularly in the context of unanimous agreements between all shareholders.

3. Parties of Shareholders' Agreements

In the draft version the amendments to the Law on JSCs with regard to SAs were clear that the company itself cannot participate in an SA concerning its shares.[56] The question is important, as the participation of the company in its shareholders' agreement strengthens the enforceability of such agreements against the company. Hence, a breach of the agreement can affect corporate acts and also indirectly third parties.

Although in the current version Art. 32.1 of the Law on JSCs does not explicitly ban such participation, legal scholars are not unanimous in their opinions. According to one approach, the interpretation of the article does not allow the company in relation to whose shares an SA is to be concluded to become a party to it.[57]

An opposite opinion offers broader list of the participants of SAs. In the absence of an explicit legal ban, there are no grounds for refusing other parties, such as a portfolio manager, a nominal holder of shares, the company itself and future shareholders, to participate in SAs.[58] However, it should be noted, that the proponents of this approach admit that the rights and obligations of the company under the shareholders' agreement should be limited (for instance, the company

[53] The use of unanimous shareholders agreements is practically impossible in listed companies with the large number of shareholders.
[54] Mathias M. Siems, *Convergence in Shareholder Law* (CUP 2008) 54-5.
[55] For the limited cases when SAs should be disclosed and acquire the status of a company's constitution *see above* notes 47-49 and accompanying text.
[56] Oda, 'Shareholders' Agreements in Russia' (2010) 21 INT'L CO. & COMMERC. L. REV. 359, 362.
[57] Dmitry Lomakin, 'Agreements on the Performance of the Rights of the Participants of Commercial Organizations as a Novel of Corporate Legislation' (2009:8) REVIEW OF THE SUPREME COMMERCIAL COURT OF THE RUSSIAN FEDERATION 6, 15 (*in Russian*); Oda, 'Shareholders' Agreements in Russia' (2010) 21 INT'L CO. & COMMERC. L. REV. 359, 366.
[58] Alexander Kudelin, 'Shareholders' Agreements under Russian Law' (Part I) (2009:10) KORPORATIVNIY YURIST 23, 24 (*in Russian*). *See also* Korneev & Arutyunyan, 'Shareholders' agreement: Execution, Content and Performance' (2010:1) KORPORATIVNIY YURIST 32, 33-4 (with regard to the participation of the holders of the rights on pledged shares, portfolio managers, holders of depository receipts, other third parties (future shareholders) and the company in SAs; although admitting that court practice might deny the enforcement of SAs with regard to the rights of third parties and non-direct (beneficiary) shareholders).

can be bound by the terms on the assignment of the shares owned by it, but it cannot participate in voting agreements[59] and cannot affect such agreements[60]). Moreover, the company should not be obliged to perform a decision made by the shareholders according to the agreement, if such decision is made in contradiction to the provisions of the company by-laws.[61] Apparently, this view allows the participation of the company in its shareholders' agreement as an owner of its own shares, rather than as an issuer of the shares. This restriction logically (from the perspective of Art. 32.1 of the Law on JSCs) and rationally limits the effect of the enforcement of an SA on company decisions and resolutions and on relations with third parties.

In English law the question of the possibility of the participation of a company in its shareholders' agreement does not raise doubts. However, common law has developed restrictive standards for such participation. One of the landmark cases is *Russell v Northern Bank Development Corporation Ltd.* The SA between the all shareholders of *Tyrone Brick Ltd.* and the company itself provided that further share capital can be issued only by the written consent of each party to the agreement. Further, the agreement established that its terms should have precedence between the shareholders over the articles of association of *Tyrone Brick Ltd.*[62] The House of Lords decided that a company cannot be party to an SA which restricts its statutory powers; however, an agreement between the shareholders with the same effect is not invalid and can be enforced by courts.[63] In other words, if the company participates in its shareholders' agreement and the agreement sets limits on the statutory powers of the company, it is considered no more than a personal voting agreement between the shareholders. In its argumentation the court, *inter alia*, relied on possible effects of such agreements on future shareholders. In *Russell* the agreement between the shareholders was permitted, as it was *"purely personal to the shareholders who executed it and … does not purport to bind future shareholders."*[64] Another important argument for permitting the personal agreement between shareholders from the perspective of economic analysis, which was not mentioned in the reasoning by the court, is that the SA of *Tyrone Brick Ltd.* included all shareholders.

Under the Companies Act 2006, a similar provision in an SA[65] will render the agreement to the company's constitution, and will trigger the requirement of its disclosure.[66] This consequence is true even if a company does not participate in the agreement. Therefore, possible conflicts of interests between the involved parties (current and future shareholders, in particular) are mitigated.

The analysis of the law in both jurisdictions shows that sound reasons exist for limiting the scope of the participation of the company in its shareholders' agreement. The restrictions have

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[59] According to Art. 72(3) of the Law on JSCs and Art. 24(1) of the Law on LLCs, in cases of owning their own shares, companies cannot vote by it.

[60] As mentioned above, Art. 32.1(2) denies the obligations of the shareholders to vote in accordance with the instructions of the bodies of the company of legal effect.

[61] Kudelin, 'Shareholders' Agreements under Russian Law' (Part I) (2009:10) KORPORATIVNIY YURIST 23, 25-6. Similarly, most of the obligations of future shareholders should be conditional and should be performed only after a party formally becomes a shareholder (*ibid.*, 26.).

[62] *Russell v Northern Bank Development Corporation Ltd.* [1992] 1 W.L.R. 588, 590.

[63] [1992] 1 W.L.R. 588, 593.

[64] [1992] 1 W.L.R. 588, 594.

[65] The SA of *Tyrone Brick Ltd.* provided that *"[n]o further share capital shall be created or issued in the company … without the written consent of each of the parties hereto"* ([1992] 1 W.L.R. 588, 590.).

[66] Companies Act 2006, s. 29. *See also above* notes 47-49 and accompanying text.

been materialized in English law. Due to the absence of court practice, Russian law is unclear not only on the scope of the restrictions, but also on the possibility of the company's participation in its shareholders' agreement in general. However, as the law does not directly restrict such participation, court practice will probably allow it subject to several restrictions.

4. Availability of Specific Performance of Shareholders' Agreements

According to legal scholarship, Russian law does not allow specific performance of SAs. Legal theory explains this limitation by the non-proprietary nature of the most of the rights and obligations included in SAs.[67] In addition, courts cannot anticipate possible breaches of SAs and require performance in line with contractual obligations in advance, for instance, by forcing shareholders to vote in a specific way. Only infringed rights are subject to legal defense.[68] This categorical view can be explained by the narrow limitation of the notion of specific performance and its equation with court injunctions.

Scholarly literature contains an opposite view, according to which specific performance of SAs (more specifically injunctions) in Russia is theoretically possible (based on the interpretation of Article 32.1 of the Law on JSCs; however, not confirmed by the case law yet) in limited cases. In particular, when the general meeting of shareholders approves a large deal in the infringement of the SA (shareholders agreed to vote against, but one of them voted for the approval of the deal), a court can issue an injunction addressed to the defaulting shareholder to vote in a specific way on a following general meeting of shareholders, which can be convened to reverse the resolution. However, this is possible as long as the large transaction is not performed yet at the time of the second meeting.[69]

The view on the unavailability of specific performance for all provisions of SAs is also questioned by Korneev and Arutyunyan. For instance, there are no reasonable explanations for denying specific performance in the case of conditional terms on selling shares. According to Art. 396(2) of Russian Civil Code, compensation for losses and payment of a penalty for non-performance of an obligation shall free a party from specific performance of the obligation, unless otherwise provided by a statute or contract. Thus, parties of an SA should be entitled to provide in the agreement that the application of liability measures does not free the defaulting party from the specific performance of her obligations (for instance, the transfer of shares under certain conditions).[70]

In the U.K. specific performance is available only when the nature of relations makes the remedy appropriate. Voting agreements are an example of such contractual relations. English common law allows granting negative/prohibitive injunctions binding shareholders to restrain from voting on a general meeting for particular resolutions.[71] Courts can also grant mandatory

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[67] Levinsky, 'Use of a Shareholder Agreement Model in Russia' (2006:10) ZAKON 123, 128-9.
[68] Ivanov & Lebedeva, 'Shareholders' Agreements: A Step Forward or Running in Place?' (2008:9) KORPORATIVNIY YURIST 50, 51-2.
[69] Alexander Kudelin, 'Shareholders' Agreements under Russian Law' (Part II) (2009:11) KORPORATIVNIY YURIST 7, 8 (*in Russian*).
[70] Korneev & Arutyunyan, 'Shareholders' agreement: Execution, Content and Performance' (2010:1) KORPORATIVNIY YURIST 32, 36.
[71] *Greenwell v Porter* [1902] 1 Ch. 530, 536.

injunctions to compel shareholders to vote in a particular manner based on their contractual obligations.[72]

In *Russell* the House of Lords in effect accepted the availability of negative injunctions when a voting agreement practically interfered in the provisions of the statute and the articles of association. The court deemed the clause of the agreement as a valid personal agreement between the shareholders.[73] After the Companies Act 2006 such court injunctions are less controversial, as the shareholders' agreement would have the status of the company's constitution.

Obviously, in the case of voting agreements specific performance is not available *ex post*, after the voting on the general meeting of shareholders has taken place. This interpretation is backed by the dictum of Lord Davey in *Thomas Abercromby Welton v Joseph John Saffery*,[74] and the argumentation of Lord Macmillan expressed in *Inland Revenue Commissioners v J. Bibby & Sons Ltd.*[75] In *Puddephatt v Leith* the court was able to enforce the defendant to vote according to the instructions of the plaintiff based on the SA, as on the last general meeting the defendant had voted against the instructions of the plaintiff and was insisting on his right to vote independently on the following meeting.[76]

Specific performance in English law encounters with other difficulties, which make specific performance in particular circumstances unavailable or impractical. Some of these difficulties are the outcome of the equitable nature of specific performance; the others are related with possible damage claims of the defendant in the event if the plaintiff does not succeed at trial.[77]

To strengthen specific performance of SAs, parties to such agreements make a special reservation which provides that in cases of a breach of the agreements parties assumed specific performance as a remedy. However, the U.K. courts are not bound by such reservations. Rather the courts grant damages as an appropriate remedy. In the absence of penalty clauses in English law, liquidated damages and an obligation to sell shares as a responsibility measure (by a pre-defined price or price defined according to a mechanisms established in advance in the agreement) play a significant role.

In summary, Russian court practice on the scope of the specific performance of SAs is absent, but the limited availability of specific performance is admitted by legal scholarship. In the U.K.

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[72] *Puddephatt v Leith* [1916] 1 Ch. 200, 202.

[73] Ferran, 'The Decision of the House of Lords in Russell v. Northern Bank Development Corporation Limited' (1994) 53 CAMBRIDGE L. J. 343, 344-5.

[74] [1897] A.C. 299, 331 (*"… individual shareholders may deal with their own interests by contract in such way as they may think fit. But such contracts, whether made by all or some only of the shareholders, would create personal obligations, or an exception personalis against themselves only, and would not become a regulation of the company, or be binding on the transferees of the parties to it, or upon new or non-assenting shareholders."*).

[75] [1945] 1 All E.R. 667, 670-1 (*"… a shareholder may be bound under contract to vote in a particular way. But with such restrictions a company has nothing to do. It must accept and act upon the shareholder's vote, notwithstanding that it may be given contrary to some duty which he owes to outsiders. The remedy for such breach lies elsewhere."*).

[76] [1916] 1 Ch. 200, 202. Similarly, in *Greenwell v Porter* shareholders threatened to vote against their contractual obligation before the general meeting ([1902] 1 Ch. 530, 531-2.).

[77] For the brief discussion of specific performance of SAs in common law *see* Michael J. Duffy, 'Shareholders Agreements and Shareholders' Remedies: Contract Versus Statute?' (2008) 20 BOND L. REV. 1, 13-4.

common law, although clear on the availability of specific performance in the context of SAs, puts significant restrictions on it.

IV. GOVERNING SHAREHOLDERS' AGREEMENTS OF RUSSIAN COMPANIES BY ENGLISH LAW: WHAT COUNTS FOR?

The analysis shows that being a contractual instrument in both jurisdictions, SAs encounter with similar treatment and enforcement issues.[78] This similarity raises a question about the claimed continuing popularity among Russian private actors of English law for governing SAs. In this part of the study we use the results of the comparative analysis, social factors and economic reasoning to explain the popularity of English law for governing SAs of Russian companies. At the same time, we do not pretend to provide the complete list of possible explanations. It is neither possible here to define the extent of the importance of particular explanations.

1. Structure (Mandatory versus Enabling) of Corporate Law

Although containing contractual obligations of the shareholders, SAs also affect the internal governance of companies. Given the important role of statutory provisions in internal governance, the scope of SAs has limits in both countries. Therefore, these limits are the result of corporate law restrictions of particular jurisdictions, rather than the outcome of contract law. The greater the role of mandatory provisions in corporate statutes, the less will be the scope of freedom in the contractual relations of the involved parties. The simple reason for this is that a contract cannot overrule statutory rules.

This shows that a crucial factor in defining the effectiveness of SAs is the nature of corporate law in general. The prevalence of enabling rules over mandatory rules in corporate law statutes affects positively the scope of the agreements. Therefore, the popularity of English law in governing the SAs of companies with the majority of Russian assets can be attributed to the factor of the mandatory structure of Russian corporate law in general and the absence of differentiated approaches of regulation for listed and non-listed business forms. While in the U.K. SAs are mainly practiced in non-listed companies, which implies both statutory flexibility and readiness of the courts to enforce private contractual arrangements due to the less acute nature of the conflicts of interests of the involved parties, Russian corporate law applies 'one-size-fits-all' approach to all companies.

The need to differentiate between listed and non-listed companies is better demonstrated by the U.S. court practice, where the rise of SAs started when the courts introduced differing

[78] The treatment of SAs in the U.S. with regard to the 'controversial issues' is slightly different from the ways English and Russian law deal with SAs. The U.S. courts are more inclined to grant specific performance and injunctions for the enforcement of SAs (Duffy, 'Shareholders Agreements and Shareholders' Remedies: Contract Versus Statute?' (2008) 20 BOND L. REV. 1, 13.). Similarly to English and Russian law, according to common law in the United States, SAs cannot violate statutory provisions too. However, it is argued that the statutory law itself has changed this approach, and currently an agreement among shareholders is effective even if inconsistent with one or more provisions of corporate statutes (*ibid.*, 6-8). Later is shown that in the reality the implications of this rule are far more similar to the approaches pursued in English and Russian law with regard to the relations between contractual arrangements of shareholders and statutory rules (*see infra* notes 83-84 and accompanying text).

approaches for corporations and close corporations.[79] In the early twentieth century inflexible governance structures designed for large listed companies in the form of mandatory rules did not provide much room for contractual arrangements of the participants of smaller non-listed firms. Courts, for their part, rejected to consider differences between listed and close corporations arising from differing needs of the involved parties.[80] However, gradually the attitude of the courts towards the needs of close corporations changed, and by the mid of the twentieth century shareholders of close corporations got more opportunities for regulating internal corporate relations by private agreements.[81] At the final stage corporate statutes were changed to acknowledge special features of close corporations.[82]

New statutory rules on close corporations allowed their participants to depart from the rules by providing for special internal governance rules in SAs. In other words, the nature of statutory corporate rules has been changed. While listed companies are subject to mandatory rules, more enabling rules have been introduced for close corporations. In particular, the Revised Model Business Corporation Act provides in section 7.32(a) that an agreement among the shareholders of a corporation is effective among the shareholders and corporation *"even though it is inconsistent with one or more other provisions of this Act"*. Later the act lists several important limitations illustrating that section 7.32 does not imply prevalence of the provisions of SAs over the provisions of the act. These limitations are:

1. the agreement should be included either in the articles of incorporation or by-laws of a corporation and approved by its all shareholders, or in a unanimous SA;
2. the agreement should be subject to amendment only by all shareholders, unless otherwise provided in the agreement;
3. the agreement should be valid for 10 years, unless it provides otherwise; and
4. the agreement is available only for closely-held corporations.[83]

Official comments to the Model Act further clarify that

> *"[s]ection 7.32 is not intended to establish or legitimize an alternative form of corporation. Instead, it is intended to add, within the context of the traditional corporate structure, legal certainty to shareholder agreements that embody various aspects of the business arrangement established by the shareholders to meet their business and personal needs. … Section 7.32 also recognizes that many of the corporate norms contained in the Model Act, as well as the corporation statutes of most states, were designed with an eye towards public companies, where management and share ownership are quite distinct. … These functions are often conjoined in the close corporation. Thus, section 7.32 validates for*

[79] Steven N. Bulloch, 'Shareholder Agreements in Closely Held Corporations: Is Sterilization an Issue' (1986) 59 TEMP. L. Q. 61, 68–71; Wells, 'The Rise of the Close Corporation and the Making of Corporation Law' (2008) 5 BERKELEY BUS. L. J. 263, 297-304, 308.
[80] Wells, 'The Rise of the Close Corporation and the Making of Corporation Law' (2008) 5 BERKELEY BUS. L. J. 263, 285-9, 292 (describing the leading case of *Jackson v Hooper*, where the Court of Errors and Appeals of New Jersey stroke down the agreement between the shareholders on account of contradictions with statutory provisions, especially with the rules ensuring the independence of board members).
[81] *Ibid.*, 304.
[82] *Ibid.*, 312-4.
[83] Revised Model Business Corporation Act, s. 7.32(b) and (d).

> *nonpublic corporations various types of agreements among shareholders even when the agreements are inconsistent with the statutory norms contained in the Act."*[84]

Therefore, given the fact that the Model Act offers rules for both listed and non-listed corporations, section 7.32(a) can be interpreted as acknowledging the enabling nature of the provisions of the act with regard to non-listed close corporations, rather than granting prevalence to SAs over mandatory statutory rules.

In Russia, after the 2008 amendments, the Law on LLCs provides more flexibility to the participants of LLCs.[85] Shareholders of LLCs enjoy more autonomy as compared both to the old regime and statutory rules on JSCs in such matters as voting rights, procedures for convening and holding general meetings, the distribution of powers between corporate bodies – general meeting of shareholders, board of directors and management. Therefore, SAs in LLCs provide more opportunity for private autonomy. This development, although moderate, is a step in the direction of applying different levels of flexibility in business forms based on the level of their engagement with external financing and the sophistication of the involved parties. At the same time, neither the amendments of the Law on JSCs, nor the amendments of the Law on LLCs were accompanied with a systematic revision of statutory provisions with regard to their nature – should they continue to be mandatory, or the extent of the underlying conflicts allows providing to the end users of the business forms opt-out or opt-in menus?

2. Legal Certainty and Network Effects

Many aspects of SAs in the U.K. have been developed based on case law. The abstract wording of Art. 32.1 and Art. 8(3) of Russian Laws on JSCs and LLCs respectively attributes important role to court practice as well. Yet, this practice still has to develop. The introduction of new legal institutions and rules always encounters with the potential drawback of being a relatively untested phenomenon that has not generated a large body of case law and academic research.[86] Apparently, legal certainty matters for private actors. In particular, scholarly literature on regulatory competition attains important role to well-developed stable case law for attracting companies.[87]

Additionally, network externalities – the present value of future judicial decisions interpreting legal rules – play important self-reinforcing role for maintaining leading positions for a jurisdiction (rule) that is popular among the users. By adopting a rule that has already been adopted or will be adopted by a large number of other users, a user can obtain the benefit of future judicial interpretations of the rule. More applications of a rule produce a steady stream of

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[84] *Model Business Corporation Act: Official Text with Official Comments and Statutory Cross-References Revised through June 2005* (ABA 2005), 7-72–7-73.

[85] Brief description of the amendments is provided in Dmitry Stepanov, 'LLC Law Reform: Toward Freedom of Contract Principle in Corporate Law' (Part I) (2009:6) KORPORATIVNIY YURIST 13 (*in Russian*); Dmitry Stepanov, 'LLC Law Reform: Toward Freedom of Contract Principle in Corporate Law' (Part II) (2009:7) KORPORATIVNIY YURIST 4 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1508348> (*in Russian*).

[86] Francisco Reyes & Erik P.M. Vermeulen, 'Company Law, Lawyers and 'Legal' Innovation: Common Law versus Civil Law' (2011) Lex Research Topics in Corporate Law & Economics Working Paper No. 2011-3, 9 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1907894> (discussing legal uncertainty issues related with the introduction of new 'hybrid business forms').

[87] Roberta Romano, 'Law as a Product: Some Pieces of the Incorporation Puzzle' (1985) 1 J. L. ECON. & ORG. 225, 250-1, 274, 280-1; Roberta Romano, *The Genius of American Corporate law* (AEI Press 1993) 39-40.

case law that addresses relevant issues in a timely fashion. This, in its turn, attracts even more private actors that are willing to use the rule. Similar contribution of network externalities strengthens the quality of judiciary and legal services.[88]

Hence, legal certainty – resulting from well-established English case law – and network externalities – the result of larger number of SAs governed by English law as compared to Russian law – offer competitive advantages for and further strengthen the position of English law as the governing law of SAs. In contrary, new Russian rules on SAs so far have only the backing of the predictions of legal scholars.

3. Quality of Judiciary

The literature on regulatory competition points to the important role of judiciary in ensuring competitive advantage for a particular jurisdiction. In particular, Bebchuk and Hamdani list Delaware's Chancery Court – which delivers judgments expediently and has developed specialized expertise – among one of the important advantages of Delaware in attracting company incorporations.[89] Similar argument is made by Kahan and Kamar.[90] An empirical investigation of corporate incorporations in U.S. states by Kahan found significant evidence that companies are more likely to incorporate in states which offer flexible rules with regard to governance of companies, and which have higher quality judicial systems.[91]

The *Rule of Law Index* is one of the few available projects that cover the comparison of judiciaries in wide range of jurisdictions. The *Rule of Law Index 2011* includes data on 66 countries, including the courts of the U.K. and Russia. Although with limitations, this index demonstrates the significant advantages of U.K. courts almost in all variables related with civil justice and civil procedure in relation with Russian courts – due process of law, judicial corruption, improper government influence on courts, and effective enforcement of judgments. The courts of the two jurisdictions come closer only with regard to unreasonable delays in courts, yet U.K. courts still perform better.[92]

The second available index for comparing courts in different jurisdictions is the *Lex Mundi* project. The project provides data on procedural formalism and time needed to obtain and enforce judgments on basic disputes (eviction of a tenant for nonpayment of rent and collection of money) in the courts of 109 countries. Although the speed of delivering judgments and formal procedural rules are a limited argument for making suggestions about the quality of court systems, the data again confirms the advantages of U.K. judiciary. In Russia the eviction of a tenant is expected to take 130 days, and money collection requires 160 days. Pursuing the same

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[88] Michael Klausner, 'Corporations, Corporate Law, and Networks of Contracts' (1995) 81 VA. L. REV. 757, 779, 843-47 (explaining the success of Delaware in charter competition by network effects: more companies in Delaware increase case law, and thus make it more predictable); Romano, *The Genius of American Corporate Law* (1993) 44. *See also* Brett H. McDonnell, 'Two Cheers for Corporate Law Federalism' (2004) 30 J. CORP. L. 99, 104.

[89] Lucian Arye Bebchuk & Assaf Hamdani, 'Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters' (2002) 112 YALE L. J. 553, 588-9.

[90] Marcel Kahan & Ehud Kamar, 'The Myth of State Competition in Corporate Law' (2002) 55 STAN. L. REV. 679, 725-6 (the specialized court is part of Delaware's competitive advantage).

[91] Marcel Kahan, 'The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?' (2006) 22 J. L. ECON. & ORG. 340, 352-7.

[92] Mark D. Agrast, Juan C. Botero & Alejandro Ponce, *WJP Rule of Law Index 2011* (The World Justice Project 2011) 90, 102.

claims in U.K. courts is expected to take 115 and 101 days respectively. Court proceedings in the U.K. are also less formalized.[93]

By choosing foreign law as governing law of SAs, the parties usually opt for foreign courts or international arbitration institutions as the forums for the resolution of their disputes. Hence, the quality of Russian courts can explain the choice of English law as well.

4. Interactions with Contract Law

The controversial restrictive practice of Russian courts on conditional provisions in contracts can be an important reason for avoiding the application of Russian law. Conditional clauses are important both for the main obligations of SAs (as many buy-sell clauses are conditional upon certain events), and for the specific mechanisms of their enforcement (default event clauses).

Art. 32.1(1) of the Law on JSCs and Art. 8(3) of the Law on LLCs provide that SAs can contain provisions on transactions with the shares: selling shares by a predefined price and/or with occurrence of a certain event. Can the condition in an agreement be controlled by the parties (such as selling shares by the requirement of the other party without any indication on reasons), or the condition should be out of their control (such as share price changes, financial crisis, other)? Russian commercial courts have wrongly developed formal interpretation of the term 'certain undefined events'[94] and refuse to consider as a condition any future event that depends on the will of one of the parties. According to the established case law, conditions cannot be actions or inactions of the parties of an agreement. Rather they are unpredictable external circumstances (non-) occurrence of which does not depend on the will of the parties.[95] This renders the provisions of SAs on buy-sell options and default events invalid, and hence, significantly limits the scope and effectiveness of SAs.

English contract law allows contingent conditions to bind a party (condition precedent) or to determine her obligations (condition subsequent) depending on actions or will of the other party.[96] *E.g.* a condition in a contract may provide that a binding obligation of one party to pay allowances to the other party is to come to an end, if the latter party marries.

Similar approach is applied all over Europe and is also recommended in the Principles of European Contract Law.[97] Certainly, conditions that are heavily dependent upon the will of one party are a recognized issue. When this dependence is so heavy as to signify a total lack of

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[93] Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, 'Courts' (2003) 118 Q. J. ECON. 453, 478-89, 494-500.

[94] Art. 157(1) and (2), Civil Code of the Russian Federation (*"1. A transaction shall be considered made on a condition precedent, if the parties have placed the arising of rights and duties in dependence upon a circumstance with respect to which it is unknown whether it will occur or not. 2. A transaction shall be considered made on a condition subsequent, if the parties have placed the termination of rights and duties in dependence upon a circumstance with respect to which it is unknown whether it will occur or not."* (my translation)).

[95] For an exhaustive list of references to the judgments of higher commercial courts *see* Stepanov, 'LLC Shareholders Agreement' (2010:12) REVIEW OF THE SUPREME COMMERCIAL COURT OF THE RUSSIAN FEDERATION 65, 84.

[96] Hugh G. Beale (gen. ed), *Chitty on Contracts, Vol. 1, General Principles* (30th edn, Thomson Reuters 2008) 227 para. 2-148; Edwin Peel, *Treitel on the Law of Contract* (12th edn, Sweet & Maxwell 2007) 67-8 para. 2-110.

[97] Ole Lando & Hugh Beale (eds), *The Principles of European Contract Law, Part I: Performance, Non-Performance and Remedies* (Martinus Nijhoff Publishers 2000) 229-33.

contractual commitment by that party, the contract is invalid. However, *"[s]uch arbitrary conditions are to be distinguished from valid conditions where one party's obligation is dependent upon the will of another."*[98] For example, a seller may be bound to supply raw materials to a buyer at a stated price in the event of the buyer deciding to accept an offer by a third person to purchase goods specially manufactured by the buyer.

Conditional terms in SAs are clear examples falling within the second valid category of conditions. Interestingly, the Principles of European Contract Law, similar to Russian Civil Code, recognize that conditions in contracts must relate to *"uncertain future events"*. Yet, nothing prevents to enforce obligations of a party after the occurrence of certain events dependent on the will of the other party (rather than on the arbitrary own will).

Differences in statutory and judicial interpretation of other contractual arrangements between the two jurisdictions may have important implications for the choice of governing law too. One example is restrictive covenants in SAs – such as non-competition and non-solicitation covenants. In *Dawnay Day & Co. Ltd and Another v D'Alphen and Others* the High Court and the Court of Appeal enforced the restrictive covenants included in the SA as a reasonable restraint of trade. Usually such covenants are enforced in the context of business sale/purchase cases – in order to protect the proprietary interest of a buyer in the goodwill of the business – and in employment relations. However, the High Court ruled that an investment too is a legitimate proprietary interest to protect by a restrictive covenant not to compete, if parties are joining together to participate in a venture.[99] Therefore, the covenant can also "bite" in cases when shares are not disposed. The appellate court went even further indicating that *"the covenant may be enforced when the covenantee has a legitimate interest, of whatever kind, to protect, and when the covenant is no wider than is necessary to protect that interest."*[100]

In Russian corporate practice anecdotal evidence suggests that non-competition clauses are usually submitted to the Federal Antimonopoly Service for a prior approval. However, in court practice non-competition covenants have never been enforced, and hence, are surrounded by uncertainty, especially with regard to their compatibility with the rights to work, to free choice of employment, to free enterprise, and with the provisions of competition law.

The position of Russian legislation and court practice on penalty clauses is also usually blamed for the shift to foreign law in governing SAs. In particular, Russian Civil Code entitles courts to reduce the amount of a contractual penalty, if it is obviously disproportionate to the consequences of the breach of an obligation.[101] This characteristic subjects penalty clauses to a different regime of treatment with regard to contractual freedom, as opposed to other contractual clauses.[102] The importance of fully enforceable penalty clauses is crucial for the

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[98] *Ibid.*, 230.
[99] [1998] I.C.R. 1068, 1093.
[100] [1998] I.C.R. 1068, 1107.
[101] Art. 333, the Civil Code of the Russian Federation. According to the position of the Constitutional Court of the Russian Federation, reducing the amount of penalties by the courts is one of the legal means against the abuse of rights; therefore, Art. 333 deals with the obligation, rather than with the right, of the court to establish a balance between a responsibility measure and the real amount of loss (Decision of the Constitutional Court of the Russian Federation of December 21, 2000, No. 263-O.).
[102] In the beginning of 2011 the Supreme Commercial Court of the Russian Federation clarified the rules on reducing the amount of a penalty. First, courts can reduce the amount of a penalty only when it is obviously disproportionate to the consequences of the breach of a right, and any other circumstances

enforcement of SAs, as the nature of the obligations of such agreements often makes impossible or ineffective other traditional contractual remedies (*e.g.* compensation of damages).

However, the basic principle of English law is that penalty clauses are not allowed at all.[103] In common law payments for non-performance of obligations are divided into penalty and liquidated damages clauses. Penalty clauses are invalid as bargains *"in terrorem"*.[104] Such payments can be considered as liquidated damages – and hence, be valid – if they are: (1) incorporated into a contract where an accurate and precise prediction of damages is not possible; (2) introduced by the parties with the intention of predicting the actual amount of the damage; and (3) a reasonable *ex ante* estimate of the amount of actual damage that could follow.[105] Broad discretion granted to the courts in deciding whether non-performance payments are void penalty clauses or can be enforced as liquidated damages intensifies uncertainty among contractual parties and stipulates speculative litigation with the aim of declaring the clause invalid.[106]

Therefore, the position of English law on penalty clauses does not offer much advantage relative to the enforcement of penalty clauses by Russian courts. Moreover, it can be argued that current Russian law is more efficient. First, courts in Russia can reduce the amount of penalty clauses, but not invalidate the clauses. Second, Art. 333 of the Civil Code – by referring to *"the consequences of the breach of an obligation"* as a proxy to define *"obviously disproportionate"* amount of a penalty, in effect links penalty clauses with actual damages. The difficulty of defining such damages in the context of SAs can make the courts less willing to reduce the amount of penalties in cases related with breaking SAs. Finally, the introduction of the functional equivalent of liquidated damages into Russian rules on SAs (compensation clauses) provides parties with an additional remedy of ensuring the specific performance of obligations. Yet in the absence of court practice legal scholarship is not unanimous whether clauses on compensation can be reviewed by the courts based on Art. 333 of the Civil Code or not.[107]

At the same time, it should be pointed that the strong enforcement of penalty clauses is only one element of the efficient model of contractual penalties. The second element is the clearness and

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(such as financial problems of a debtor or severe economic situation) cannot be considered by courts as such basis. Second, courts cannot reduce the amount of a penalty without the claim of a defendant and evidence provided by her, as the previous practice of court action on its own motion violated the principle of adversarial procedure (Resolution of the Presidium of the Supreme Commercial Court of the Russian Federation of January 13, 2011, No. 11680/10 (Russian legal system does not apply classic precedent law; however the decisions of the Supreme Commercial Court are highly influential and as a rule are observed by lower commercial courts).).

[103] For a global perspective on the enforcement of penalty clauses *see* Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 AM. J. COMP. L. 427, 433-8.

[104] *Clydebank Engineering and Shipbuilding Co. Ltd and Others v Don Jose Ramos Yzquierdo Y Castaneda and Others* [1905] A.C. 6; *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] A.C. 79, 86.

[105] Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 AM. J. COMP. L. 427, 435-6.

[106] *Ibid.*, 432, 436.

[107] Ivanov & Lebedeva, 'Shareholders' Agreements: A Step Forward or Running in Place?' (2008:9) KORPORATIVNIY YURIST 50, 53 (claiming that given the difficulty of defining damages under SAs, Art. 333 should not be applicable to penalty clauses included in SAs); Korneev & Arutyunyan, 'Shareholders' agreement: Execution, Content and Performance' (2010:1) KORPORATIVNIY YURIST 32, 37 and Stepanov, 'LLC Shareholders Agreement' (2010:12) REVIEW OF THE SUPREME COMMERCIAL COURT OF THE RUSSIAN FEDERATION 65, 89 (for a claim that compensation is different than penalty clauses, so they cannot be decreased by the courts).

certainty of the position of courts on their enforcement.[108] And here – notwithstanding the broad discretion English courts enjoy in enforcing liquidated damages clauses – the reach case law and standardized practice of SAs in English law might have advantages for drafting and enforcing SAs. In particular, liquidated damages clauses in the agreements of shareholders governed by English law include standard clear indications on the acknowledgement by the parties that non-performance sums are liquidated damages and represent a genuine pre-estimate of the loss, that they are not intended as a penalty to compel performance, and the amount of the liquidated damages is not disproportionate to the likely actual loss.

5. The Role of Supplementary Mechanisms

English law offers other supplementary mechanisms that allow strengthening the effectiveness of SAs. For instance, voting agreements are strengthened by granting irrevocable proxies to one of the parties to the agreement or to an independent party. The latter votes for all shareholders who granted the proxy according to the provisions of the agreement, while the shareholders themselves waive their right to vote. Although English law is stricter on irrevocable proxies to vote shares compared to U.S. law,[109] the use of irrevocable powers of attorney to vote shares is practiced in SAs governed by English law too.

The closest functional equivalent of such proxies in Russian law is a power of attorney. However, irrevocable powers of attorney are impossible in Russian law, which makes using powers of attorney as a means for strengthening the enforcement of SAs valueless.[110] Granting voting rights by the means of creating agency relations governed by Russian law is not effective as well due to the same possibility of termination at the will of the parties,[111] and uncertainty about the possibility of granting voting rights by an agency contract in general.

6. The Rise of Anglo-American Law Firm and the Interests of Corporate Lawyers

In the study of transnational law practice Abel pointed to the dominance of common law lawyers due to the prevalence of U.S. and U.K. large law firms. In the early 1990s American law firms accounted for seven of the ten largest firms in the world and 25 of the 40 largest firms. Even within Europe 25 of the 30 largest firms were British.[112] In the following two decades this leadership strengthened even further. The *2011 Global 100* ranking of law firms compiled by the *American Lawyer* shows that 78 of the top law firms by revenue are American, 12 are British, six

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[108] Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 AM. J. COMP. L. 427, 432.

[109] In the U.S. several states amended statutes to limit the possibility of revoking proxies to vote shares, which was previously possible as the agent may well have no interest of his own to prevent revocation (the lack of consideration). For the description of irrevocable proxies to vote shares and their differences from classic agency relations in U.S. law *see* Deborah A. DeMott, 'Irrevocable Proxies' (2008) 82 AUSTRALIAN L. J. 516. In English law the revocation of proxies to vote shares still remains a problem limiting the value added of using such proxies in SAs. The only reasoning available to prevent revocation probably is the notion of fraud on the other proxy granting shareholders (Francis M.B. Reynolds, *Bowstead & Reynolds on Agency* (18th edn, Sweet & Maxwell 2006) 614 para. 10-013.).

[110] Art. 188(1)(2), Civil Code of the Russian Federation (the power of attorney ceases to be effective after its revocation by the person who issued it).

[111] Art. 1010, Civil Code of the Russian Federation (termination of an agency contract by the withdrawal of one of the parties).

[112] Richard L. Abel, 'Transnational Law Practice' (1994) 44 CASE W. RES. L. REV. 737, 741.

are from Australia, and the remaining four are from Canada, France, Spain and the Netherlands. U.S. and U.K. firms also dominate the ranking of the top 100 global law firms by the number of lawyers: 69 American law firms, 16 British, six Australian, three Canadian, three French, two Spanish, and one Dutch firm.[113]

There are several rankings of law firms in Russia. Rankings of the *Chambers Global* and the *Legal 500* focus more on large international law firms. In particular, in the last ranking of the *Legal 500* in the field of corporate law and M&A (Moscow) out of 28 law firms 24 are local offices of U.S. and U.K. law firms. Only two Russian law firms are included in the list.[114] The ranking compiled by *PRAVO.ru* is ignored by some large foreign law firms, and hence is biased too. However, the ranking for 2011 still names three U.K., three U.S. and one Canadian firm in the top 17 law firms in the field of corporate law and M&A.[115] The *Best Lawyers* prepares its own and probably more balanced ranking of law firms in Russia. In the 2012 survey results of the *Best Lawyers* the list of law firms in the field of corporate law is dominated by foreigners: 25 foreign and 12 Russian law firms. The vast majority of foreign law firms are American and British.[116]

Common law lawyers, if involved in transactions, naturally prefer to use common law as a governing law. Therefore, the data on law firms in Russia can explain the popularity of English law as the governing law of SAs, and the inclusion of standardized Western-style clauses and provisions in the SAs of Russian companies. Law firms with U.K. origin probably tend to offer to their clients the law with which they are familiar and around which they created their networks of knowledge (court interpretations, standardized templates and clauses, other). The opposite situation, when the demand for English law has resulted in the increase in the number of foreign law firms, is also likely. This scenario, however, is more realistic in situations when one of the contractual parties is a foreigner interested in the application of neutral or more familiar English law, rather than Russian law.[117] As this is not always the case, the causal link between the demand for English law and the resulting increase in the number of U.K. law firms should be approached carefully.

The factor of foreign law firms can play a certain role in the application of foreign law, and in particular English law, also in another way. The introduction by Anglo-American law firms of the initial practice of drafting the SAs of Russian companies according to English law led during the subsequent years to the development of a network of knowledge around these agreements. Reyes and Vermeulen describe the risk-averse conservative behavior of corporate lawyers with regard to using new business forms. Three main reasons lead to the 'wait-and-see' strategy of corporate lawyers: (1) a network of court cases, legal opinions, standardized documents and other legal materials have usually been created around existing legal institutions and rules, providing corporate lawyers with a feeling of alleged legal certainty and comfort; (2) lawyers have usually invested considerable resources in existing institutions (rules) and their networks, while the development of new networks requires additional resources and costs, which can also benefit to other free-riding lawyers; (3) the promotion of new legal innovative products could

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[113] *The American Lawyer*, 'The 2011 Global 100', September 28, 2011.
[114] <http://www.legal500.com/c/russia/corporate-and-manda/moscow> (last visited on June 24, 2012).
[115] <http://pravo.ru/stat/rating2011_results/corporate_law/> (last visited on June 24, 2012).
[116] *Vedomosti* (by Philip Sterkin), 'Hard to Pass Around Foreigners', April 23, 2012 (*in Russian*).
[117] *See infra* section VI.7.

damage the professional reputation of lawyers, if it is successfully challenged in court.[118] The same factors suggest that the professional consultants of Russian private actors might have weak incentives to shift to the new Russian rules on SAs.

7. The English Language as *Lingua Franca* of Foreign Investors and Shareholders

Scholarly literature indicates to the growing tendency of 'Americanization' of the international legal culture. The important role of the English language as a *lingua franca* is evident in both legal education and in legal practice.[119] Heringa describes the increasing role of English ("Euro-English") in European law schools.[120] English is also dominating in international business transactions and in transnational lawyering.[121]

Anglo-American law firms and the English language are in a pair and are mutually reinforcing each other. The growth of Anglo-American law firms fosters the dominance of English, and the dominance of English language encourages even more clients to seek Anglo-American counsel.[122] This, in its turn, contributes to the prevalence of U.S. and English law and contracting techniques. Reyes argues that the establishment of English as the new *lingua franca* is probably the single most significant factor for the propagation of the common law institutions in the world.[123]

Therefore, it is reasonable to expect the use of the English language – and probably also English law as a governing law – in the SAs of Russian companies where one or more parties are foreign investors.

8. The Tradition of Referring to English Law in Commercial Contracts

The study of the choice of substantive law in commercial contracts disputed in international arbitration institutions shows that English, Suisse and French law were the most commonly chosen governing law of the agreements in 2003 (24, 20 and 19 percent respectively).[124]

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[118] Reyes & Vermeulen, 'Company Law, Lawyers and 'Legal' Innovation: Common Law versus Civil Law' (2011) 27.

[119] Peter L. Murray & Jens Drolshammer, 'The Education and Training of a New International Lawyer' (2000) 2 EUR. J. L. REFORM 505, 542 (pointing to the important role of the English language in commercial contracting, foreign legal education, and foreign legal professions).

[120] Aalt Willem Heringa, 'European Legal Education: The Maastricht Experience' (2010) 29 PENN ST. INT'L L. REV. 81, 86-8.

[121] Lawrence M. Friedman, 'Erewhon: The Coming Global Legal Order' (2001) 37 STAN. J. INT'L L. 347, 355; Filip De Ly, 'Law and Practice of Drafting International Contracts' (2002:3/4) INT'L BUS. L. J. 461, 469-72.

[122] Roger P. Alford, 'The American Influence on International Arbitration' (2003) 19 OHIO ST. J. DISP. RES. 69, 86-7.

[123] Francisco Reyes, 'Corporate Governance in Latin America: A Functional Analysis' (2008) 39 U. MIAMI INTER-AM. L. REV. 207, 213.

[124] Stefan Voigt, 'Are International Merchants Stupid? Their Choice of Law Sheds Doubt on the Legal Origin Theory' (2008) 5 J. EMP. LEG. STUD. 1, 12. The data relates only to the International Court of Arbitration of the International Chamber of Commerce in Paris. This, indeed, might imply some bias towards French law, although the study considers this counterargument with regard to the figures "not convincing".

Adjusted to the country of origin of the parties involved in disputes, English law is chosen 5.35 times more often than was to be expected.[125]

These data illustrate that in agreements involving parties from different countries there is a tradition of referring to English law as the substantive governing law. There are no strong reasons to believe that SAs are completely different from other commercial agreements. Therefore, it is reasonable to expect the SAs of Russian companies to be governed by English law (or other foreign law), if at least one of the parties of the agreement is a foreign investor.

V. TOWARDS A MODEL FOR INTERPRETING THE RULES ON SHAREHOLDERS' AGREEMENTS BY RUSSIAN COURTS

In effect SAs (and especially voting agreements) can set restrictions on the expectations (rights) of shareholders which are based on statutory rules and the provisions of the articles of association (*e.g.* caps on the size of dividends or agreed voting against the payment of dividends). Although not formally, these provisions actually can change statutory rules and the provisions of the articles of association. This justifies the careful approach of courts in different jurisdictions towards the enforcement of SAs.

Within the debate on the structure of corporate law (mandatory versus enabling) Bebchuk offered an analytic framework that distinguishes opting out from corporate rules in the initial stage of the company by-law approval and opting out in the midstream stage (at the charter amendment stage).[126] The suggestion is justified given significantly different effects of opting out at the two different stages for involved parties due to decision-making procedures – unanimous agreement at the initial stage, and majority voting at the stage of altering articles of association.

The framework implies that in a situation when all shareholders are participating in the agreement, provisions that in fact restrict the rights of shareholders do not create significant conflicts. Moreover, the use of a contractual mechanism that requires unanimity for amendments (whatever the size of shareholdings is) offers better protection than the introduction of the changes through the articles of association, as in the latter case 75 percent majority voting requirement, as a rule, is sufficient for amending resolutions to be passed.[127] The important issue of unanimity in SAs was first mentioned in the judgment of the Court of Appeals of New York in *Manson v Curtis*:

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[125] *Ibid.*, 15.

[126] Lucian Arye Bebchuk, 'Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments' (1989) 102 HARV. L. REV. 1820.

[127] Both U.K. and Russian law require 75% majority voting for the alterations of the articles of association (Companies Act 2006, s. 21 (amendment of articles) and s. 282 (special resolutions); Law on JSCs, Art. 49(4)). In Russian LLCs the minimum threshold for the approval of the alterations is set at the level of 2/3 of the votes (Law on LLCs, Art. 37(8).). It should be admitted that both jurisdictions offer remedies for non-consenting shareholders in the cases of the alterations of the articles (Companies Act 2006, s. 994–996 (protection of shareholders against unfair prejudice); the Law on JSCs, Art. 75(1) and Art. 76(5) (the protection offered by Russian legislation is limited, as the law imposes a cap on the maximum amount that can be spent by the company for buying back the shares of non-consenting shareholders).).

> *"The rule that all the stockholders by their universal consent may do as they choose with the corporate concerns and assets, provided the interests of creditors are not affected, because they are the complete owners of the corporation, cannot not be invoked here."*[128]

Although the case did not involve a unanimous shareholders' agreement, it pointed that the factor of unanimity, as well as external factors (the interests of creditors) are important in deciding on the enforcement of SAs. In *Clark v Dodge* the court for the first time approved an SA mainly based on unanimity considerations.[129] Currently unanimous SAs are also strongly enforced outside the U.S.[130]

More controversial is the case when an SA with similar effect on statutory rules and the articles of association involves only the majority of shareholders. While such agreement creates reasonable expectations for its parties, it in fact suppresses the reasonable expectations of non-participating shareholders deriving from the articles of association, as the latter do not participate in decision-making, while the former would not always take into account the effects of their agreements on third parties. To mitigate the conflict arising out of significant externalities for non-participating shareholders and to correct information asymmetries, English law requires the disclosure of such SAs, as in effect SAs materially change the company's governance and serve as its articles of association. This measure is efficient and effective for future shareholders, as they can obtain information and make informed decisions about buying shares.[131] But the disclosure requirement offers only limited protection for the current shareholders who do not participate in the agreement, yet have to make changes in their initial expectations with regard to their investments in the company's shares.

Russian law does not require the disclosure of SAs in such cases.[132] However, the Civil Code offers a remedy to strike down the agreements in such cases by referring to the abstract concept

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[128] 119 N.E. 559, 562-3 (N.Y. 1918).

[129] 119 N.E. 641, 642 (N.Y. 1936) (another important consideration was the absence of a damage to third parties).

[130] For the U.K. *see above* notes 53-55 and accompanying text. For Canada *see e.g.* Richard James Hay & Lucinda Ann Smith, 'The Unanimous Shareholder Agreement: A New Device for Shareholder Control' (1985) CAN. BUS. L. J. 440. In Germany the Federal Court of Justice (*Bundesgerichtshof*) has developed similar position with regard to the unanimous agreements of the members of *GmbH* – if there is one SA among all shareholders, then a breach of the agreement can serve as a ground for the invalidation of the decision of the general meeting of shareholders (BGH NJW 1983, 1910, 1911 and BGH NJW 1987, 1890, 1892.).

[131] Ferran argues that there are no risks for future minority shareholders, even when contractual covenants are not disclosed. *Ex post* remedies of petitioning the court for relief from unfairly prejudicial conduct (non-disclosure of important agreements before selling shares is considered as such conduct) proved to be effective (Ferran, 'The Decision of the House of Lords in Russell v. Northern Bank Development Corporation Limited' (1994) 53 CAMBRIDGE L. J. 343, 363.). However, *ex post* enforcement can create additional costs. Usually share purchase agreements contain other substitute contractual techniques that can protect future shareholders (such as representations and warranties of a seller).

[132] The Federal Antimonopoly Service of Russia has proposed regulatory changes that require the disclosure of SAs. However the aim of the disclosure requirement is completely different – control by the agency of the observance of antimonopoly legislation by companies. This indeed will affect the scope of disclosure, as to achieve the aim all SAs, at least in companies with large market shares, should be disclosed (*Financial Times* (by Catherine Belton), 'Russian agency proposes changes to end BP stand-off with AAR', June 7, 2012.).

of abuse of rights[133]. While deciding on the validity of the agreement, the efficiency standard requires from the courts to consider three important factors that affect the scope of conflicting interests with regard to SAs:

(1) the coverage of the agreement – all shareholders or only part;
(2) the status of a company/type of a business form – apparently, in listed companies it is practically impossible to involve in an SA all shareholders. While in such cases the interests of non-participating minority shareholders require special protection, in non-listed companies private contracting plays greater role in practice, and can serve better the interests of the involved parties;
(3) the fact of possible public disclosure of the agreement – with introducing the distinction between existing and new shareholders if necessary.

The recent amendments of the Law on LLCs took into account the important factor of unanimous decision-making, although in a context not directly related with SAs. In particular, different aspects of preemptive and first refusal rights of buying shares – buying shares by a price pre-determined in the articles, including the changes of the price and a mechanism for its definition, buying or offering shares in non-proportionate amounts with regard to the existing shareholdings – shall be established either at the initial stage of incorporating an LLC or by a unanimous decision of shareholders at later stages.[134] The courts can extend the framework considered by the legislature to interpret the effects of the provisions of SAs on corporate resolutions – unanimous agreements in effect have a status of a company's constitution. While this factor is also important for defining the limits of private autonomy in SAs, it is hardly possible that the courts can rely on it without the backing of express legislative action.

The same amendments provide some evidence that the legislature has made the first steps in the direction of substantively separating statutory regimes of LLCs and JSCs based on the autonomy of their participants. As opposed to JSCs, the principle of contractual freedom has wider application in LLCs. Thus, if the courts apply this approach of differentiated treatment, the same provisions that might be invalidated in the agreements of the shareholders of JSCs, can be enforced in the SAs of the participants of LLCs.[135] The approach will be further boosted by the proposal to introduce the division of business forms into public (listed) and non-public (non-listed) entities at the legislative level.[136]

The draft law reforming civil legislation contains also other proposals that are essential for the enforcement of SAs. In particular, the proposals include amendments to penalty clauses,[137] conditional provisions in agreements,[138] and powers of attorney.[139] The draft law, if adopted,

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[133] Art. 10(1) of the Civil Code of the Russian Federation (*"Actions of citizens and legal entities exercised exclusively with the intention to cause harm to another person are not allowed, nor is abuse of a legal right allowed in other forms."* (my translation)).
[134] Law on LLCs, Art. 21(4) paras 4-6.
[135] Stepanov, 'LLC Shareholders Agreement' (2010:12) REVIEW OF THE SUPREME COMMERCIAL COURT OF THE RUSSIAN FEDERATION 65, 70-1.
[136] Draft Federal Law of the Russian Federation No. 47538-6 Amending the First, Second, Third and Fourth Parts of the Civil Code of the Russian Federation and Other Legislative Acts of the Russian Federation, Art. 66.3 <http://asozd2.duma.gov.ru/main.nsf/%28Spravka%29?OpenAgent&RN=47538-6&02> (*in Russian*).
[137] Limiting significantly the possibility of the reduction of the amount of penalties by the courts in commercial agreements.
[138] Allowing conditional provisions to depend on the will of a contractual party.

will also clarify the relations between the provisions of SAs and articles of association. Draft Art. 67.2(6) provides that the parties of an SA cannot claim invalidity of the agreement by virtue of its contradictions with the provisions of the articles of association of the company. As the comparative analysis shows, this provision should not be interpreted as a declaration of the prevalence of the provisions of SAs over the provisions of articles of association. The only justified implication of the provision is that in the cases of contradictions between the two documents, the actions of shareholders consistent with the articles are valid, yet they breach their contractual obligations. Hence, the defaulting contractual party can be held liable to pay damages, or contractual penalties, or perform other actions according to the shareholders' agreement.

As the above comparative analysis shows, in some cases the amendments are needed to change the existing court practice, rather than are the result of the flaws in the texts of the current statutory provisions. In some cases the amendments are quite detailed, which can be explained with the aim of ensuring legal certainty for the involved parties in the absence of extensive court practice. Here the interests of legislatures and Russian law firms interestingly overlap. Apparently, the wish to 'return' the commercial transactions of Russian private actors into the domain of Russian law is strong enough to prevent the legislature from adopting the strategy of waiting for the changes in court practice. At the same time, the factor of using foreign law and 'national sovereignty' concerns might also be leveraged by different lobbying groups of practicing lawyers to promote amendments in the legislation, instead of pursuing a risky strategy of attempting and changing court practice.

VI. CONCLUSIONS

The comparative analysis conducted in the thesis shows that the issues of the enforcement of shareholders' agreements encountered by private actors in Russia are not unique and country-specific. The questions of relations between the provisions of SAs on the one hand and mandatory statutory rules and a company's articles of association on the other hand, the participation of the company and third parties in the shareholders' agreement, the specific performance of SAs, and the effects of SAs on corporate acts and non-participating parties raise much debates and encounter with problems in the U.K. as well. The analysis also shows that the rules on SAs should be examined within the general framework of corporate and contract law.

These conclusions allowed to offer other explanations for the popularity of English law for governing SAs entered between Russian private actors, rather than to blame the 'wrong' concept of SAs offered by the Law on JSCs and the Law on LLCs. Among others, the most important explanations seem to be the general mandatory nature of corporate legislation in Russia, legal uncertainty related with the application of the new statutory provisions on SAs, quality of Russian courts, the 'unfavorable' practice of the courts on several contractual concepts crucial for the effectiveness of SAs, the influence of foreign law firms and the interests of practicing lawyers. Apparently, in SAs with foreign investors the widespread use of the English language and English law in commercial transactions matters too. None of these factors can be claimed to play the only and the most important role in the popularity of English law. Together, however, they can explain the choice of private actors.

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[139] Introducing irrevocable proxies for entrepreneurs.

The last part of the work uses the results of the comparative study and economic reasoning to offer a general model for the interpretation of the provisions of SAs by the courts. The model relies on three elements that should be considered by the courts: (non-) unanimity of the agreement, the type of a business form, and the disclosure of the shareholders' agreement.

The development of the case law in line with the offered model of SAs is the main condition for increasing the demand for Russian rules on SAs. This development cannot be achieved without a comprehensive reform of Russian corporate law oriented towards the introduction of different levels of balance between mandatory and enabling rules depending on the type of business forms (JSCs versus LLCs) and the number of their shareholders (listed versus non-listed companies). Still, as some of the explanations of the popularity of English law show – network externalities in particular –, it will probably maintain its dominance, at least for large investors who can afford additional costs related with obtaining advice on foreign law and adjudicating in international arbitration and foreign courts.

The analysis also indicates two directions of prospective research related with shareholders' agreements in general and with the practice of shareholders' agreements in Russia in particular. The first direction is related with the economic analysis of the provisions of SAs and with drawing parallels with takeover rules applicable to listed companies. While law and finance analysis of takeover rules is abundant, similar studies of the provisions of SAs are lacking. The second direction of prospective research concerns the role of judiciary in regulatory competition. The active role of Russian legislature in drafting and enacting rules aimed to create conditions for the enforcement of SAs in Russia suggests that Russian courts are less involved in the process of regulatory competition, than the legislature, and that comparative law hardly plays an important role in judicial analysis of Russian courts.

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