# Answers

**1** The question tested the candidates' knowledge of federal laws and legal codes within the legal system of the Russian Federation.

**(a)** In common with most European countries, the Russian legal system is a civil law, or codified, system in which legal codes and legislation are the main sources of law, subordinate only to the Constitution and international treaties.

Legal codes are enacted by the government in order to lay down fundamental principles that apply to citizens and legal entities. The codes apply to generic activities or behaviours, such as penal law and civil law. The intention of these codes is to establish guiding principles which may then be reinforced by legislation. For example, the Civil Code describes three generic models by which different types of enterprise may be categorised. Legislation then sets out detailed provisions relating to each specific type of person or enterprise.

It is unusual but not impossible for the principles contained in codes to be inconsistent with legislation. However, the content and intention of legal codes must be consistent with the provisions of the Constitution and any legally binding international laws.

Some codes are administrative in nature, setting down guiding principles on matters such as procedures to be adopted by public bodies. Others apply to interrelationships between humans, and between humans and legal entities, such as the Labour Code, which regulates employer–employee relations under labour agreements, and the Civil Code, which regulates, *inter alia*, basic human rights, civil capacity, contractual obligations and non-contractual obligations.

**(b)** Federal laws are primary legislation, enacted by the government of the Russian Federation. They are subservient only to the provisions of the Constitution and any international laws that are considered to be binding within the Russian Federation. Therefore, the provisions contained within federal laws must be consistent with these higher sources.

All federal laws must be sanctioned by the State Duma and the Federation Council, and signed by the President before they can come into effect.

Federal laws are definitive sets of rules with which all citizens and legal entities must comply. They often amplify or expand on the general principles contained within legal codes. As the business environment becomes more complex, it becomes increasingly difficult to envisage future developments that may render written laws inappropriate or redundant, so it is often necessary for the government to amend or replace laws to take account of these. It is also possible for the provisions of some laws to be inconsistent with others (such as the insolvency laws contained in the Federal Law on Bankruptcy and the Civil Code).

Federal laws may empower subordinate bodies to enact detailed rules and regulations to support their provisions. Such sources are called secondary legislation. They comprise the decrees of the President and regulations enacted by ministries and government agencies within their respective terms of reference.

**2** The question asked candidates to explain the meaning and operation of two methods of securing contractual obligations: forfeit and pledge.

The laws relating to securing obligations are laid out in chapter 23 of the Civil Code, and the specific means of securing obligations are set out in Article 329.

**(a)** Article 330 of the Civil Code defines a forfeit as a fine or penalty, expressed in financial terms. A debtor is obliged to pay a forfeit to a creditor in the event that a contractual obligation is not discharged, is improperly discharged, or if there is a delay in discharging the obligation.

The forfeit may be defined by a specific law or within the contract itself. If so stipulated, it is sufficient that breach of obligation, improper performance or delay have occurred and there is no onus on the creditor to prove that losses have been incurred. However, if the debtor is not responsible for the breach, improper discharge or delay, the creditor is not able to claim.

Article 331 states that the right to forfeit must be in written form, even if the contract between the parties is not in written form. Failure to do so renders any right to forfeit void.

Article 332 specifically confers rights in respect of legal forfeit. In such cases the right to forfeit arises under statute, so a claim may be made by the creditor irrespective of whether any details of the forfeit are set out in the agreement between the parties. Additional forfeit may be agreed between the parties, unless this is in contravention of any existing law.

Article 333 envisages circumstances under which the forfeit may be reduced. If the forfeit is obviously disproportionate to the consequences of the breach of the contractual obligation, the court is empowered to reduce the forfeit. Article 404 states that if the breach is due to the actions of both parties to the contract, the court may reduce the debtor's obligation. This may also occur if the creditor exacerbates the losses incurred through his or her own actions or inactions, or has not taken reasonable steps to mitigate them.

Article 394 foresees situations in which the forfeit may not cover the losses incurred by the creditor. In such cases, the creditor may seek additional compensation to cover the actual losses. The same Article states that the law or the contract itself may stipulate that the forfeit but not losses will be covered, that full losses over and above the forfeit may be claimed, or that the creditor may elect to claim either the forfeit or the losses.

**(b)** Article 334 lays down general provisions in relation to the pledge of property.

A pledge is a form of collateral contract through which a creditor (pledgee) obtains rights over an asset belonging to the debtor (pledgor), so that in the event of failure to discharge the contract, or improper discharge, the former may realise the value of the object of pledge.

The rights of the creditor over the object of pledge are not absolute, in that he or she may be liable for any loss or damage to the object of pledge while it is subject to the control of the creditor. These rights are amplified in Article 344. Article 346 confers significant rights in favour of the pledgor, including those of income, rental and even the right to bequeath, subject to the consent of the pledgee.

Certain pledges are subject to the Law on Mortgages. These include plots of land, enterprises, buildings and other forms of immovable property. For example, the realisation of such assets on default by the debtor are subject to strict rules relating to the method of sale and the minimum price that must be obtained. Article 336 lays down limitations on assets that may be offered, such as public property and rights that are inalienable from the individual (such as alimony).

Article 335 states that the pledgor may be the debtor or a third party. Some restrictions apply here, in that the pledgor must have the right of economic management over the object of pledge, and any leased property cannot be offered as an object of pledge without the agreement of the owner.

Article 337 states that the pledge may cover the principal debt and also interest, forfeit, compensation of losses and expenses incurred in securing the asset.

Article 338 stipulates that the pledged asset shall remain in the custody of the pledgor unless otherwise agreed between the parties. In certain circumstances the pledged object may be transferred but will be deemed by law to be in the custody of the pledgor.

Article 339 requires the pledge to be in written form, with full details of the pledged object as well as conditions relating to amount, substance and custody. Where the pledge is subject to legal mortgage, the contract must be notarised and registered. Failure to observe these requirements invalidates the pledge.

Article 350 lays down specific duties in respect of realisation of pledged property on default by the debtor. Sale of the asset must be effected through open auction. The court may fix the price for realisation, and may postpone the sale for up to one year. If the proceeds of sale exceed the creditor's claim against the debtor, any surplus must be returned to the debtor. However, important changes to the Civil Code were introduced in 2008. Article 348 of the Civil Code now provides that in both a pledge contract and afterwards (in the case of non-fulfilment of obligations secured by the pledge) the ability to sell the pledged property, and to set a price, is possible without recourse to the court.

If the pledgor is a 'natural person', or the pledge is of real estate such agreements must be notarised. Where periodic payments are due, consistent infringement of payment terms (occurring more than three times within 12 months) will result in the seizure of the pledged property. Even if the pledgor does not fulfil their agreed obligations on the seizure of the pledged property, a special execution may be based on a notarised endorsement. The pledgee must inform the pledgor on the initiation of the recovery procedure without recourse to court.

In certain cases, such as the sale of securities, an independent appraiser, invited by both parties, must evaluate the mortgaged property.

A court decision to sanction the execution on the object of a pledge can only take place in certain circumstances, including with the consent or permission of the counterparty, when the object of the pledge is property of considerable historic, artistic or other cultural value for society, if the pledgor is absent and is impossible to locate, and when the object of the pledge is residential accommodation belonging to a natural person.

A claim for enforcing the pledge may be rejected by the court if the violation committed by the debtor is insignificant. This is when the sum of the overdue obligation is worth less than 5% of the value of the subject of the pledge, and the overdue period is less than three months.

**3** The question asked candidates to explain any five ways in which a labour agreement between an employer and an employee differs from a contract for service between a company and an outside contractor.

(a) The statutory difference between the two types of contract lies in the sources of law that govern each. All contracts between employers and employees are governed by the Labour Code, whereas contracts between companies and service providers are governed by the provisions of the Civil Code.

(b) Labour contracts must be executed in writing, with the Labour Code laying down very specific minimum requirements. By contrast, civil contracts do not always have to be concluded in writing (though the vast majority of such contracts are in writing), and the law is generally non-prescriptive in respect of their content.

(c) The Labour Code identifies two specific types of labour agreement. These are indefinite term and fixed-term contracts. The latter are subject to constraints, in particular the right to roll over the contract only once. Contracts with external providers are rarely, if ever, indefinite and fixed contracts may be rolled over as often as necessary.

(d) Labour contracts are divisible. This means, for example, that an employee leaving the company on the 14th day of a 31 day month will be entitled to 14/31 of the month's salary. Civil contracts are generally very specific in relation to the fee payable and the terms under which any divisibility will apply.

(e) Employees have significant rights in relation to probation, holidays, sick leave and dismissal (including redundancy). There are also specific provisions protecting, *inter alia*, mothers of young children and carers. Any such rights pertaining to service providers are non-obligatory and subject to conditions mutually agreed between the parties.

**4** The question asked candidates to explain the procedure through which a company limited by shares (joint-stock company) is formed, and to explain the implications of separate legal personality for the founders, its shareholders and the company itself once the company has been registered.

**(a)** The provisions of law in respect of formation are set out in Chapter 2 of the Federal Law on Companies Limited by Shares.

Article 8 states that a company may be formed either as an entirely new entity or by reorganisation of an existing legal entity. The company is deemed to come into existence upon its State registration.

Article 9 makes provisions in respect of the founders of the company. Article 10 specifies that the founders may be individuals or legal entities, but forbids State or other public bodies from engaging in the formation of a company unless permitted by other laws.

There can be one or more founders. If there are two or more founders it is necessary to hold an initial meeting, the details of which must be formally recorded. Decisions must be taken at this meeting on formalities relating to formation, including the content of the Charter, monetary contributions of the founders, and the type and value of securities and other property rights. These decisions must be taken unanimously. Obviously, a sole founder need not hold a meeting but must formally document the same details.

The meeting also decides the composition of the company's management bodies, its internal audit commission (if appropriate) and auditor by super-majority (minimum 75%) decision.

The founders of the company must enter into a legally binding contract setting out the procedure for foundation, the Charter capital, the types of security to be placed and the rights and duties of the founders.

There is no limit to the number of founders of an open company, but a closed company may have no more than 50 founders. These persons remain personally liable, jointly and severally, for any dealings carried out before the company is registered. Conversely, Article 10 absolves the company from responsibility for pre-incorporation dealings.

Article 11 states that the Charter is the founding document of the company. Its provisions are binding on all company bodies and shareholders. The same Article sets out the minimum content of the Charter. This may be changed subsequently by the general meeting of shareholders (Article 12).

Article 13 states that the company must be registered as a legal entity.

**(b)** Separate legal personality refers to the existence of a legal entity as a body that may obtain an identity and incur rights and obligations in its own right. In essence, once a legal entity is registered, it becomes an artificial legal person. It can own assets and incur liabilities, generate income and expenditure, instigate legal action and be subject to legal action. Like a natural person, a company can become bankrupt and can also 'die', when it is liquidated and dissolved.

The legal principles that underpin separate legal personality are set out in Articles 48 and 49 of the Civil Code.

The following (abridged) phrase in Article 48 expresses the nature of separate personality:

'The legal entity … has in its ownership, economic management or operative management the set-apart property and … is answerable by its obligations with this property and may on its own behalf acquire and exercise … property and … personal non- property rights'.

From the founders' perspective, once a company is registered they no longer have to incur personal responsibilities for transactions carried out on its behalf. As explained in part (a), the founders bear personal responsibility for pre-incorporation transactions. In most cases, the founders become shareholders, and perhaps executives of the organisation. The decisions they take, at the general meeting of shareholders and at board meetings respectively, are binding on the company and it is the company itself that bears responsibility, except in those few cases specified in law in which personal liability arises.

From the date of registration, the founders also know that any property transferred to the company by way of contribution to capital becomes the property of the company itself. The contribution of the founders becomes a stake in the company, expressed in shares, and not a right to specific property thus contributed.

The most important implication of separate legal personality for the shareholders is that they enjoy limited liability. The shareholders only stand to lose the value of their investments in shares. With some exceptions, they cannot be held responsible for the company's acts, even if they themselves participate in the decisions taken at general meetings. In some cases the shareholders may bear additional liability on liquidation, such as when their shares have not been fully paid up.

By contrast, the company itself has unlimited liability for its actions and obligations. Any assets accumulated by the company are owned by the company, and liabilities to others are those of the company and not its representatives. The net worth of the company is separable from the shareholders and can only be transferred to the latter when the company's capital is reduced or on liquidation.

The company is even vicariously liable in most instances for the wrong-doing of its employees, though it has a right of regress against the employees for losses suffered by their acts.

**5** The question required candidates to explain the provisions of law governing increasing and decreasing the share capital of a company limited by shares, and the rules applicable to the distribution of dividends.

**(a)** The statutory requirements relating to increasing share capital are laid down in Article 28 of the Federal Law on Joint-Stock Companies.

A company may increase its share capital by either increasing the nominal value of existing shares or by placing new shares. Any decision to increase the capital of the company must be sanctioned by the general meeting of shareholders. The Charter of the company may permit the shareholders to delegate this decision to the directors. If the Charter does not include such a provision, the shareholders may agree to change the Charter to enable such delegation.

The Charter may also place limits on the extent to which the capital may be increased. This does not present a problem if the additional shares to be placed results in the total capital exceeding the total authorised capital.

If additional shares are placed, existing shareholders have a pre-emptive right to the additional shares on a proportionate basis to prevent any dilution of their rights.

An increase in capital cannot exceed the difference between the net assets of the company and the sum of its Charter capital and reserve fund when a company's authorised capital is being increased at the expense of the company's assets.

Article 100 states that a company cannot increase its capital for the purpose of dealing with losses.

Consistent with the principles of capital maintenance, the law is less permissive in respect of reducing capital. The main provisions are set out in Article 29.

A company must reduce its share capital under certain circumstances. For new companies, if the capital is not paid up within the maximum time-limits, it is necessary to reduce the capital to reflect the paid up capital. For existing companies, if the net assets of the company are less than the Charter capital at the end of the second or subsequent financial year, the capital must be reduced. If the capital falls to below minimum statutory limits, the company has to be reorganised or wound up.

A company can reduce its capital voluntarily for several reasons. For example, the financial accounts may not accurately reflect its true value, or the company may decide to repay capital to a shareholder. This may require amendment of the Charter or a resolution of the shareholders. The company may also decide that it is in the interests of its shareholders to increase its gearing, by reducing share capital and increasing loan capital.

A reduction in capital may be facilitated by reducing the nominal value of shares or by reducing the number of shares. This must be approved by the general meeting of shareholders and is subject to a minimum majority of at least 75% of the shareholders. Any reduction must be applied on a *pro rata* basis.

Any decision to reduce the capital of a company must be communicated to the creditors of the company in writing within 30 days of the decision (Article 30). The creditors are then entitled to demand any monies due to them within 30 days of the notification.

**(b)** Dividends are the returns paid by a company to its shareholders for their contribution to the risk capital of the company. Preference shareholders are entitled to a fixed dividend expressed as a percentage of nominal value or fixed amount (Article 32(2)), while that paid to ordinary shareholders is dependent on the profitability of the company and on the recommendation of the board of directors.

The law relating to payment of dividends is set out in Articles 42 and 43 of the Federal Law on Joint-Stock Companies.

Article 42 states that a company may announce the payment of dividends on placed shares in respect of the result of the first quarter, first six months, first nine months or for the whole year. The decision must be taken within three months of the end of the relevant period.

Article 43 states that dividends must be paid out of net profit. For some types of preference share, dividends may be paid out of funds earmarked for this purpose. However, as a general rule, unless this latter point applies neither ordinary nor preference shareholders have an absolute guarantee that a dividend will be paid to them every year.

The decision on payment of dividends is taken by the general meeting of shareholders. However, in practice the shareholders have little direct influence over this, as Article 42(3) states that the dividend cannot exceed the recommendation of the board of directors. Theoretically, the general meeting of shareholders could vote for a smaller dividend than that recommended by the board, but this is highly unlikely.

The timing and process for the payment of dividends is set out in the Charter of the company or by the general meeting of shareholders, though constrained by the provisions in Articles 42 and 43. In the absence of any clause in the Charter or decision of the shareholders, the dividend must be paid within 60 days of its announcement.

Those entitled to receive dividends is determined by the list of shareholders eligible to attend the general meeting of shareholders at which the dividend is decided.

Article 43 sets out limitations on the payment of dividends. A company cannot pay dividends at all if:

(i) its Charter capital is not fully paid;

(ii) the company displays symptoms of bankruptcy;

(iii) the value of the net assets is less than the charter capital, plus the reserve fund, plus the excess over par value of the liquidation value determined by the charter of the issued preferred stock (or if this will arise once the dividend has been paid).

Article 43 also includes rules on the priority of dividends. No dividend may be disbursed to ordinary shareholders unless those due to preference shareholders have been paid. These may include rights carried over from previous financial years in respect of cumulative preference shares.

**6** The question asked candidates to explain how the internal audit commission is appointed, the eligibility criteria for membership of the commission, and the powers and duties of the internal audit commission.

**(a)** The laws relating to the internal audit commission are set down in Chapters II and XII of the Federal Law on Joint-Stock Companies.

For new companies, Article 9 states that the internal audit commission is appointed by the founders, subject to a super-majority vote through which at least 75% of those voting must agree. Article 85 states that appointment of the internal audit commission falls within the exclusive competence of the general meeting of shareholders.

Article 85 lays down limitations in respect of membership of the internal audit commission. Its members may not simultaneously be members of the board of directors or supervisory board, and may not hold office in any other management bodies of the company. These provisions ensure that, while the members of the internal audit commission are employees of the company, they exercise their responsibilities independent from those charged with operational management.

**(b)** The powers and duties of the internal audit commission are defined in very general terms in Article 85.

The primary objective of the internal audit commission is to exercise control over the economic and financial management of the company. In practical terms, this is usually taken to mean that the commission should advance the process of ensuring that the company has reasonable assurance that it will achieve its objectives.

The internal audit commission's terms of reference should be defined in the Charter of the company. The procedures for the exercising of its duties must be set out in an inner policy document sanctioned by the general meeting of shareholders.

The verification of the activities of the company should be carried out in respect of the company's results for the year, and also at the initiative of the commission itself, the general meeting of shareholders, the board of directors, or any shareholder or group of shareholders holding an aggregate of at least 10% of the company's shares.

The internal audit commission is entitled to require officers of the company to submit any documents relevant to the discharge of its responsibilities.

The internal audit commission has the right to convene an extraordinary general meeting of the company.

Article 87 states that the internal audit commission shall submit an opinion on the reliability of the data contained in the reports and other financial documents of the company, and any violations of procedures for bookkeeping and the submission of financial reports under statute law.

**7** The question asked candidates to define corporate governance, identify the parties responsible for effective corporate governance, and to discuss the relevance of corporate governance to companies whose securities are not traded on a recognised capital market.

**(a)** Corporate governance is the system through which an organisation is directed and controlled.

Corporate governance is concerned with promoting managerial practices that will maximise the best interests of shareholders and ensure that they are treated fairly and equally. This implies having an effective board that formulates and implements strategies that will serve the medium to long-term interests of the company. It is generally accepted that executive decision-takers should also be mindful of the company's responsibilities, both legal and fiduciary, to its stakeholders, including customers, employees, suppliers, providers of finance and the community. In discharging these responsibilities, those who direct and control the company should maintain a transparent approach in reporting to shareholders and the government.

The primary responsibility for corporate governance lies with the directors of the company. However, the general meeting of shareholders is the supreme decision-taking body within the company, so shareholders also bear some degree of responsibility for monitoring and controlling those who act on their behalf. In particular, institutional investors (such as financial institutions and venture capital providers), have shareholders of their own, and their responsibilities to these shareholders can only be served effectively if the performance of the companies included in their investment portfolios are monitored and reviewed on an ongoing basis.

In larger companies, best practices in corporate governance are also promoted by having proper systems of internal control and review. The ultimate responsibility for these systems lies with the board, but specific duties may be delegated to the internal audit commission or other internal bodies involved in compliance, such as the tabulation commission.

Finally, the external auditor has a legal responsibility for giving a professional opinion on the financial statements of the company. To the extent that the company, shareholders and prospective investors may rely on this opinion, the external auditor also has an important role to play.

**(b)** Most attempts to promote effective corporate governance have focused on public companies whose securities are openly traded. There are several reasons for this. Public companies are usually large and have many shareholders. They also deal with a wide range of stakeholders, and their actions have more profound implications for the economy. The most relevant consideration, however, is that public companies have a greater degree of separation between those who own the company and those who manage it on their behalf. This is sometimes called the 'agency problem', as the directors act as agents for the shareholders.

Corporate governance is relevant to many types of organisation, and the generally accepted principles can be applied not only in smaller commercial organisations, such as limited liability companies and partnerships, but also not-for-profit organisations and even public sector bodies.

Except in the very smallest organisations, the agency problem exists to some extent. For example, both limited liability companies and closed companies limited by shares can have up to 50 shareholders. Those who own the organisation can exert control over the executive bodies, but the information on which they take decisions to intervene is both limited and largely historical. Furthermore, the ability to take certain actions, such as proposing matters to be discussed at general meetings of shareholders, is subject to statutory minimum holdings of voting shares. As a result, those with very small shareholdings have very little power in practice, except perhaps to dispose of their shares.

It is just as important to protect shareholders' rights and maintain equal treatment in small companies as large companies. Although federal laws protect these interests to some extent, they cannot envisage every eventuality, including practices such as large shareholders 'freezing' out minorities.

It is rather simplistic as well as incorrect to regard quoted companies as 'large' and unquoted companies as 'small'. Limited liability companies and closed companies limited by shares can have large numbers of employees and suppliers, so the responsibility to consider the interests of these stakeholders is relevant in many unquoted companies.

Many not-for-profit organisations, such as charities and religious organisations, do not maximise profits or have shareholders to remunerate. However, they have fiduciary responsibilities to those they serve. Therefore, they have a duty to adopt practices that will pay due regard to the interests of their stakeholders, as well as maintaining policies that will ensure compliance with the law and minimise risks.

**8** The question asked candidates to discuss whether prices displayed on a website may be regarded as an offer that is capable of acceptance, and whether communications and actions between a buyer and seller could be regarded as offer, counter-offer or acceptance.

**(a)** The scenario described a situation in which Svetlana ordered a consignment of chocolates based on information provided by –ZAO- Choc on its website. In response to Svetlana's order, –ZAO- Choc responded that the information given on the website was out-of-date and that new prices were now in place.

The relevant law is set out in Articles 433, 435 and 437 of the Civil Code.

Article 433 states that a contract is concluded at the moment that a person who has forwarded an offer receives an acceptance. Svetlana believes that she has accepted the 'offer' displayed on –ZAO- Choc's website and that her company will be able to obtain the 100 boxes of chocolates ordered at the price shown of 1,000 roubles per box.

Article 435 goes on to state that an offer is a proposal addressed to one or several concrete persons, that is sufficiently comprehensive and confirms intent to enter into a legally binding contract if it is accepted.

Article 437 distinguishes an offer from a 'public offer'. The latter is an invitation to make an offer. The Article refers to 'addressed to an infinite number of persons', as distinct from the wording of Article 435, which refers to one or more concrete persons. A public offer therefore serves as a representation but cannot be regarded as an offer that is capable of acceptance.

Applying these provisions to the case, the information on the website was certainly not addressed to one or more concrete persons, unless the term 'concrete' is taken to mean every trader with access to the internet. As such, the out-of-date information must be regarded as a public offer, and Svetlana is unable to insist on paying 1,000 roubles per box for the chocolates.

**(b)** The letter sent by –ZAO- Choc to Svetlana included an up-to-date price list. Although this contained concrete information on prices and was addressed to a specific person, it did not communicate an intention to enter into a binding relationship, as it did not refer to specific terms and conditions, such as delivery dates, discounts for bulk orders and so on. Any response by Svetlana to this communication would form an offer, however, provided Svetlana provided specific details of what her company required and the terms on which its order would be made.

–ZAO- Choc then sent the consignment of chocolates with an invoice for the goods at the correct price. Although this may appear to be an acceptance, it was in fact an offer as it complied with all of the attributes set out in Article 435. The consignment contained a specific amount of goods and was addressed to a specific person. Svetlana could then accept the offer by paying for the goods, or could return them if the new price was considered to be unacceptable.

Svetlana's response that she would only pay the original price could be regarded as a counter-offer. For the reasons discussed in part (a), she cannot hold –ZAO- Choc accountable for delivery of chocolates at 1,000 roubles per box, and –ZAO- Choc cannot insist on the price of 1,200 roubles per box, as no contract has come into existence.

**9** The question tested the candidates' ability to apply their understanding of the law relating to limited liability companies to a scenario in which two shareholders wished to withdraw in order to form a new company.

**(a)** Agata and David submitted a request to the company to withdraw their Charter capital in order to pursue alternative business interests.

Until Federal Law 312-FZ came into effect in July 2009, any participant in a limited liability company had a statutory right to withdraw his or her Charter capital. The new law took away this mandatory right, and limited liability companies are now able to include bespoke provisions in either the participants' agreement and/or the Charter that will determine how any withdrawal of a participant will be facilitated.

As the Charter of –OOO- Holiday permits Bogdan, Eva and Filipp to exercise pre-emption rights, this enables them to buy out the interests of Agata and David at their own discretion.

Should Bogdan, Eva and Filipp choose not to exercise these pre-emption rights, Agata and David are able to offer their interests in the company to third parties. If Agata and David do so, any transfer of their shares in –OOO- Holiday is subject to notarisation, and is only when this is confirmed to both the company and the Unified State Register that this will take effect.

The practical dilemma for Agata and David is that if their three colleagues are not prepared to buy out their interests, they will have to find alternative investors who are prepared to invest in what is both a relatively new business and one that is failing in its formative years.

**(b)** It is relatively common for small businesses to protect their interests by the inclusion of restraint of trade clauses, restricting participants (and sometimes executives) from directly competing in the event of leaving the organisation. These clauses may restrict the individual from forming a new business within a specific period of leaving, or within a certain geographical area.

All five participants in –OOO- Holiday entered into a participants' agreement in which they undertook not to compete directly with the company within one year of withdrawal. This is a legally binding contract.

As Agata and David have taken steps to form a new closed company limited by shares, this is a contravention of the agreement. The potential consequence of this is that –OOO- Holiday can petition the Arbitrazh Court to prevent them from going ahead with their new venture, at least for the agreed one year period.

Should Agata and David proceed to form the company and trade, –OOO- Holiday could take action against them in respect of any lost business and/or missed profits resulting directly from their unlawful act.

**10** The question described a company that was experiencing financial difficulties, and the responses of the board of directors in its attempt to deal with these difficulties. The chief executive officer persuaded the board to sell a warehouse, and in order to generate cash quickly the price was heavily discounted. The chief executive officer also entered into a transaction to purchase football shirts, but the inventory was made up of designs that were soon to be obsolete. It transpired that the chief executive officer's brother-in-law was a substantial shareholder in the supplier company.

**(a)** The board of directors agreed to sell the warehouse for 30% of its market value, suggesting that the board may have been negligent in respect of its duties to the company. Article 71 of the Federal Law on Joint-Stock Companies states that the executive body must, when exercising its rights and performing its duties, operate in the interests of the company, and act reasonably and in good faith.

It is generally accepted that a company that is experiencing financial difficulties may have to sell assets at a discounted price. The main reason for this is that time is usually of the essence, and a lower price may attract potential purchasers more quickly. Another reason is that the company's difficulties may be known to others, so purchasers can drive a harder bargain.

The extent to which the board should have discounted the price depends on many factors, including the conditions in the property market and the degree of pressure exerted by payables.

As the company failed to recover and was subject to an order for bankruptcy, the sale of the warehouse could come under scrutiny from the insolvency practitioners charged with the duty of dealing with the case. Federal Law 73-FZ amended the bankruptcy law in 2009, introducing the concept of 'under-value'. An under-value arises when a counterparty is deemed to have provided 'unequal consideration'. Whether the discounted price for the warehouse would be considered to be an under-value would be dependent on market conditions and the perceived urgency of raising funds.

Potentially, therefore, Sergei in particular, and the members of the board in general, are exposed to the prospect of two actions against them.

First they could be liable under Article 71 of the Federal Law on Joint-Stock Companies if their actions are considered to be not in the best interests of the company. This means that the company, or its shareholders, could bring an action against them.

Second those responsible for liquidation (or recovery) of the company could bring an action in respect of the sale of the warehouse for under-value.

In either case, or both cases, the directors could be held jointly and severally liable for any losses caused by their decision.

**(b)** The purchase of the football shirts proved to be disastrous because the company acquired the inventory when new designs were shortly to be introduced. At face value, this could be considered to be simply an unwise commercial transaction. However, –ZAO- Sport is a company that deals with such products in its normal course of business, so it is difficult to understand why a decision might be taken to purchase potentially obsolete inventory.

The purchase of the inventory was arranged by Sergei, who as chief executive officer would be expected to act without power of attorney for such transactions, unless precluded from doing so by the Charter or inner rules of the company. However, Sergei's brother-in-law happened to be a shareholder in –ZAO- Shirt, holding 28% of the equity. This presents two possible grounds for action against Sergei by the company, the shareholders or the insolvency practitioners.

As Sergei was dealing with a company in which his brother-in-law was a prominent shareholder, the transaction could be regarded as an interested party transaction under Articles 81–84 of the Federal Law on Joint-Stock Companies. Such a transaction requires approval by non-interested directors, or the general meeting of shareholders.

If the court concludes that the transaction was carried out unlawfully, it could be declared null and void, and Sergei and/or his colleagues on the board could be held personally liable for any losses sustained.

Depending on the precise timing of the transaction and filing for bankruptcy, the transaction could also be regarded as a harmful transaction within the meaning of Federal Law 73-FZ. 'Harmful' is defined as '… significant decrease in the value of the debtor's assets or increase of the value of claims to the debtor and any other consequences which resulted into infeasibility to satisfy creditors' claims'. As 'controlling persons', Sergei and his colleagues could be held jointly and severally liable for losses incurred.

Finally, the transaction may have contravened Article 71 of the Federal Law on Joint-Stock Companies, as described in part (a) above, if Sergei and the other directors are considered not to have acted in the best interests of the company.

**Fundamentals Level – Skills Module, Paper F4 (RUS)**
**Corporate and Business Law (Russia)** **December 2012 Marking Scheme**

| | | | |
|---|---|---|---|
| **1** | **(a)** | Position of codes in hierarchy of laws | 1 mark |
| | | General principles and guidelines in specific areas | 1 mark |
| | | Platform on which specific laws can be based | 1 mark |
| | | Consistency with Constitution and international laws | 1 mark |
| | | Examples | 1 mark |
| | | | (5 marks) |
| | **(b)** | Position of federal laws in the hierarchy of laws | 1 mark |
| | | Enacted by Duma and Federation Council | 1 mark |
| | | Deal with specific areas of activity | 1 mark |
| | | Platform for subordinate laws | 1 mark |
| | | Consistency with Constitution, codes and international laws | 1 mark |
| | | Examples | 1 mark |
| | | | (Maximum 5 marks) |
| | | | **(Total 10 marks)** |
| **2** | **(a)** | Definition of forfeit | 1 mark |
| | | Operation of forfeit | Up to 3 marks |
| | | | (4 marks) |
| | **(b)** | Definition of pledge | 1 mark |
| | | Operation of pledge | Up to 5 marks |
| | | | (6 marks) |
| | | | **(Total 10 marks)** |
| **3** | | Different sources of law (Labour Code and Civil Code) | Up to 2 marks |
| | | Form of agreement | Up to 2 marks |
| | | Fixed and indefinite term | Up to 2 marks |
| | | Divisibility | Up to 2 marks |
| | | Protection of employees | Up to 2 marks |
| | | | **(Total 10 marks)** |
| **4** | **(a)** | Basis of formation – new company or reorganisation | 1 mark |
| | | Founders | 1 mark |
| | | Founders' meeting | 1 mark |
| | | Charter | 1 mark |
| | | Registration | 1 mark |
| | | | (5 marks) |
| | **(b)** | Significance of separate personality to founders | Up to 2 marks |
| | | Significance of separate personality to shareholders | Up to 2 marks |
| | | Significance of separate personality to the company | 1 mark |
| | | | (5 marks) |
| | | | **(Total 10 marks)** |
| **5** | **(a)** | Provisions for increasing capital | Up to 2 marks |
| | | Provisions for decreasing capital | Up to 3 marks |
| | | | (5 marks) |
| | **(b)** | Paid from net profits | 1 mark |
| | | Conditions for paying dividends | 1 mark |
| | | Specific provisions relating to types of share | Up to 2 marks |
| | | Priority of dividends | 1 mark |
| | | Process | 1 mark |
| | | | (Maximum 5 marks) |
| | | | **(Total 10 marks)** |

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| **6** | **(a)** | Appointment by general meeting of shareholders | 1 mark |
| | | Eligibility criteria: | |
| | | – must not be members of board | 1 mark |
| | | – must not be managers | 1 mark |
| | | – in order to remain independent | 1 mark |
| | | | (4 marks) |
| | **(b)** | Duties laid down in Charter/inner documents | 1 mark |
| | | Duty to respond to shareholders' concerns | 1 mark |
| | | Duty to report on financial statements | 1 mark |
| | | Duty to give an independent opinion | 1 mark |
| | | Right to investigate | 1 mark |
| | | Right to refer to documents and seek explanations | 1 mark |
| | | Right to convene an extraordinary meeting | 1 mark |
| | | | (Maximum 6 marks) |
| | | | **(Total 10 marks)** |

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| **7** | **(a)** | Definition of corporate governance | 1 mark |
| | | Parties responsible for corporate governance | Up to 4 marks |
| | | | (5 marks) |
| | **(b)** | Identification of general areas in which governance is important | 1 mark |
| | | Specific application to: | |
| | | Agency problem and transparency | Up to 2 marks |
| | | Direction and management | Up to 2 marks |
| | | Shareholders' rights | Up to 2 marks |
| | | Stakeholders | Up to 2 marks |
| | | Compliance | 1 mark |
| | | | (Maximum 5 marks) |
| | | | **(Total 10 marks)** |

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| **8** | **(a)** | Attributes of offer | Up to 3 marks |
| | | Attributes of public offer | 1 mark |
| | | Application to scenario | 1 mark |
| | | | (5 marks) |
| | **(b)** | Price list is not an offer | 1 mark |
| | | Delivery of goods is an offer capable of acceptance | Up to 2 marks |
| | | No right to insist on website price | 1 mark |
| | | Insistence on old price is counter-offer | 1 mark |
| | | Conclusion that no contract formed at any stage | 1 mark |
| | | | (Maximum 5 marks) |
| | | | **(Total 10 marks)** |

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| **9** | **(a)** | No mandatory right to withdraw | 1 mark |
| | | Role of participants' agreement and Charter | Up to 2 marks |
| | | Implications of pre-emption rights | 1 mark |
| | | Transfer of shares | Up to 2 marks |
| | | | (6 marks) |
| | **(b)** | Restraint of trade clause as a binding contract | Up to 2 marks |
| | | Implications and consequences of breach of agreement | Up to 2 marks |
| | | | (4 marks) |
| | | | **(Total 10 marks)** |

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|---|---|---|---|
| **10** | **(a)** | Duty to act in the best interests of the company | 1 mark |
| | | Under-value transaction | Up to 2 marks |
| | | Implications and consequences of sale | Up to 2 marks |
| | | | (5 marks) |
| | **(b)** | Interested party transaction | Up to 2 marks |
| | | Possible failure to act in best interests | 1 mark |
| | | Implications and consequences of transaction | Up to 2 marks |
| | | | (5 marks) |
| | | | **(Total 10 marks)** |