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THE DOCTRINE OF BENEFICIAL OWNERSHIP IN RUSSIAN LAW

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ABSTRACT

The article deals with the problems of differentiation of the spheres of application of doctrine, the piercing corporate veils and the doctrine of beneficial ownership. Both doctrines are used to challenge corporate decisions. Challenging is possible if a person exercising corporate control has abused them or has lost the reality of its course. The article proposes solution of the problem when persons controlling a legal entity, thus structuring contractual relations, so as not to lose control over the company and in cases of introduction of bankruptcy procedures, and transfer of management by its creditor. The doctrine of beneficial ownership is applicable where the following conditions are met: the beneficiary makes a full disclosure of corporate information and details of the business structure; the complexity of the business structure is immaterial; the beneficiary has proved that he exercised corporate control over the company whose decision or transaction he is contesting, but has lost this control as a result of wrongdoing; the contested resolution of the company's general meeting is void (voidable); the beneficiary has acted in good faith; the beneficiary has motivation due to fear of financial losses, which he is certain to suffer unless the transaction or decision is contested; the doctrine is applied by way of exception.

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1. INTRODUCTION

The supreme judicial authorities in Russia adopted the doctrine of shareholder reinstatement, the doctrine of piercing the corporate veil, the beneficial ownership doctrine, corporate estoppel, and others. It is these doctrines that are quite often invoked in challenges to corporate decisions and transactions.

Although they are all rooted in the principle of good faith, these doctrines differ in their scope of application and must not be in conflict with each other. The judicial doctrines under discussion have both common features, which enable their systematization, and differences.

2. IMPLEMENTATION OF THE DOCTRINE OF BENEFICIAL OWNWERSHIP INTO RUSSIAN LAW

The doctrine of beneficial ownership has been developed and is widely used in English law as an equitable remedy. Webster's Online Dictionary defines a beneficial owner as one who enjoys the benefit of a property of which another is the legal owner [4]. The situation here is where an asset is held by a company, but the person who controls it behaves to all intents and purposes as the owner of the asset.

Black’s Law Dictionary offers a more detailed definition of beneficial owner: one recognized in equity as the owner of something because use and title belong to that person, even though legal title may belong to someone else [1].

It is only natural that the doctrine was fine-tuned and localized when incorporated into Russian law. This is largely due to the fact that the doctrine of beneficial ownership was developed in English law in the context of trust property. There is no such doctrine in Russian law; moreover, it is alien to codified private law, with its key separation of property and contract law.

In Russian law, provisions dealing with trust property are covered by contract law and an asset management contract. Neither, however, can the Russian courts disregard the doctrine of beneficial ownership because business structuring using offshore companies and trusts is fairly common. And it is English law that most offshore jurisdictions follow in their legislation. That is why, when introducing the doctrine of beneficial ownership in its case law, the SC RF changed it from the classic English model.

For a long time, Russian law ignored the beneficial owner as an entity and afforded him no legal status. However, as trusts and offshore companies became more widespread, a trend arose for beneficiaries

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to be held liable at first for tax and then for civil debts of a company controlled by him (secondary liability, piercing the corporate veil affiliation etc. [6]).

Recently, judicial authorities have been increasingly focusing on the figure of the beneficiary in dispute adjudication:

– in referring to a beneficiary when either considering a matter (the RF SAC Presidium judgment of 21.01.2014, No 9324/13, in case No A12-13018/2011; the RF Supreme Court determination of 30.01.2017, No 305-16409, in case No A40-100700/2015; the RF Supreme Court determination of 28.12.2015, No 308-ES15-1607, in case No A63-4164/2014; the RF Supreme Court determination of 27.05.2015, No 305-KG15-5431, in case No A40-68718/2014; the RF Supreme Court determination of 18.06.2013, No 5-KG13-61; the RF SAC determination of 22.04.2014, No VAS-13433/12 in case No A40-21546/2011; the RF Supreme Court decision of 18.07.2016, No AKPI16-421);

– making a legal ruling on his actions (the RF SAC Presidium judgment of 10.06.2014, No 8095/12, in case No A40-126114/11-137-435; the RF Supreme Court determination of 21.12.2015, No 305-ES15-16066, in case No A40-129788/14; the RF Supreme Court determination of 09.02.2015, No 301-ES14-6363, in case No A79-8878/2013; the RF Supreme Court determination of 15.08.2014 in case No 305-ES14-67, A40-74217/2013).

Note that the words “ultimate beneficiary”, “recipient of benefit”, and “ultimate recipient of benefit” are used to refer to a beneficiary in case law. In terms of its scope of application, the legal status of beneficiary is identified in disputes over the division of marital property (the RF Supreme Court determination of 07.07.2015, No 5-KG15-34) or over voidance and reversal of a transaction (the RF Supreme Court determination of 01.12.2016, No 305-ES15-12239, in case No A40-76551/2014), including alienations of equity interests (the RF Supreme Court determination of 15.12.2014, No 309-ES14-923, in case No A07-12937/2012) and divestitures of corporate real estate assets (the RF Supreme Court determination of 21.09.2016, No 305-ES16-11168, in case No A40-106582/14).

The enactment of the principle of good faith, in art. 1 of the CC RF, as a doctrine affected the availability of redress against any entity, including beneficiaries. This, coupled with art. 10 of the CC RF, laid down the rule that this category of persons must act reasonably and in good faith, which spells out the prohibition of actions likely to cause harm to another person and a controlled company.

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But the legal status must involve not only duties and liability, but also legal rights and guarantees. That is why the option of holding a beneficiary liable for debts of a controlled company should be quite naturally coupled with the option for the beneficiary to challenge transactions and decisions of the controlled company. Because the beneficiary has a legitimate interest in the preservation of the assets of the company under his control.

The SC RF formulated the Russian doctrine of beneficial ownership based on the construct of "right to actual income" in the context of proceedings in cases No A40-104595/14 and No A40-95372/14. That is why the decision of the Moscow Court of Arbitration of 5 August 2016 in case No A40-104595/14 says: "Seeing that Plaintiff is an ultimate beneficiary, the court upholds his legitimate interest in the governance of ZAO Aspekt-Finans". The beneficiary has a legitimate interest in preserving the assets of the controlled company and in challenging decisions and transactions he will have standing as the beneficial owner of the company. The same decision says that according to the bright-line rule laid down in cl. 2 of the determination of the Constitutional Court of the Russian Federation of 17.02.2015, No 404-O, the provisions of art. 181.5 of the CC RF that formulate criteria for categorizing meeting resolutions as void are designed to provide redress both for the persons involved and for others who might be legally affected by the resolutions adopted.

The decision of the Moscow Court of Arbitration of 5 August 2016 was appealed against but was upheld by the Ninth Arbitration Court of Appeal in its judgment of 17.10.2016 and by the Arbitration Court of the Moscow District in its judgment of 19.01.2017; the SC RF in its determination of 12 May 2017, No 305-ES15-14197, threw out a cassation complaint. To a large extent, the judgment of the trial court is based on the arguments put forward in prior rulings entered by the SC RF upon completion of the first round of the legal precedent-setting case under analysis (SC RF determination of 31.03.2016, No 305-ES15-14197, and SC RF determination of 27.05.2016, No 305-ES15-16796).

The case under investigation further proves that the SC RF equates in its case law meeting resolutions with the legal framework of transactions. In this context, the SC RF held that a corporate decision can be challenged in the above-referenced matter on grounds that third parties can challenge a decision if it infringes their rights. The beneficiary, however, has no privity with the controlled company. The beneficiary's standing to challenge a decision of the controlled company can be based on the construct of legitimate expectation [3] [7] [9].

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The term “legitimate expectations” was first used by the judge Lord Denning in Schmidt v Secretary of State, 1968, where he said that apart from legal rights and legitimate interest a person can also have legitimate expectations. The RF Constitutional Court used the term “legitimate expectations” in its judgments more than once, saying that the legislature should change the conditions for the acquisition of any legal right in furtherance of the principle of public trust in law and the government, which calls for preserving reasonable stability of statutory regulation and precluding arbitrary enactments. Citizens are entitled in this context to legitimate expectations that the right acquired by them under the laws in place will be respected by the authorities and will be exercisable (judgment of the RF Constitutional Court of 24.05.2001, No 8-P; judgment of the RF Constitutional Court of 20.04.2010, No 9-P; judgment of the RF Constitutional Court of 25.06.2015, No 17-P).

Initially, the doctrine of legal expectations was applied in disputes with the state and from administrative law [2] [11]. But later it was developed in other institutions of law, including in the sphere of rights to things [5] [10].

The Russian doctrine of beneficial ownership has not been enacted as such, having been developed in the case law of the SC RF. Indirectly, a regulatory framework can be said to be provided by art. 1 and 10 of the CC RF, cl. 2, art. 7 of the Tax Code of the Russian Federation (TC RF) and the Model Tax Convention on Income and on Capital of the Organization for Economic Cooperation and Development (updated 22 July 2010).

The court rulings in the cases under review provide no rationale for the decisions, which makes it impossible to follow the reasoning of the SC RF. Absent a rationale, the question remains as to the grounds on which a beneficiary can challenge decisions and transactions.

3. APPLICABILITY CRITERIA FOR THE DOCTRINE OF BENEFICIAL OWNERSHIP IN RUSSIAN LAW

Our review of the court rulings in cases No A40-104595/14 and No A40-95372/14 suggests that the beneficiary can challenge corporate decisions and transactions of the controlled company where the following conditions are met:

First, a full disclosure of corporate information and details of the business structure: the chain of the affiliated companies and trusts through which the beneficiary controls the business. This is how the beneficiary proves that he holds not direct, but indirect equity interests in the controlled company.

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Note that the term "ultimate beneficiary" is quite often used in the Russian case law, which highlights the absence of nominal owners down the chain and the focus not on a straw man, but on the real business owner, who determines the strategy.

Second, the complexity of the business structure and length of the chain of legal entities, offshore companies, and trusts to structure the business is inconsequential.

It is important to understand that the incorporation and operation of an offshore company or its use in business structuring is not a legal wrong in and of itself. This is why beneficiaries cannot be faulted because they hide behind legal entities rather than hold stock in the controlled company directly.

Of significance in this regard is the RF SAC Presidium decree of 26 March 2013, No 14828/12, which lays down the following bright-line rule for the first time: "Ownership of real property in the Russian Federation by an offshore corporate, which therefore does not disclose publicly its beneficiary, does not constitute a legal wrong in and of itself."

Adverse consequences from using an offshore company are only suffered when the offshore companies do not name their beneficiary. Failure to disclose this information is held by the court to be wrongdoing (art. 10 of the CC RF). This is because offshore jurisdictions have special rules on the disclosure of details of companies' beneficiaries, which obscures the equity-holding structure of an offshore company.

Therefore, an offshore company which does not name its beneficiary is held to be acting in bad faith, which shifts the burden of proof and is punishable under art. 10 of the CC RF, including, without limitation, by denial of redress.

Beneficiaries exercise control over offshore companies through a nominee director and a nominee shareholder (acts as the legal owner (legal title holder) of stock in the offshore company). Oversight of the activities of these straw men is arranged under a trust agreement (declaration of trust), based on confidentiality and freedom of contract. This gives the beneficiary the so-called beneficial owner's rights in equity.

A trust is an institution which does not canonically fit into the Russian system of private law. A trust is outside of schools and outside of systems, so to speak. It has a number of unique features. A trust is not a legal entity, which generally eliminates the need for public registration or accountability. A trust

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is created when assets are transferred to a trustee (trustee) and he accepts them in this capacity. Nor is the trust a contract: the relationship between a trustee and a beneficiary are based on equity rather than contract law.

The concept of trust rests on two ideas. One: the trustee must hold assets (trust property) for the trust beneficiaries and do this on the terms and conditions set forth in the trust agreement (his bundle of rights is determined by the agreement rather than by operation of law). The trust is most typically created by a settlor, who enters into a confidential trust agreement with a trustee. Two: a trustee has fiduciary duties to a beneficiary. The trust property is owned by neither the settlor nor the beneficiaries. Generally speaking, neither can remove property from the trust.

The focus on trust is largely due to the tendency to ratchet up the requirements for the disclosure of corporate information of offshore companies, specifically by naming the beneficiary of the offshore company. For example, effective as of 30 June 2017, the authorities of one of the most popular offshore jurisdictions, the British Virgin Islands (BVI), have agreed to disclose the official details of the owners of incorporated companies to the UK authorities. The BVI's BOSS Act (The Beneficial Ownership Secure Search System Act, effective date 15 July 2017) lays down the procedure for punishing those who refuse to name the beneficial owner of an offshore company. The BVI Government has set up a database called BOSS (Beneficial Ownership Secure Search System), which allows searches. Given that the BVI is the UK's dependency, the details of the beneficiaries of BVI offshore companies are already available to the UK authorities. Note that access to this database will only be available to the British, and no content thereof will be shared with foreign governments without an Interpol enquiry. However, enabling private asset holding will require a more sophisticated corporate structure of business, with a greater use of trust agreements.

Third, the beneficiary has proved that he controls the company whose decision or transaction he contests. It is worth bearing in mind that this doctrine can also apply where a beneficiary has lost control over a company as a result of third-party wrongdoing and is seeking to re-establish corporate control.

The SC RF's judgment leaves open the question of the extent of control that a beneficiary must have in order to have standing to challenge a corporate decision of a controlled company. This is because the legal case under discussion (No A40-104595/14) involved three beneficiaries, who equally co-owned the first company in a chain of affiliates. Therefore, the court allowed a challenge to a corporate decision

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by a beneficiary who owned a third of the company. It appears that the matter can be resolved because ultimate beneficiaries are few.

Fourth, a beneficiary can only challenge a company's decision that is voidable. Pursuant to art. 181.3 of the CC RF, a meeting resolution can be voided on grounds laid down in a code or other laws, by a court of law (a voidable decision) or by operation of law (a void decision).

And whereas a challengeable decision can only be voided if requested by a shareholder, a voidable decision can be voided if requested by any person with a legitimate interest infringed by the decision (by analogy with the voidance of transactions the provisions wherefor can be extended to decisions). It is this premise that the SC RF used in examining cases No A40-104595/14 and No A40-95372/14 and finding that the beneficiary has standing to challenge the decision of the controlled company. The transaction was most likely found to be voidable because the contested decision is at variance with the legal framework or morality (cl. 4, art. 181.5 of the CC RF).

However, limiting a beneficiary's standing to challenge decisions to ones that are voidable (art. 181.5 of the CC RF) does not seem very reasonable. It would be more fair to allow the beneficiary to challenge any decision, whether challengeable [voidable] or void.

Fifth, the beneficiary's bona fides, but not in a subjective way (whether he was or was not aware of any circumstances), but in an objective way—as a manifestation of the principle of good faith—his behavior matches normal business conduct; he uses no deception or subterfuge.

The principle of good faith is that a person is not only required to fully comply with the law, but also to exercise his rights as diligently as is generally practiced, i.e. act “as others do”, “as is customary”. This reasoning yields a number of inferences:

a) bona fide conduct can be said to be that which is shown by a normal, average economic agent. Mala fides is deviation from the typical and generally accepted patterns of behavior. Mala fides conduct is affected, contrived.

The principle of good faith is most often taken to mean a yardstick for business conduct.

b) bona fides is a term of art rather than a category of ethics or morals.

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c) the principle of good faith is established for practical considerations rather than pursuant to any legal theory, let alone any legal requirement, and this principle has but applicatory relevance.

The West-European school of thought understands bona fides as a standard of behavior rather than law. However, as far back as Ancient Rome, lawyers premised that bona fides was a legal concept: if you act in good faith, then you are within the law.

It is more consistent and logical to treat bona fides as a legal concept rather than a behavioral standard. Anyone who is technically within the law but acts in bad faith shall be deemed to be in breach of the law. Anyone who acts in good faith in grey areas of the law shall be deemed to be law-abiding.

Bona fides can be found in legislation not only in as a principle (objective bona fides), but also as subjective bona fides: awareness of any factual circumstance. The best example of subjective bona fides is denial of recovery where property has been acquired in good faith for a consideration and where usucapion is involved (art. 234 of the CC RF and 302 of the CC RF).

Naturally, the beneficiary's bona fides must be assessed in terms of the principle of good faith because he cannot claim ignorance of the corporate structure of his business.

Sixth, motivation due to fear of financial losses, which the beneficiary is certain to suffer unless the transaction or decision is contested. The beneficiary's legitimate interest is in the preservation of the company's assets. Therefore, the challenged corporate decision or transaction must involve stripping of the controlled company's assets.

Seventh, the exceptional nature of application of the doctrine under discussion: it is only applied by the court as a last resort where no other *restitutio in integrum* remedy is available against the transaction or decision that is challenged.

The exceptionality of the application of the doctrine of beneficial ownership is explained by the fact that no one has standing to challenge corporate decisions and transactions except a shareholder (art. 181.4 of the CC RF). Therefore, exceptional circumstances are needed for a beneficial owner to gain standing to challenge transactions and decisions. Run-of-the-mill, garden-variety situations cannot give a beneficiary standing to challenge decisions and transactions of the company under his control.

Because a beneficiary can only put forth challenges in exceptional circumstances, he can only do so through the courts. Only a court can ascertain such exceptionality and grant this opportunity. This is

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why the doctrine under discussion was developed in the case law of courts at different levels (RF SC determination of 7 July 2015, No 5-KG15-34; Ninth Arbitrazh Court of Appeal judgment of 16 March 2015, No 09AP-4138/2015 in case No A40-17025/2014, Ninth Arbitrazh Court of Appeal judgment of 23 November 2015, No 09AP-46990/2015 in case No A40-70319/15; Moscow Arbitrazh Court decision of 16 December 2014 in case No A40-17025/2014).

Eighth, it is a means of dealing with corporate conflicts or resolving corporate disputes, that is, it is only used in corporate or trust contexts.

The applicability criteria of the doctrine of beneficial ownership focuses on situations wherein the beneficiary has standing to challenge corporate decisions and transactions of the controlled company. It is, however, important to understand that the doctrine of beneficial ownership has a broader scope of application because Russian courts apply this construct to disputes between former spouses over the division of marital estate, where the court extends the legal treatment of joint tenancy to the assets of offshore companies and trusts controlled by a spouse.

4. CONCLUSION

Our research suggests the following conclusions.

First, the Russian doctrine of beneficial ownership has not been enacted as such, having been developed in the case law of the SC RF. The court formulated the Russian doctrine of beneficial ownership via the construct of "entitlement to earnings." The beneficiary can challenge the decisions and transactions of a controlled company even where he exercises control through a chain of parent-subsidiary companies.

Second, the SC RF case law is shaped based on equating meeting resolutions with the legal framework of transactions. A beneficiary who exercises actual corporate control has no privity with the controlled company. The beneficiary's standing to challenge decisions of the controlled company can be based on the construct of legitimate expectation.

Third, the doctrine of beneficial ownership is applicable where the following conditions are met: the beneficiary makes a full disclosure of corporate information and details of the business structure; the complexity of the business structure is immaterial; the beneficiary has proved that he exercised corporate control over the company whose decision or transaction he is contesting, but has lost this control as a result of wrongdoing; the contested resolution of the company's general meeting is void (voidable); the

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