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The Enforcement of Shareholder Agreements under English and Russian Law

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Despite the numerous legal reforms of recent decades, the development of legal rules continues to be one of the central problems in Russia and the other "following" countries. This problem is aggravated by the fact that the corporate sector develops rather rapidly, as globalization, international competition, open markets, and arbitration between regulatory regimes enables businesses to learn, borrow and use foreign practices. Because "Western-style" contracting techniques are well developed and effective, there are strong incentives and temptations for private actors from "following" countries and their consultants to adapt foreign experience. A common feature in these countries is that modern business practices, and sometimes new fragmented statutory rules, encounter enforcement issues in local courts.[1]

Within a relatively short period after the adoption of basic laws concerning different business models, juridical persons in Russia began to enter into shareholder agreements, which were not regulated by Russian laws. Such agreements allow for the detailed regulation of relations between shareholders in cases where legislative provisions are deemed to be not sufficient or not appropriate. From an economic perspective – given dynamic moral hazard and uncertainty – shareholder agreements permit the pursuit of 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] The contractual arrangements of shareholders in companies and joint ventures can also induce the parties to negotiate and

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[1] For the issues related with the enforcement of shareholder agreements in the Ukraine, see Timur Bondaryev and Markian Malskyy, "Recent Developments Concerning Dispute Resolution of Shareholder Agreements in Ukraine: For Better or For Worse?", *Stockholm International Arbitration Review*, no. 3 (2008), pp. 83-95. The pitfalls of implementing United States 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", *Pacific Rim Law and Policy Journal*, XIII (2004), pp. 439-470. Brazilian legislation also causes problems for private equity and venture capital contracting structures. See 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?", *Law and Business Review of the Americas*, XIII (2007), pp. 355-380.

[2] Gilles Chemla, Michael A. Habib and Alexander Ljungqvist, "An Analysis of Shareholder Agreements", *Journal of the European Economic Association*, V (2007), pp. 94, 116.

continue relations if deadlock situations arise.[3] Finally, shareholder agreements provide an opportunity to engage in an efficiency-based choice between rules and standards for the better-informed participants of corporate relations rather than legislatures.[4]

This new practice of Russian private actors – borrowed from foreign jurisdictions – encountered enforcement problems in Russian *arbitrazh* courts (which consider economic and certain administrative cases) because some provisions of shareholder agreements were considered to be invalid by reason of their incompatibility with the basic requirements of the law and the internal documents of companies. This situation, in effect, transformed shareholder agreements governed by Russian law into nothing more than a gentlemen's agreement between the parties. The result was the extensive use of other functionally equivalent instruments that achieved similar outcomes, and a shift to foreign law as the applicable law of such agreements.

However, these new practices created additional costs for private actors in the form of tax obligations, obtaining foreign legal services, and litigation in foreign jurisdictions and international arbitration tribunals. In cases where the assets of the parties were in Russia, problems arose related to the recognition and enforcement of the decisions and awards by Russian courts. Moreover, the fact that substitute techniques could easily circumvent legal restrictions necessitated legislative action. Additional concerns were related to the loss of national sovereignty over the regulation of corporate transactions and adjudication of disputes, and to the interests of local law firms, which had conceded a large part of the legal services market in the field of corporate law to the offices of foreign law firms in Moscow and St. Petersburg.

In late 2008 and in the summer of 2009 the legislature responded to this problem by amending the Federal Laws on Limited Responsibility Societies[5] and on Joint-Stock Societies[6] respectively and introducing the concept of shareholder agreements in Russian law. However, anecdotal evidence suggests that the use of foreign law (especially English law) as the applicable law of shareholder agreements remains widespread. This raises two questions. First, is the new Russian model of shareholder agreements different from the analogous concept used in English law? And second, if the two models are not significantly different, what other factors may explain the refusal to use Russian law as the applicable law to govern shareholder agreements and instead to prefer English law?

The objective of this study is to demonstrate the essential similarities and differences of the Russian and United Kingdom approaches towards shareholder agreements by comparing the treatment of the principal "controversial" provisions of shareholder agreements (from the perspective of their enforcement in Russian *arbitrazh* courts) in the two jurisdictions, and to define a general framework that can be used by Russian *arbitrazh*

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[3] Joseph A. McCahery and Erik P.M. Vermeulen, *Corporate Governance of Non-Listed Companies* (2008), p. 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 in public legislatures make the choice of contractual structures (precise rules versus standards) by legislatures less efficient, than the choice made by the better informed participants of corporate relations. See Louis Kaplow, "Rules Versus Standards: An Economic Analysis", *Duke Law Journal*, XLII (1992), pp. 608–611.

[5] Federal Law "On Limited Responsibility Societies", as amended; С3 РФ (1998), no. 10, item 785; transl. in W.E. Butler, *Russia & The Republics: Legal Materials* (loose-leaf service; 2006).

[6] Federal Law "On Joint-Stock Societies", as amended; С3РФ(1996), no. 1, item 1; transl. in Butler, note 5 above.

courts to interpret statutory rules on shareholder agreements. To strengthen the normative dimension of legal comparisons, the study also applies economic reasoning to construct the general framework.

This study examines the ways in which Russian and English law deal with the relations that 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 shareholder rights over the participatory shares and stocks and certified by the stocks. The comparative analysis is multilayered. The first layer includes legal rules on shareholder agreements. Because the common law plays a significant role in regulating contracts in the United Kingdom, and statutory rules obtain their meaning through their interpretation by courts, both statutory and case law are here considered (though Russian cases on shareholder agreements are few and almost non-existent after the amendments of the legislative provisions concerning shareholder agreements). The second layer is the legal context of the rules: other rules, institutions, and branches of law that affect the application of the rules. The third layer is the non-legal context: institutional, social, and historical factors that affect the development and application of legal rules.

The choice of English law for comparison is based on the alleged extensive use of the latter as the applicable law for shareholder agreements related to Russian companies. A recent survey by a leading Russian law firm demonstrated that more than half of the Russian companies responding do not trust Russian law and that not more than 10% of their significant transactions were made subject to Russian law. Transactions such as mergers and acquisitions, shareholder agreements, project financing, joint ventures, and debt restructuring are usually structured according to foreign, and mainly English, law.[7]

In a comparative analysis it is a challenge to define a neutral research question. One of the main methodological problems of this study was the definition of shareholder agreements in abstract non-legal terms because these agreements contain different provisions. For the purposes of this study a shareholder agreement is an agreement concerning the internal governance of the company, rights certified by the shares (or stocks), and/or concerning special rules on the of issuing and transferring shares (or stocks). However, the definition is not fully neutral, being based on such legal terms as internal governance, rights certified by stocks, and the transfer and issuance of shares or stocks. But because this concept has been borrowed by Russian private actors from abroad, rather than developed domestically, the agreements have a similar meaning in both England and Russia. This common origin allows a common basis and clear scope for comparison to be established.

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

[7] Dmytri Afanasiev, «Суверенитет на 10%» [Sovereignty over 10%], Ведомости [Gazette], 27 June 2012. See also Hiroshi Oda, "Shareholders' Agreements in Russia", *International Company and Commercial Law Review*, XXI (2010), p. 359.

The general imperative nature of Russian corporate law as compared with United Kingdom 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 United Kingdom make shareholder agreements governed by English law more convenient, and hence, probably, in greater demand. 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 affect the choice of the applicable law of shareholder agreements. However, the development of case law oriented towards the balancing of the rights and interests of the parties from the perspective of the framework offered in this article may contribute to more agreements being made subject to Russian law.

The article will proceed as follows. First, a brief historical background of the development of the concept of shareholder agreements in Russian corporate practice and corporate law will be provided. Next the first research issue is raised, and the article will address the principal "controversial" provisions used by the Russian corporate sector in shareholder agreements and will analyze their legality and enforcement under the new approach of Russian law and of English law. The third part will use the comparative analysis to explain the extensive use of English law by 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 shareholder agreements introduced in the Law on Joint-Stock Societies and the Law on Limited Responsibility Societies.

RISE OF SHAREHOLDER AGREEMENTS IN RUSSIAN CORPORATE PRACTICE

Shareholder agreements (hereinafter the term encompasses both stockholder agreements concluded among stockholders of a joint-stock society and shareholder agreements concluded by participants in a limited responsibility society) are among the most discussed "private legal transplants" in Russian corporate practice. They were borrowed by private actors from foreign practice[8] and used without special legal regulation and case law.[9] However, the decisions of the courts in the *Megafon* case, which involved the first stockholder agreement dealt with by Russian courts, rang a bell for Russian companies, stockholders and their consultants. The courts declared the agreement between the major stockholders of Russian mobile operator *Megafon* void.[10] In its decision the Federal Arbitrazh Court of the West-Siberian Region stated that agreements between stockholders cannot be contrary to national legislation and the constitutive documents of juridical persons.

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[8] See Igor Ostapets and Aleksei Konovalov, «Соглашения акционеров в практике совместных предприятий с российским участием» [Stockholder Agreements in the Practice of Joint Enterprises with Russian Participation], Слияния и поглощения [Mergers and Acquisitions], no. 1-2 (2006), p. 50.

[9] See Ilia Nikiforov and Ilia Bulgakov, «Соглашение между акционерами в российском праве: есть ли альтернатива?» [Stockholder Agreements in Russian Practice: Is There an Alternative?], Корпоративный юрист [Corporate Jurist], no. 11 (2006), p. 27.

[10] Decision of the Federal Arbitrazh Court of West-Siberian Region, 31 March 2006, No. Ф04-2109/2005(14105-А75-11), Ф04-2109/2005(15210-А75-11), Ф04-2109/2005(15015-А75-11), Ф04-2109/2005(14744-А75-11), Ф04-2109/2005(14785-А75-11). The court of cassation upheld the decisions of the first instance and appellate courts. The Supreme Arbitrazh Court of the Russian Federation did not review the judgments.

In particular, the courts declared invalid the provisions of the stockholder agreement that did not comply with the imperative rules of the Law on Joint-Stock Societies, such as the clauses changing the terms for convening general and extraordinary meetings of stockholders, the terms of notification about general meetings, requirements on the quorum for general meetings, questions that within the exclusive competence of the general meeting of stockholders, the rules of electing board members and managers, the clauses restricting voting rights on the general meetings of stockholders, the clauses establishing pre-emption rights for buying stocks in an open joint-stock society, as well as restrictive covenants imposing non-competition obligations on the stockholders.[11]

In fact, the only provision of shareholder agreements that did not cause significant problems with regard to legality was voting agreements.[12] However, these clauses were considered as not in force at the enforcement stage. According to the Law on Joint-Stock Societies (Article 49), a resolution of the general meeting of stockholders can be disputed if the resolution has been adopted in violation of legislation and the company charter. Therefore, breaching obligations enshrined in a stockholder agreement cannot be a legal ground for overturning the resolution of the general meeting of stockholders. The enforceability of specific performance of obligations (a court direction to vote in specific way) also was not available. The only available remedies in such cases could be found in the law on obligations, namely by claiming damages or penalties.[13]

In general response to problems with the legality and enforceability of shareholder agreements, Russian corporate practice shifted to the law of foreign jurisdictions. To avoid international private law restrictions on the *lex societatis* and public policy concerns in Russian courts,[14] instead of providing that the shareholder agreements of Russian companies were subject to foreign law, shareholders usually established special purpose vehicles in foreign jurisdictions and entered into agreements at the level of these foreign juridical persons (usually under English law).[15] Foreign juridical persons were inserted as

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[11] Ibid.

[12] Ostapets and Konovalov, note 8 above, at 51; Nikiforov and Bulgakov, note 9 above, at 28.

[13] In fact, the last two remedies could be ineffective as well. Damage claims encountered the practical difficulty of proving the amount of damages, whereas penalty clauses were usually enforced by courts in an amount lower than the original sum. For more details on penalty clauses, see notes 104-111 below and accompanying text.

[14] In the *Megafon* case the Federal Arbitrazh Court of West-Siberian Region refused to enforce the stockholder agreement by referring, *inter alia*, to Article 1202 (relations of a juridical person with its participants shall be regulated by the law applicable to the juridical person) and Article 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 (Decision of the Federal Arbitrazh Court of West-Siberian Region, note 10 above).

[15] See Ostapets and Konovalov, note 8 above, at 54. Using foreign law to govern transactions with underlying Russian assets is not limited to shareholder agreements 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"* ("Not Entirely Free, Your Honour", *The Economist*, 31 July 2010). Even State-controlled companies and banks in Russia acknowledge that foreign law governs their important agreements and that disputes are considered by foreign courts. See Dmytri Kazmin and Philip Sterkin, «Юристы теряют рынок» [Lawyers Are Losing the Market], Ведомости [Gazette], 27 January 2011). The *Financial Times* speculated 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 (Catherine Belton, Caroline Binham and Neil Buckley, "Oligarchs in London", *Financial Times*, 8 October 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".

an additional layer between the beneficiary shareholders and Russian companies, holding the shares or stocks of the latter.

To cope with the developments in corporate practice the legislator decided to act,[16] and the Law on Joint-Stock Societies was amended in June 2009.[17] According to the amendments (Article 32.1(1)), a stockholder agreement is an agreement concerning the exercise of rights certified by stocks, and/or concerning special rules of exercising rights over stocks.[18] By this agreement parties are bound to exercise rights certified by the stocks and/or rights to the stocks 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 stockholder agreements may provide for the obligation of the parties to:

- vote in a certain way at the general meeting of stockholders;
- agree on a variant of the voting with other stockholders;
- acquire or dispose of stocks at a pre-determined price and/or with occurrence of a certain event;
- refrain from the disposing of stocks until the occurrence of a certain event;
- 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 stockholder agreements. First, stockholder agreements cannot bind its parties to vote according to the instructions of the management organs of a society whose stocks are affected by the agreement (Article 32.1(2)). And second, a stockholder agreement is binding only for its parties (Article 32.1(4)). The latter has two implications: agreements with third persons which result in the breaches of a stockholder agreement cannot be declared invalid on the mere ground of breaching the stockholder agreement;[19] and a breach of a stockholder agreement cannot serve as grounds for invalidating the decisions and resolutions of the governing bodies of the company.

Further, the amendments provide that stockholder agreements can define measures for securing the fulfillment of obligations and civil law remedies for non-performance or improper performance of the obligations.[20] Such remedies can be compensation of damages,

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[16] In the United States, although stockholder agreements 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", *Berkeley Business Law Journal*, V (2008), pp. 297-304.). Apparently, in "following" countries the unenforceability of popular contractual mechanisms is more likely to result in legislative changes, because 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.

[17] Federal Law "On Changing the Federal Law 'On Joint-Stock Societies' and Article 30 of the Federal Law 'On the Securities Market'"; СЗРФ(2009), no. 23, item 2770. For more details on the history of the legal reform see Oda, note 7 above, at 361-364.

[18] Rights over stocks relate to the transfer of stocks (purchase, sale, assignment of stocks, other property rights), whereas rights certified by stocks are those rights which are derived from the stocks and can be exercised by their holders (for instance, voting rights, dividend rights, information rights).

[19] The only exclusion when courts can invalidate agreements with third persons is when the third person was aware or should have been fully aware about the limitations set by the stockholder agreement. The interested parties of the stockholder agreement can bring such claims. The plaintiff also bears the burden of proof, which significantly complicates court action, because stockholder agreements are – as a matter of practice – generally confidential. Courts have to define a practice when third persons can be deemed to be aware about the provisions of a confidential stockholder agreement.

[20] Article 32.1(7), Law on Joint-Stock Societies.

penalty clauses, the payment of compensation for breaching a stockholder agreement (in a fixed amount or in an amount defined according to a stockholder agreement),[21] as well as other remedies available in contract law (such as actions concerning the validity of contracts and contract termination).[22] Another measure aimed at strengthening the effectiveness of contractual arrangements of stockholders is conditional stock buy-sell clauses.

Shortly before the changes in the Law on Joint-Stock Societies, the legislature introduced into the Law on Limited Responsibility Societies similar rules on agreements between the members of limited responsibility societies. Article 8(3) of the Law on Limited Responsibility Societies contains only general information about the issues that may be included in the shareholder agreements of the members of limited responsibility societies. In contrast to the changes to the Law on Joint-Stock Societies, it does not specify further limits for the agreements, nor does it provide any guidelines for the enforcement of shareholder agreements. The wording of Article 8(1) is similar to the definition of stockholder agreements contained in Article 32.1(1) of the Law on Joint-Stock Societies.[23] This abstract wording in effect serves the aim of confirming the legality of shareholder agreements in principle, and leaves much room for future judicial interpretation.

ENFORCEABILITY OF THE PROVISIONS OF SHAREHOLDER AGREEMENTS UNDER RUSSIAN AND ENGLISH LAW

The issues raised in Russian judicial practice on shareholder agreements[24] and in doctrinal writings on the use of shareholder agreements in Russia[25] allow the following

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[21] Article 32.1(7) of the Law on Joint-Stock Societies does not use the term "liquidated damages" by reason of the principle of full compensation of damages under Russian civil law. However, the suggested remedy of compensation probably will serve as the functional equivalent of liquidated damages in Russian law, allowing the parties of stockholder agreements to make a choice between the specific performance of their obligations and the payment of compensation/damages.

[22] By reason of 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 shareholder agreement, termination.

[23] See note 18 above and accompanying text. For a brief description of Article 8(1) and its legislative history see Oda, note 7 above, at 362-363.

[24] Decision of the Federal Arbitrazh Court of West-Siberian Region, note 10 above (declaring illegal the provisions of the stockholder agreement deviating from the imperative rules of the Law on Joint-Stock Societies and company charters); Decision of the Arbitrazh Court of Moscow, 26 December 2006, No. A40-62048/06-81-343 (the stockholder agreement was considered invalid because its provisions were contrary to imperative rules of the Civil Code, the Law on Joint-Stock Societies and the provisions of the charter of the company; the court also stated that the provision of the agreement establishing its priority over the charter was illegal); Decision of the Arbitrazh Court of Moscow, 13 March 2008, No. A40-68771/07-81-413 (an imperative statutory rule cannot be altered by the agreement of stockholders; although the defendant also raised the question of relations between the stockholder agreement and the charter, the court refrained from expressing its position on the issue).

[25] See Ostapets and Konovalov, note 8 above, at 51, 54 (for the contradictions between imperative rules and the provisions of stockholder agreements, the availability of specific performance of the agreements and default event clauses, and the effect of the breaches of stockholder agreements on corporate acts); Evgenii Levinskii, «Использование модели соглашения акционеров в России" [Use of a Stockholder Agreement Model in Russia], Закон [Law], no. 10 (2006), pp. 128-129 and Alexander Ivanov and Nadezhda Lebedeva, «Соглашения акционеров: шаг вперед или топтание на месте» [Stockholder Agreements: A Step Forward or Running in Place], Корпоративный юрист [Corporate Jurist], no. 9 (2008), pp. 51-53 (explaining the impossibility of specific performance of stockholder agreements according to Russian law and showing the limits of penalty clauses); Oda, note 7 above, at 364, 366-368 (with regard to the disposal and acquisition of shares as a means to secure the performance of obligations arising out of a shareholder agreement, the participation of the company

"controversial" issues to be singled out with regard to the enforcement of shareholder agreements:

- non-compliance of shareholder agreements with imperative norms and/or the internal documents of companies (company charters);
- the effect of breaches of shareholders agreements on company decisions (resolutions) and on transactions with third persons;
- the right of a company to be a party in a shareholder agreement between its shareholders;
- claiming specific performance of a shareholder agreement in court/using court injunctions for the specific performance of shareholder agreements.

In the remainder of this section these questions are the basis for the comparative analysis of English and Russian law on shareholder agreements.

Contradictions between Imperative Norms and Company Charters and Shareholder Agreements

Russian judicial practice concerning shareholder agreements is clear on the priority of imperative legal rules and of charter provisions over shareholder agreements. Those provisions of shareholder agreements which do not comply with imperative legal requirements and are in conflict with charter provisions are invalid, and thus do not create any legal consequences. In the *Megafon* case the court listed all the imperative provisions of the Law on Joint-Stock Societies and the charter provisions of Megafon Open Joint-Stock Society that were in conflict with the stockholder agreement– among them the quorum rules for general and extraordinary stockholder meetings and board of directors, rules on notification of stockholders, 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 stockholders and board.[26] The Arbitrazh Court of Moscow adopted a similar approach in the *Russian Standard Insurance* case.[27]

This approach was confirmed by the courts in a similar dispute involving a shareholder agreement between the participants of a limited responsibility society.[28] The Arbitrazh

itself in the shareholder agreement, the enforceability of a shareholder agreement against the company, the effect of the breach of a shareholder agreement on transactions with third persons and on the decisions of corporate bodies, the availability of specific performance of shareholder agreements); Dmytri Stepanov, «Договор об осуществлении прав участников ООО» [Contract of Participants of a Limited Responsibility Society], Вестник Высшего Арбитражного Суда Российской Федерации [Herald of Supreme Arbitrazh Court of Russian Federation], no. 12 (2010), pp. 66-74, 78-79, 87, 90 (discussing the contradictions between shareholder agreements, on one hand, and statutory rules and the charter on the other, participation of the society in its shareholders' agreement, specific performance of shareholder agreements, possible results of breaching a shareholder agreement on corporate acts and transactions with third persons).

[26] Decision of the Federal Arbitrazh Court of West-Siberian Region, note 10 above.

[27] Decision of the Arbitrazh Court of Moscow, note 24 above (in contravention of the statute and the charter of the insurance company, the stockholder agreement, for instance, provided for different number of the board members, differing procedures for the appointment of the company chief executive officer and the election of the board members).

[28] Legal practitioners simulated the dispute between the members of *Vernyi Znak Limited Responsibility Society* in order to clarify the position of courts on the changes on shareholder agreements. The shareholders of the limited responsibility society entered into a shareholder agreement and included in it provisions which

Court of Moscow confirmed the priority of imperative legal rules and charter provisions over the provisions of shareholder agreements by stating that an agreement serves the aim of providing more details with regard to the allocation of the rights of the members of limited responsibility societies (rather than replace those of the charter of the company).[29]

The priority of imperative rules over the provisions of shareholder agreements in Russian law is also supported in legal scholarship published after the introduction of the rules on stockholder agreements in the Law on Joint-Stock Societies.[30]

The relation between the articles of association and a shareholder agreement 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 a shareholder agreement.[31] Sometimes shareholder agreements provide the obligation for the parties to amend the articles of association in line with the provisions of the agreement. In such cases shareholder agreements 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 they entitle the use of 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*.[32] 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. A similar provision was included in the articles of association of the defendant company. After the defendant refused to accept the nomination of 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.[33]

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were in contradiction with the federal law and the charter of the society. In particular, the parties tested the possibility of the participation of the society in the agreement, restricting the right to sell shares, depriving a party of voting rights as a result of breaching the agreement (Yulia Govorun and Philip Sterkin, «Эксперимент для прецедента» [An Experiment for a Precedent], Ведомости [Gazette], 3 March 2010; Dmytri Dmitriev, «Актуальный пример оспаривания договора об осуществлении прав участников ООО» [Actual Example of Contesting the Shareholder Contract of a Limited Responsibility Society], Слияния и поглощения [Mergers and Acquisitions], no. 1-2 (2010), p. 66).

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

[30] See Igor Korneev and Victoria Arutiunian, «Акционерное соглашение: заключение, содержание и исполнение» [Shareholder Agreement: Conclusion, Content, and Performance], Корпоративный юрист [Corporate Jurist], no. 1 (2010), p. 33.

[31] See Christopher Rose, "Don't be the Second Little Pig", *International Financial Law Review*, no. 10 (2007), p. 33. The main benefit of integrating the provisions of a shareholder agreement into the articles of association is that while a breach of a shareholder agreement gives rise 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 informational disadvantages, because shareholder agreements usually are confidential, whereas the company's articles are available to the public.

[32] [1915] 2 Ch. 186.

[33] [1915] 2 Ch. 186, 193-5.

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 the 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.[34] 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 where the articles were altered. The articles of association were entrenched indirectly by placing a financial premium on their alteration.[35]

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.[36] As the House of Lords did not make any reference to the *dicta* in *Southern Foundries (1926) Ltd. v Shirlaw*, it can be presumed that the case is overruled.[37] Yet, the House of Lords distinguished between the agreements between the company and the shareholders, on 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 the personal contractual obligations of shareholders, which can in effect prevent alterations of the articles of association – such as the agreement of shareholders to vote unanimously for such alterations.[38] Hence, contradictions between the provisions of shareholder agreements and articles of associations do not invalidate the former, and at least lead to the obligation of the defaulting party to compensate damages.

Case law on the relationship between shareholder agreements and imperative statutory provisions is clearer. The rules on the duties of company directors who own shares of the company demonstrate this relation. The contractual arrangements of such shareholders (directors) cannot fetter their statutory general duties in the capacity of the company directors (for example, the duty to promote the success of the company, duty to exercise independent judgment).[39] In *Kregor v Hollins* the court established a rule that directors must not fetter their discretion (independent judgment).[40] For example, a director cannot agree in a shareholder agreement to vote in a particular way in the interests of a creditor or other shareholder.

The priority of imperative statutory rules over the provisions of shareholder agreements also follows from the long established principle in case law, which prescribes that a company forgo its statutory right to alter its articles of association. Any provision

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[34] [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.).

[35] Clare M. S. McGlynn, "The Constitution of the Company: Mandatory Statutory Provisions v Private Agreements", *Company Lawyer*, XV (1994), p. 302.

[36] [1992] 1 W.L.R. 588, 593.

[37] McGlynn, note 35 above, at 303.

[38] [1992] 1 W.L.R. 588, 594-5.

[39] Companies Act 2006, sections 170-177.

[40] *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.).

that limits the power of a company to alter its articles is invalid on the ground that it is contrary to the statute.[41]

Voting agreements can be viewed as exceptions that actually can alter the statutory provisions on the required minimum voting thresholds. The common law acknowledges the freedom of shareholders to enter into contracts that prescribe the way they will exercise their votes.[42] 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 a 75% majority vote.[43] As is shown below in more detail, the court banned a company from participating in alternative undertakings (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.[44]

Due to the subtle distinction established in *Russell*, a similar effect can be achieved by the means of a shareholder agreement that does not include the company as a party. For instance, an agreement between shareholders to vote unanimously for a resolution to change the articles of association is a substitute mechanism that 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 resolutions were considered as imperative with respect to the company's obligations. But the same provisions were treated as enabling with regard to the personal undertakings of shareholders.[45]

However, the claim that voting agreements can alter imperative 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 that 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, section 184).[46] The decision of the court was based on the reasoning that the Companies Act specified the type of the resolution required (ordinary resolution), whereas companies and shareholders are free in allocating voting rights for such resolutions.[47] Therefore, in the light of *Bushell v Faith* the definition of required voting thresholds for specific matters

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[41] *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.

[42] Eilis Ferran, "The Decision of the House of Lords in Russell v. Northern Bank Development Corporation Limited", *Cambridge Law Journal*, LIII (1994), p. 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.).

[43] Companies Act 2006, section 283.

[44] See below the discussion of *Russell v Northern Bank Development Corporation Ltd*.

[45] Peter Jaffey, "Contractual Obligations of the Company in General Meeting", *Legal Studies*, XVI (1996), p. 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"*. See McGlynn, note 35 above, at 303-304, 306.

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

[47] [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. See Ferran, note 42 above, at 346-347 (with references to the scholarly literature).

by shareholder agreements is interfering with the provisions of the articles of association, rather than with statutory provisions.[48]

To ensure a consistent approach regarding the relations between the provisions of shareholder agreements and the articles of association a disclosure requirement has been introduced by the Companies Act 2006.[49] When the provisions of a shareholder agreement, 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.[50] 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;
c) any agreement that effectively binds all shareholders of a class of shares though not agreed to by all those shareholders.[51]

A provision of a shareholder agreement 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 laws are clear on the priority of imperative statutory rules over the provisions of shareholder agreements. With regard to the relationship between the company charters and shareholder agreements, Russian law has the same approach: in case of conflicts, the provisions of shareholder agreements are invalid. In contrary to this, in English law the conflicts between the company articles and shareholder agreements do not invalidate the latter. But such conflicts – more particularly

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[48] At the same time, it should be admitted that *Bushell v Faith* and *Russell* contain contradictory implications, for the first tolerates distinctions from statutory powers in the company's articles of small businesses, whereas 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 imperative 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 (imperative or enabling) see Peter Jaffey, "Restraining the Exercise of Corporate Statutory Powers", *Denning Law Journal*, IX (1994), pp. 68-77.

[49] It is worth mentioning that a liberal view in English scholarship arguing for maximum contractual freedom in shareholder agreements (including with regard to the participation of the company in its shareholder 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 shareholder agreements. See Ferran, note 42 above, 362.

[50] Mads Andenæs and Junko Ueda, "Shareholders' Agreements: Some EU and English Law Perspectives", *Tsukuba Law Journal*, no. 3 (2007), p. 137.

[51] Companies Act 2006, section 29(1). The interpretation of Section 29 by the courts can be broader and might require the disclosure of shareholder agreements in other cases as well. See Anna Ovcharova and Ekaterina Sjostrand, «Правовое регулирование и практические аспекты заключения и исполнения соглашений акционеров по российскому и английскому праву: сравнительный анализ» [Legal Regulation and Practical Aspects of the Conclusion and Performance of Stockholder Agreements under Russian and English law: Comparative Analysis], *Слияния и поглощения* [Mergers and Acquisitions], no. 12 (2009), p. 73.

in cases where they have external effects for non-participating shareholders and/or third persons – in effect change the status of shareholder agreements by rendering them into a company constitution and leading to their registration and disclosure.

External Effects of a Breach of Shareholder Agreements

As mentioned above, the changes in Russian law directly rule out any effect of breaches of stockholder agreements on the decisions and resolutions of the corporate organs of the involved company, including with respect to transactions with third persons.[52] The restrictions follow from the clear demarcation between the contractual relations of the parties to a stockholder agreement and the relations of a stockholder with a company. They can be explained by the aim of limiting the external effects of stockholder agreements given their confidential nature. The provisions of stockholder agreements in general do not create effects for non-participating stockholders, for the company itself, its contracting parties, and personal creditors of stockholders. To create such external effects, similar provisions would need to be included in the charter.

In English law the analysis of shareholder agreements within the contractual context shows that unlike the articles of association,[53] shareholder agreements create personal obligations between their immediate parties only. They do not become a "constitution" of the company (by 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.[54] Similarly, the contractual nature of shareholder agreements implies that such agreements do not affect transactions with third persons and company resolutions.

Some exceptions are possible when shareholder agreements exceed the bounds of the contractual context, the main one being the unanimous shareholder agreements in private limited companies.[55] Case law equated unanimous informal agreements of all shareholders with a resolution of a general meeting.[56] The requirement of the disclosure of unanimous shareholder agreements of the Companies Act 2006 transforms them into part of a company's constitution.[57] In these cases it is no surprise that shareholder agreements create external effects for companies' acts and third person transactions. For instance, an action breaching a company's constitution, such as a transfer of shares to a third person in breach of restrictions, is invalid.

To sum up, both Russian and English law set strict limits on the external effects of shareholder agreements, conditioning such effects on the availability of information.

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[52] See above note 19 and accompanying text.

[53] 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. See Andenæs and Ueda, note 50 above, at 138-139.

[54] Andenæs and Ueda, note 50 above, at 138-140; Len Sealy and Sarah Worthington, *Cases and Materials in Company Law* (2008), p. 230.

[55] The use of unanimous shareholders agreements is practically impossible in listed companies with the large number of stockholders.

[56] Mathias M. Siems, *Convergence in Shareholder Law* (2008), pp. 54-55.

[57] For the limited cases when shareholder agreements should be disclosed and acquire the status of a company's constitution see above notes 49-51 and accompanying text.

But Russian law permits external effects of shareholder agreements for third person transactions only, whereas English law takes a step further allowing external effects for company resolutions as well. At the same time, possible effects of shareholder agreements on company resolutions in Russian law should not be ruled out, because the courts still have to express their opinion on this matter, more particularly in the context of unanimous agreements between all shareholders (stockholders).

Parties to Shareholder Agreements

In the draft version, the changes to the Law on Joint-Stock Societies with regard to stockholder agreements were clear that the company itself cannot participate in a stockholder agreement concerning its stocks.[58] This is important because the participation of the company in a stockholder agreement strengthens the enforceability of such agreements against the company. Hence, a breach of the agreement can affect corporate acts and also indirectly third persons.

Although, in the current version, Article 32.1 of the Law on Joint-Stock Societies 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 society in relation to whose shares a stockholder agreement is to be concluded to become a party to it.[59]

The opposite opinion offers a broader list of the participants of shareholder agreements. 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 (stocks), the society itself and future shareholders (stockholders), to participate in shareholder agreements.[60] However, it should be noted that the proponents of this approach concede that the rights and obligations of the society under the stockholder agreement should be limited: for instance, the society can be bound by the terms on the assignment of the stocks owned by it, but it cannot participate in voting agreements[61] and cannot affect such agreements.[62] Moreover, the society should not be obliged to perform a decision made by the stockholders according to the agreement, if such a decision is made in contradiction to the provisions of the society charter.[63] Apparently, this view allows for the participation of the society

[58] Oda, note 7 above, at 362.

[59] Dmytri Lomakin, «Договор об осуществлении прав участников хозяйственных обществ как новелла корпоративного законодательства» [Agreements on the Effectuation of the Rights of Participants of Economic Societies as a Innovation of Corporate Legislation], Вестник Высшего Арбитражного Суда Российской Федерации [Herald of Supreme Arbitrazh Court of Russian Federation], no. 8 (2009), p. 15; Oda, note 7 above, at 366.

[60] Alexander Kudelin, «Акционерное соглашение по российскому праву» (Часть I) [Stockholder Agreements under Russian law, Part I], Корпоративный юрист [Corporate Jurist], no. 10 (2009), p. 24. See also Korneev and Arutiunian, note 30 above, at 33-34 (with regard to the participation of the holders of the rights on pledged stocks, portfolio managers, holders of depository receipts, other third persons (future stockholders) and the company in stockholder agreements; although admitting that court practice might deny the enforcement of stockholder agreements with regard to the rights of third persons and non-direct (beneficiary) stockholders).

[61] According to Article 72(3) of the Law on Joint-Stock Societies and Article 24(1) of the Law on Limited Responsibility Societies, in cases of owning their own stocks (shares), companies cannot vote them.

[62] As mentioned above, Article 32.1(2) denies legal effect to the obligations of the stockholders to vote in accordance with the instructions of the company organs.

[63] Kudelin, note 60 above, at 25-26. Similarly, most obligations of future shareholders should be conditional and should be performed only after a party formally becomes a shareholder (id., at 26.).

in its stockholders' agreement as an owner of its own stocks, rather than as an issuer of the stocks. This restriction logically (from the perspective of Article 32.1 of the Law on Joint-Stock Societies) and rationally limits the effect of the enforcement of a stockholder agreement on society decisions and resolutions and on relations with third persons.

In English law the question of the possibility of the participation of a company in a shareholder agreement does not raise doubts. However, the common law has developed restrictive standards for such participation. One landmark case is *Russell v Northern Bank Development Corporation Ltd.* The shareholder agreement between the all shareholders of *Tyrone Brick Ltd.* and the company itself provided that further share capital could 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*.[64] The House of Lords decided that a company cannot be party to a shareholder agreement which restricts its statutory powers; however, an agreement between the shareholders with the same effect is not invalid and can be enforced by courts.[65] 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 the possible effects of such agreements on future shareholders. In *Russell* the agreement between the shareholders was permitted because it was "*purely personal to the shareholders who executed it and … does not purport to bind future shareholders*".[66] 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 shareholder agreement of *Tyrone Brick Ltd.* included all shareholders.

Under the Companies Act 2006, a similar provision in a shareholder agreement[67] will transform the agreement into part of the company's constitution and will trigger the requirement of the disclosure thereof.[68] This consequence follows 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 materialized into 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 company participation in a shareholder agreement in general. However, as the law does not directly restrict such participation, court practice will probably allow it subject to several restrictions.

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[64] *Russell v Northern Bank Development Corporation Ltd.* [1992] 1 W.L.R. 588, 590.
[65] [1992] 1 W.L.R. 588, 593.
[66] [1992] 1 W.L.R. 588, 594.
[67] The shareholder agreement 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.).
[68] Companies Act 2006, section 29.See also above notes 49-51 and accompanying text.

Availability of the Specific Performance of Shareholder Agreements

According to legal doctrine, Russian law does not allow for the specific performance of shareholder agreements. Legal theory explains this limitation by the non-proprietary nature of the most of the rights and obligations included in shareholder agreements.[69] In addition, courts cannot anticipate possible breaches of shareholder agreements 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.[70] This categorical view can be explained by the narrow limitation of the notion of specific performance and the equating thereof with court injunctions.

Doctrinal writings contain the opposite view, according to which specific performance of stockholder agreements (more specifically, injunctions) in Russia is theoretically possible (based on an interpretation of Article 32.1 of the Law on Joint-Stock Societies; however, not confirmed by the judicial practice yet) in limited cases. In particular, when the general meeting of stockholders approves a large-scale transaction in violation of the stockholder agreement (stockholders 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 stockholder to vote in a specific way in the next general meeting of stockholders, which can be convened to reverse the resolution. However, this is possible as long as the large-scale transaction is not yet performed at the time of the second meeting.[71]

The unavailability of specific performance for all provisions of shareholder agreements 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 Article 396(2) of the 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 legislation or contract. Thus, parties to a shareholder agreement 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 its obligations (for instance, the transfer of shares under certain conditions).[72]

In the United Kingdom specific performance is available only when the nature of relations makes the remedy appropriate. Voting agreements are an example of such contractual relations. English law of equity allows for the granting of negative/prohibitive injunctions binding shareholders to refrain from voting in a general meeting for particular resolutions.[73] Courts can also grant binding injunctions to compel shareholders to vote in a particular manner based on their contractual obligations.[74]

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

[69] Levinskii, note 25 above, at 128-129.
[70] Ivanov and Lebedeva, note 25 above, at 51-52.
[71] Alexander Kudelin, «Акционерное соглашение по российскому праву» (Часть II) [Stockholder Agreements under Russian Law, Part II], Корпоративный юрист [Corporate Jurist], no. 11, p. 8.
[72] Korneev and Arutiunian, note 30 above, at 36.
[73] *Greenwell v Porter* [1902] 1 Ch. 530, 536.
[74] *Puddephatt v Leith* [1916] 1 Ch. 200, 202.

agreement between the shareholders.[75] After the Companies Act 2006, such court injunctions are less controversial, as the shareholder agreement would have the status of the company 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*,[76] and the argumentation of Lord Macmillan expressed in *Inland Revenue Commissioners v J. Bibby & Sons Ltd.*[77] In *Puddephatt v Leith* the court was able to require the defendant to vote according to the instructions of the plaintiff based on the shareholder agreement, because in the preceding general meeting the defendant had voted against the instructions of the plaintiff and was insisting on his right to vote independently in the following meeting.[78]

Specific performance in English law encounters 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.[79]

To strengthen the specific performance of shareholder agreements, parties to such agreements make a special clause which provides that, in cases of a breach of the agreements, the parties assumed specific performance as a remedy. However, United Kingdom courts are not bound by such clauses. 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 (at 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 shareholder agreements is absent, but the limited availability of specific performance is acknowledged by legal scholarship. In the United Kingdom, the law of equity, although clear on the availability of specific performance in the context of shareholder agreements, puts significant restrictions on it.

SHAREHOLDER AGREEMENTS OF RUSSIAN COMPANIES GOVERNED BY ENGLISH LAW: WHAT COUNTS?

Analysis shows that in their capacity as a contractual instrument in both jurisdictions, shareholder agreements encounter similar treatment and enforcement issues.[80] This

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[75] Ferran, note 42 above, at 344-345.

[76] [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."*).

[77] [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."*).

[78] [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.).

[79] For the brief discussion of specific performance of shareholder agreements in common law jurisdictions see Michael J. Duffy, "Shareholders' Agreements and Shareholders' Remedies: Contract Versus Statute?", *Bond Law Review*, XX (2008), pp. 13-14.

[80] The treatment of shareholder agreements in the United States with regard to the "controversial issues"

similarity raises a question about the alleged continuing popularity, among Russian private actors, of English law to govern shareholder agreements. 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 as the law applicable to shareholder agreements of Russian companies. At the same time, we do not pretend to provide a complete list of possible explanations. Nor is it possible here to determine the importance of particular explanations.

Structure (Imperative versus Enabling) of Corporate Law

Although containing contractual obligations of the shareholders, shareholder agreements also affect the internal governance of companies. Given the important role of statutory provisions in internal governance, the scope of shareholder agreements 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 imperative provisions in corporate statutes, the less will be the scope of freedom in the contractual relations of the parties. The simple reason for this is that a contract cannot override statutory rules.

This shows that a crucial factor in defining the effectiveness of shareholder agreements is the nature of corporate law in general. The prevalence of enabling rules over imperative rules in corporate law statutes affects positively the scope of the agreements. Therefore, the popularity of English law in governing the shareholder agreements of companies with a majority of Russian participants can be attributed to the nature of the imperative structure of Russian corporate law in general and the absence of differentiated approaches of regulation for listed and non-listed business entities. Whereas in the United Kingdom shareholder agreements are mainly encountered in non-listed companies, implying 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 a "one-size-fits-all" approach to all societies.

The need to differentiate between listed and non-listed companies is better demonstrated by United States court practice, where the rise of shareholder agreements started when the courts introduced differing approaches for corporations and close corporations.[81] In the early twentieth century inflexible governance structures designed for large listed companies in the form of imperative rules did not provide much scope for contractual arrangements of the participants of smaller non-listed firms. Courts, for their part, refused to consider differences between listed and close corporations arising from differing needs

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is slightly different from the ways English and Russian law deal with shareholder agreements. The United States courts are more inclined to grant specific performance and injunctions for the enforcement of shareholder agreements (Duffy, note 79 above, at 13). Similarly to English and Russian law, according to common law in the United States, shareholder agreements cannot violate statutory provisions. 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 (id., 6-8). Below it is shown that in 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 85-86 and accompanying text).

[81] Steven N. Bulloch, "Shareholder Agreements in Closely Held Corporations: Is Sterilization an Issue", *Temple Law Quarterly*, LIX (1986), pp. 68–71; Wells, note 16 above, at 297-304, 308.

of the involved parties.[82] However, gradually the attitude of the courts towards the needs of close corporations changed, and by the mid of the twentieth century stockholders of close corporations got more opportunities for regulating internal corporate relations by private agreements.[83] At the final stage corporate statutes were changed to acknowledge the special features of close corporations.[84]

New statutory rules on close corporations allowed their participants to depart from the rules by providing for special internal governance rules in shareholder agreements. 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 stockholders of a corporation is effective among the stockholders 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 shareholder agreements 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 stockholders, or in a unanimous shareholder agreement;
2. the agreement should be subject to amendment only by all stockholders, 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.[85]

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 nonpublic corporations various types of agreements among shareholders even when the agreements are inconsistent with the statutory norms contained in the Act."[86]

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[82] Wells, note 16 above, at 285-9, 292 (describing the leading case of *Jackson v Hooper*, where the Court of Errors and Appeals of New Jersey struck down the agreement between the shareholders on account of contradictions with statutory provisions, especially with the rules ensuring the independence of board members).
[83] Id., 304.
[84] Id., 312-314.
[85] Revised Model Business Corporation Act, section 7.32(b) and (d).
[86] *Model Business Corporation Act: Official Text with Official Comments and Statutory Cross-References Revised through June 2005* (2005), 7-72–7-73.

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 shareholder agreements over imperative statutory rules.

In Russia, after the 2008 changes, the Law on Limited Responsibility Societies provides more flexibility to the members of limited responsibility societies.[87] Shareholders of limited responsibility societies enjoy more autonomy as compared to both the old regime and the statutory rules on joint-stock societies in matters such as voting rights, procedures for convening and holding general meetings, the distribution of powers between corporate bodies – general meeting of members, board of directors and management. Therefore, shareholder agreements in limited responsibility societies 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 changes in the Law on Joint-Stock Societies, nor the changes in the Law on Limited Responsibility Societies were accompanied by a systematic revision of statutory provisions with regard to their nature – should they continue to be imperative, or does the extent of the underlying conflicts allow providing to the end users of the business forms opt-out or opt-in menus?

Legal Certainty and Network Effects

Many aspects of shareholder agreements in the United Kingdom have been developed from case law. The abstract wording of Article 32.1 and Article 8(3) of the Russian Federal Law on Joint-Stock Societies and the Federal Law on Limited Responsibility Societies respectively attribute an important role to court practice as well. However, this practice has yet to develop. The introduction of new legal institutions and rules always encounters the potential drawback of being a relatively untested phenomenon that has not generated a large body of case law and academic research.[88] Apparently, legal certainty matters for private actors. In particular, the scholarly literature on regulatory competition imparts an important role to a well-developed stable case law for attracting companies.[89]

Additionally, network externalities – the present value of future judicial decisions interpreting legal rules – play an important self-reinforcing role for maintaining leading positions for a jurisdiction (rule) that is popular among the users. By adopting a rule that

[87] Brief description of the amendments is provided in Dmytri Stepanov, «Реформа законодательства об ООО: к принципу свободы договора в корпоративном праве» (Часть I) [Reform of Legislation on Limited Responsibility Societies: Toward the Principle of Freedom of Contract in Corporate Law, Part I], Корпоративный юрист [Corporate Jurist], no. 6 (2009), pp. 13-19; Dmytri Stepanov, «Реформа законодательства об ООО: к принципу свободы договора в корпоративном праве» (Часть II) [Reform of Legislation on Limited Responsibility Societies: Toward the Principle of Freedom of Contract in Corporate Law, Part II], Корпоративный юрист [Corporate Jurist], no. 7 (2009), pp. 4-11.

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

[89] Roberta Romano, "Law as a Product: Some Pieces of the Incorporation Puzzle", *Journal of Law, Economics, and Organization*, I (1985), pp. 250-251, 274, 280-281; Roberta Romano, *The Genius of American Corporate Law* (1993), pp. 39-40.

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 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.[90]

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

Quality of the Judiciary

The literature on regulatory competition points to the important role of the judiciary in ensuring a competitive advantage for a particular jurisdiction. In particular, Bebchuk and Hamdani list Delaware's Chancery Court – which delivers judgments expeditiously and has developed specialized expertise – among one of the important advantages of Delaware in attracting company incorporations.[91] A similar argument is made by Kahan and Kamar.[92] An empirical investigation of corporate incorporations in American 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.[93]

The *Rule of Law Index* is one of the few available projects that compares judiciaries in a wide range of jurisdictions. The *Rule of Law Index 2011* includes data on 66 countries, including the courts of the United Kingdom and Russia. Although with limitations, this index demonstrates the significant advantages of United Kingdom courts in almost all variables related to civil justice and civil procedure in relation to 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 United Kingdom courts still perform better.[94]

The second available index for comparing courts in different jurisdictions is the *Lex Mundi* project. The project provides data on procedural formalism and the time needed to obtain and enforce judgments on basic disputes (eviction of a tenant for nonpayment

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[90] Michael Klausner, "Corporations, Corporate Law, and Networks of Contracts", *Virginia Law Review*, LXXXI (1995), pp. 779, 843-847 (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, note 89 above, at 44. See also Brett H. McDonnell, "Two Cheers for Corporate Law Federalism", *Journal of Corporation Law*, XXX (2004), p. 104.

[91] Lucian Arye Bebchuk and Assaf Hamdani, "Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters", *Yale Law Journal*, CXII (2002), pp. 588-589.

[92] Marcel Kahan and Ehud Kamar, "The Myth of State Competition in Corporate Law", *Stanford Law Review*, LV (2002), pp. 725-726 (the specialized court is part of Delaware's competitive advantage).

[93] Marcel Kahan, "The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?",*Journal of Law, Economics, and Organization*, XXII (2006), pp. 352-357.

[94] Mark D. Agrast, Juan C. Botero, and Alejandro Ponce, *WJP Rule of Law Index 2011* (2011), pp. 90, 102.

of rent and collection of money) in the courts of 109 countries. Although the speed of delivering judgments and formal procedural rules offer limited arguments for making suggestions about the quality of court systems, the data again confirms the advantages of the United Kingdom judiciary. In Russia the eviction of a tenant is expected to take 130 days, and money collection requires 160 days. Pursuing the same claims in United Kingdom courts is expected to take 115 and 101 days respectively. Court proceedings in the United Kingdom are also less formalized.[95]

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

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 shareholder agreements (because many buy-sell clauses are conditional upon certain events), and for the specific mechanisms of their enforcement (default event clauses).

Article 32.1(1) of the Law on Joint-Stock Societies and Article 8(3) of the Law on Limited Responsibility Societies provide that stockholder (shareholder) agreements can contain provisions on transactions with the stocks or shares: selling shares at a predefined price and/or upon the occurrence of a certain event. Can the conditions in an agreement be controlled by the parties (such as selling shares at the demand of the other party without any indication of the reasons), or should the conditions be out of their control (such as share price changes, financial crisis, other)? Russian *arbitrazh* courts have wrongly developed a formal interpretation of the term "certain undefined events"[96] and refuse to consider as a condition any future event that depends on the will of one of the parties. According to Russian judicial practice, conditions cannot be actions or failure to act of the parties to an agreement. Rather they are unpredictable external circumstances (non-)occurrence of which does not depend on the will of the parties.[97] This renders the provisions of shareholder agreements on buy-sell options and a default events invalid, and thus significantly limits the scope and effectiveness of shareholder agreements.

English contract law allows for contingent conditions to bind a party (condition precedent) or to determine the obligations thereof (condition subsequent), depending on actions or will of the other party.[98] For example, a condition in a contract may provide that

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[95] Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "Courts", *Quarterly Journal of Economics*, CXVIII (2003), pp. 478-489, 494-500.

[96] Article 157(1) and (2), Civil Code of the Russian Federation (*"1. A transaction shall be considered to be concluded under a condition subsequent if the parties have made the arising of rights and duties dependent upon a circumstance relative to which it is unknown whether this will ensue or not. 2. A transaction shall be considered to be concluded under a condition precedent if the parties have made the termination of rights and duties dependent upon a circumstance relative to which it is unknown whether it will ensue or not"*. W. E. Butler (transl. & ed.), *Civil Code of the Russian Federation* (2010), p. 67.

[97] For an exhaustive list of references to the judgments of higher *arbitrazh* courts see Stepanov, note 25 above, at 84.

[98] Hugh G. Beale (gen. ed), *Chitty on Contracts, Vol. 1, General Principles* (30th ed., 2008), p. 227, para. 2-148;

the binding obligation of one party to pay allowances to the other party is to come to an end if the latter party marries.

A similar approach is applied throughout Europe and is recommended in the Principles of European Contract Law.[99] 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 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."*[100] 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 shareholder agreements are clear examples, falling within the second valid category of conditions. It is noteworthy that 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 the enforcement of the 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 applicable law too. One example is restrictive covenants in shareholder agreements – 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 shareholder agreement 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.[101] Therefore, the covenant can also "bite" in cases when shares are not disposed. The appellate court went even further by 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."*[102]

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 thus 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 often blamed for the shift to foreign law as the applicable law of shareholder agreements. In particular, the Russian Civil Code entitles courts to reduce the amount of a contractual penalty if it

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Edwin Peel, *Treitel on the Law of Contract* (12th ed., 2007), pp. 67-8, para. 2-110.

[99] Ole Lando and Hugh Beale (eds), *The Principles of European Contract Law, Part I: Performance, Non-Performance and Remedies* (2000), pp. 229-233.

[100] Ibid., 230.

[101] [1998] I.C.R. 1068, 1093.

[102] [1998] I.C.R. 1068, 1107.

is obviously disproportionate to the consequences of the breach of an obligation.[103] This subjects penalty clauses to a different regime of treatment with regard to contractual freedom, as opposed to other contractual clauses.[104] The importance of fully enforceable penalty clauses is crucial for the enforcement of shareholder agreements because the nature of the obligations of such agreements often makes impossible or ineffective other traditional contractual remedies (such as compensation of damages).

However, the basic principle of English law is that penalty clauses are not allowed at all.[105] 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"*.[106] 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.[107] 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.[108]

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, Article 333 of the Civil Code – by referring to *"the consequences of a violation of an obligation"* as a proxy to determine the *"obviously disproportionate"* amount of a penalty, in effect links penalty clauses with actual damages. The difficulty of defining such damages in the context of shareholder agreements can make the courts less willing to reduce the amount of penalties in cases related with breaking shareholder agreements. Finally, the introduction of the functional equivalent of liquidated damages into Russian rules on shareholder agreements(compensation clauses) provides parties with an additional remedy of ensuring the specific performance of obligations. Yet, in the absence of court practice, doctrinal writings are not unanimous on

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[103] Article 333, the Civil Code of the Russian Federation. According to the Constitutional Court of the Russian Federation, reducing the amount of penalties by the courts is one of the remedies against abuse of right; therefore, Article 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. See Decision of the Constitutional Court of the Russian Federation, 21 December 2000, no. 263-O.

[104] In the beginning of 2011 the Supreme Arbitrazh Court of the Russian Federation clarified the rules on reducing the amount of a penalty. First, courts may 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 (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 it, as the previous practice of court action on its own motion violated the principle of adversarial procedure. See Decree of the Presidium of the Supreme Arbitrazh Court of the Russian Federation, 13 January 2011, No. 11680/10 (Russian legal system does not apply classic precedent law; however the decisions of the Supreme Arbitrazh Court are highly influential and as a rule are observed by lower *arbitrazh* courts).

[105] For a global perspective on the enforcement of penalty clauses see Ugo Mattei, "The Comparative Law and Economics of Penalty Clauses in Contracts", *American Journal of Comparative Law*, XLIII (1995), pp. 433-438.

[106] *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.

[107] Mattei, note 105 above, at 435-436.

[108] Ibid., 432, 436.

whether clauses regarding compensation can be reviewed by the courts based on Article 333 of the Civil Code.[109]

At the same time, it should be pointed out that the strong enforcement of penalty clauses is only one element of an efficient model of contractual penalties. The second element is the clearness and certainty of the position of courts on their enforcement.[110] And here – notwithstanding the broad discretion English courts enjoy in enforcing liquidated damages clauses – the wealth of case law, and standardized practice of shareholder agreements in English law might have advantages for drafting and enforcing shareholder agreements. 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.

Role of Supplementary Mechanisms

English law offers other supplementary mechanisms that allow strengthening the effectiveness of shareholder agreements. For instance, voting agreements are strengthened by granting irrevocable proxies to one of the parties to the agreement or to an independent person. The latter votes for all shareholders who granted the proxy according to the provisions of the agreement, whereas the shareholders themselves waive their right to vote. Although English law is stricter on irrevocable proxies to vote shares compared to United States law,[111] the use of irrevocable powers of attorney to vote shares is practiced in shareholder agreements governed by English law.

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 shareholder agreements valueless.[112] 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,[113] and uncertainty about the possibility of granting voting rights by an agency contract in general.

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[109] Ivanov and Lebedeva, note 25 above, at 53 (claiming that given the difficulty of defining damages under shareholder agreements, Article 333 should not be applicable to penalty clauses included in shareholder agreements); Korneev and Arutiunian, note 30 above, at 37 and Stepanov, note 25 above, at 89 (for a claim that compensation is different than penalty clauses, so it cannot be reduced by the courts).

[110] Mattei, note 105 above, at 432.

[111] In the United States several states amended statutes to limit the possibility of revoking proxies to vote shares, which was previously possible inasmuch 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 United States law see Deborah A. DeMott, "Irrevocable Proxies", *Australian Law Journal*, LXXXII (2008), pp. 516-520. In English law the revocation of proxies to vote shares remains a problem limiting the value added of using such proxies in shareholder agreements. The only reasoning available to prevent revocation probably is the notion of fraud on the other proxy granting shareholders. See Francis M.B. Reynolds, *Bowstead & Reynolds on Agency* (18th ed., 2006), p. 614, para. 10-013.

[112] Article 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).

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

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

In a study of transnational law practice Abel pointed to the dominance of common law lawyers arising from the prevalence of large United States and United Kingdom 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.[114] 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 are from Australia, and the remaining four are from Canada, France, Spain and the Netherlands. United States and United Kingdom 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.[115]

There are several rankings of law firms in Russia. The rankings of *Chambers Global* and the *Legal 500* focus 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 United States and United Kingdom law firms. Only two Russian law firms are included in the list.[116] The ranking compiled by *PRAVO.ru* is ignored by some large foreign law firms, and thus is biased too. However, the ranking for 2011 still names three United Kingdom, three United States and one Canadian firm in the top 17 law firms in the field of corporate law and M&A.[117] *Best Lawyers* prepares its own and probably more balanced ranking of law firms in Russia. In the 2012 survey results of *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.[118]

Common law lawyers, if involved in transactions, naturally prefer to use common law as the applicable law. Therefore, the data on law firms in Russia can explain the popularity of English law as the governing law of shareholder agreements, and the inclusion of standardized Western-style clauses and provisions in the shareholder agreements of Russian companies. Law firms with a United Kingdom origin probably tend to offer 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. As this is not always the case, the causal link between the demand for English law and the resulting increase in the number of United Kingdom law firms should be approached carefully.

The influence 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 shareholder agreements of Russian

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[114] Richard L. Abel, "Transnational Law Practice", *Case Western Reserve Law Review*, XLIV (1994), p. 741.
[115] *The American Lawyer*, "The 2011 Global 100", 28 September 2011.
[116] Available at <http://www.legal500.com/c/russia/corporate-and-manda/moscow> (last visited on 24 June 2012).
[117] Available at <http://pravo.ru/stat/rating2011_results/corporate_law/> (last visited on 24 June 2012).
[118] Philip Sterkin, «Иностранцев не обойти» [Hard to Avoid Foreigners], Ведомости [Gazette], 23 April 2012.

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, whereas the development of new networks requires additional resources and costs, which can also benefit other free-riding lawyers; (3) the promotion of new legal innovative products could damage the professional reputation of lawyers, if it is successfully challenged in court.[119] The same factors suggest that the professional consultants of Russian private actors might have weak incentives to shift to the recent Russian rules on shareholder agreements.

English Language as *Lingua Franca* of Foreign Investors and Shareholders

Scholarly literature indicates the growing "Americanization" of international legal culture. The important role of the English language as a *lingua franca* is evident in both legal education and in legal practice.[120] Heringa describes the increasing role of English ("Euro-English") in European law schools.[121] English is dominant in international business transactions and in transnational lawyering.[122]

Anglo-American law firms and the English language mutually reinforce each other. The growth of Anglo-American law firms fosters the dominance of English, and the dominance of English language encourages more clients to seek Anglo-American counsel.[123] This, in turn, contributes to the prevalence of United States 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.[124]

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

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[119] Reyes and Vermeulen, note 88 above, at 27.
[120] Peter L. Murray and Jens Drolshammer, "The Education and Training of a New International Lawyer", *European Journal of Law Reform*, II (2000), p. 542 (pointing to the important role of the English language in commercial contracting, foreign legal education, and foreign legal professions).
[121] Aalt Willem Heringa, "European Legal Education: The Maastricht Experience", *Penn State International Law Review*, XXIX (2010), pp. 86-88.
[122] Lawrence M. Friedman, "Erewhon: The Coming Global Legal Order", *Stanford Journal of International Law*, XXXVII (2001), pp. 347-364, at 355; Filip De Ly, "Law and Practice of Drafting International Contracts", *International Business Law Journal*, no. 3/4(2002), pp. 469-472.
[123] Roger P. Alford, "The American Influence on International Arbitration", *Ohio State Journal of Dispute Resolution*, XIX (2003), pp. 86-87.
[124] Francisco Reyes, "Corporate Governance in Latin America: A Functional Analysis", *University of Miami Inter-American Law Review*, XXXIX (2008), p. 213.

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, Swiss, and French law were the most commonly chosen applicable law of the agreements in 2003 (24%, 20%, and 19% respectively).[125] Adjusted to the country of origin of the parties involved in disputes, English law is chosen 5.35 times more often than that was to be expected.[126]

These data illustrate that in agreements involving parties from different countries there is a tradition of referring to English law as the substantive applicable law. There are no strong reasons to believe that shareholder agreements are completely different from other commercial agreements. Therefore, it is reasonable to expect the shareholder agreements 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.

TOWARDS A MODEL FOR INTERPRETING RULES ON SHAREHOLDER AGREEMENTS BY RUSSIAN COURTS

In effect shareholder agreements (and especially voting agreements) can set restrictions on the expectations (rights) of shareholders that 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). These provisions actually can change statutory rules and the provisions of the articles of association, although not formally. This justifies the careful approach of courts in different jurisdictions towards the enforcement of shareholder agreements.

Because shareholder agreements allow for the opting out from statutory provisions, their enforcement is directly related to one of the basic issues of corporate law – the debate on the structure of corporate law (imperative versus enabling). Within this debate Bebchuk offered an analytical 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).[127] The suggestion is justified given significantly different effects of opting out at the two different stages for parties by reason of 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 a shareholding is) offers better protection than the introduction of the changes through the articles of association, because in the latter case

[125] Stefan Voigt, "Are International Merchants Stupid? Their Choice of Law Sheds Doubt on the Legal Origin Theory", *Journal of Empirical Legal Studies*, V (2008), p. 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". However, for the purposes of this study this "bias" is not relevant. Otherwise, if this is true, the significance of English law in international transactions should be even higher.

[126] Ibid., 15.

[127] Lucian Arye Bebchuk, "Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments", *Harvard Law Review*, CII (1989), pp. 1820-1860.

a 75% majority voting requirement, as a rule, is sufficient for amending resolutions to be passed.[128] The important issue of unanimity in shareholder agreements was first mentioned in the judgment of the Court of Appeals of New York in *Manson v Curtis*:

> *"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."*[129]

Although the case did not involve a unanimous stockholder agreement, the judgment pointed out that the factor of unanimity, as well as external factors (the interests of creditors), are important in deciding on the enforcement of stockholder agreements. In *Clark v Dodge* the court for the first time approved a stockholder agreement mainly based on unanimity considerations.[130] Currently, unanimous shareholder agreements are strongly enforced outside the United States.[131]

More controversial is the case when a shareholder agreement 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 shareholder agreements, as, in effect, shareholder agreements 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.[132] But the disclosure requirement offers only limited protection for the

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[128] Both United Kingdom and Russian law require 75% majority voting for the alterations of the articles of association (Companies Act 2006, section 21 (amendment of articles) and section 282 (special resolutions); Law on Joint-Stock Societies, Article 49(4)). In Russian limited responsibility societies the minimum threshold for the approval of the alterations is set at the level of 2/3 of the votes (Law on Limited Responsibility Societies, Article 37(8).). It should be noted that both jurisdictions offer remedies for non-consenting shareholders in the cases of the alterations of the articles. See Companies Act 2006, sections 994–996 (protection of shareholders against unfair prejudice); the Law on Joint-Stock Societies, Article 75(1) and Article 76(5) (the protection offered by Russian legislation is limited; 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).

[129] 119 N.E. 559, 562-3 (N.Y. 1918).

[130] 119 N.E. 641, 642 (N.Y. 1936) (another important consideration was the absence of a damage to third persons).

[131] For the United Kingdom see above, notes 55-57, and accompanying text. For Canada see Richard James Hay and Lucinda Ann Smith, "The Unanimous Shareholder Agreement: A New Device for Shareholder Control", *Canadian Business Law Journal*, X (1985), pp. 440-462. In Germany the Federal Court of Justice (*Bundesgerichtshof*) has developed similar position with regard to the unanimous agreements of the members of *Gesellschaft mit beschränkter Haftung* – if there is one shareholder agreement 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.).

[132] 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. See Ferran, note 42 above, at 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).

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 shareholder agreements in such cases.[133] However, the Civil Code offers a remedy to strike down the agreements in such cases by referring to the abstract concept of abuse of rights.[134] While deciding on the validity of the agreement, the efficiency standard requires courts to consider three important factors that affect the scope of conflicting interests with regard to shareholder agreements:

(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 all the stockholders in a stockholder agreement. While in such cases the interests of non-participating minority stockholders 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 existence of a possible public disclosure of the agreement – with introducing the distinction between existing and new shareholders if necessary.

The changes to the Law on Limited Responsibility Societies took into account the important factor of unanimous decision-making, although in a context not directly related to shareholder agreements. 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 a limited liability society or by a unanimous decision of shareholders at later stages.[135] The courts can extend the framework considered by the legislature to interpret the effects of the provisions of shareholder agreements on corporate resolutions – unanimous agreements in effect have a status of a company's constitution. Although this factor is also important for defining the limits of private autonomy in shareholder agreements, it is hardly possible that the courts can rely on it without the backing of express legislative action.

The same changes provide some evidence that the legislature has made the first steps in the direction of substantively separating statutory regimes of limited responsibility societies and joint-stock societies based on the autonomy of their members. Unlike joint-stock societies, the principle of contractual freedom has wider application in limited responsibility societies. Thus, if the courts apply this approach of differentiated treatment, the same provisions that might be invalidated in the agreements of the stockholders of joint-stock societies may be enforced in the shareholder agreements of participants of

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[133] The Federal Antimonopoly Service of Russia has proposed regulatory changes that require the disclosure of shareholder agreements. However the aim of the disclosure requirement is completely different – control by the agency over compliance with antimonopoly legislation by companies. This indeed will affect the scope of disclosure, because in order to achieve the aim all shareholder agreements, at least in companies with large market shares, should be disclosed. See Catherine Belton, "Russian Agency Proposes Changes to End BP Stand-off with AAR", *Financial Times*, 7 June 2012.

[134] Article 10(1), Civil Code of the Russian Federation (*"The actions of citizens and juridical persons effectuated exclusively with the intention to cause harm to another person, and also abuse of right in other forms, shall not be permitted"*. Butler, *Civil Code of the Russian Federation* (2010), p. 6.

[135] Law on Limited Responsibility Societies, Article 21(4) paras 4-6.

limited responsibility societies.[136] 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.[137]

The draft law reforming civil legislation contains other proposals that are essential for the enforcement of shareholder agreements. In particular, the proposals include changes to penalty clauses,[138] conditional provisions in agreements,[139] and powers of attorney.[140] The draft law, if adopted, will also clarify the relations between the provisions of shareholder agreements and charters. Draft Article 67.2(6) provides that the parties to a shareholder agreement cannot claim invalidity of the agreement by virtue of its being contrary to the charter of the society. As the comparative analysis shows, this provision should not be interpreted as a declaration of the prevalence of the provisions of shareholder agreements over charter provisions. 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 shareholder agreement.

The comparative analysis shows that in some cases the changes are needed to alter existing court practice rather than being the result of the flaws in the texts of the current statutory provisions. In some cases the changes 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 the legislature 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 be leveraged by different lobbying groups of practicing lawyers to promote changes in the legislation instead of pursuing a risky strategy of attempting and changing court practice.

CONCLUSIONS

The comparative analysis shows that the issues of the enforcement of shareholder agreements encountered by private actors in Russia are not unique and country-specific. The questions of relations between the provisions of shareholder agreements, on one hand, and imperative statutory rules and company charter, on the other hand, the participation of the company and third persons in the shareholder agreement, the specific performance of shareholder agreements, and the effects of shareholder agreements on corporate acts and non-participating parties generate much debate and encounter problems in the United

[136] Stepanov, note 25 above, at 70-71.
[137] 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, No. 47538-6, Article 66.3 (available in Russian at http://asozd2.duma.gov.ru/.
[138] Limiting significantly the possibility of the reduction of the amount of penalties by the courts in commercial agreements.
[139] Allowing conditional provisions to depend on the will of a contractual party.
[140] Introducing irrevocable proxies for entrepreneurs.

Kingdom as well. The analysis also shows that the rules on shareholder agreements should be examined within the general framework of corporate and contract law.

These conclusions allow other explanations to be suggested for the popularity of English law as the applicable law of shareholder agreements entered into by Russian private actors rather than to blame the "wrong" concept of stockholder (shareholder) agreements offered by the Law on Joint-Stock Societies and the Law on Limited Responsibility Societies. Among others, the most important explanations seem to be the general imperative nature of corporate legislation in Russia, legal uncertainty related with the application of the recent statutory provisions on shareholder agreements, quality of Russian courts, the "unfavorable" practice of the courts on several contractual concepts crucial for the effectiveness of shareholder agreements, the influence of foreign law firms and the interests of practicing lawyers. Apparently, in shareholder agreements with foreign investors the extensive use of the English language and English law in commercial transactions matters too. None of these factors can be claimed to play the sole or the most important role in the popularity of English law. Taken together, and probably supported by other factors not mentioned here, however, they may explain the choice of private actors.

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

The development of judicial practice in line with the offered model of shareholder agreements is an important condition for increasing the demand for Russian rules on shareholder agreements. This development cannot be achieved without a comprehensive reform of Russian corporate law oriented towards the introduction of different levels of balance between imperative and enabling rules depending on the type of business forms (joint-stock societies versus limited responsibility societies) and the number of their stockholders or participants (listed versus non-listed companies). Still, as some explanations of the popularity of English law show – network externalities in particular – English law 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 for prospective research related to shareholder agreements in general and with the practice of shareholder agreements in Russia in particular. The first direction is related to the economic analysis of shareholder agreements and to drawing parallels with takeover rules applicable to listed companies. While law and economics analysis of takeover rules is abundant, similar studies of the provisions of shareholder agreements are lacking. The second direction of prospective research concerns the role of judiciary in regulatory competition. The active role of the Russian legislature in drafting and enacting rules intended to create conditions for the enforcement of shareholder agreements 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 the judicial analysis of Russian courts.