# Answers

**1** The question tested the candidates' knowledge of the structure and functions of the courts of arbitration and the extent to which previously decided cases affect the outcomes of subsequent cases.

**(a)** The broad terms of reference for the Court of Arbitration are set out in article 127 of the Constitution of the Russian Federation:

'The Supreme Arbitration Court of the Russian Federation shall be the highest judiciary body resolving economic disputes and other cases considered by arbitration courts, and shall carry out judicial supervision over their activity in line with federal legal procedures and shall offer explanations on questions of judiciary practice.'

More detailed provisions are laid down in the Federal Law on the Judicial System of the Russian Federation.

The key term here is 'economic disputes', as it differentiates the main purposes of the courts of arbitration from those of the Constitutional Court and the courts of general jurisdiction. The courts therefore regulate and resolve disputes arising from legal relations concerning legal entities such as companies, partnerships and semi-state bodies as well as individual entrepreneurs. However, the courts do not deal with commercial actions that may give rise to criminal (penal) liability, nor do they deal with economic activities of individuals not registered as individual entrepreneurs.

It is also important to point out that it is the nature of the subject matter or dispute before the court, and not the status of the person or entity, that may determine the jurisdiction of the case. For example, losses arising from a traffic accident between two professional drivers who are on their way home from work would be dealt with by the courts of general jurisdiction.

The types of case considered by the courts of arbitration are broad, though nothing like as diverse as the cases heard by the courts of general jurisdiction.

The courts of arbitration consider disputes arising from contractual relations. These include those relating to the formation, variation or discharge of contracts, breaches of contract, violation of rights and undue fulfilment of obligations.

The courts of arbitration deal with many matters relating to companies, including state registration (or refusal to register), shareholders' rights, reorganisation and liquidation of enterprises. Increasingly, the courts are asked to consider cases relevant to the goodwill of the organisation and torts, or non-contractual obligations. The courts also deal with the enforcement of judgements made by foreign courts.

The courts of arbitration are structured in a hierarchical manner.

At the first (lowest) level are the federal arbitration courts of the subjects of the Russian Federation. These are the courts of first instance within their jurisdiction and deal with the majority of cases.

The second level is the appellate courts. As their name suggests, these are courts of appeal, or second instance, whose primary role is to re-examine cases already dealt with by the first level courts.

The third level is the federal arbitration circuit court. This also serves as a court of second instance but also deals with cases in the first instance involving disputes relating to normative legal acts of the president, the government and federal executive bodies relevant to business and economic activities. It hears cases concerning non-normative acts of the same bodies that claimants consider to be non-compliant with existing laws. It considers cases involving disputes between the Russian Federation and subjects of the Russian Federation and between subjects of the Russian Federation.

The highest level is the High Arbitration Court. This court has similar powers to the Supreme Court but with terms of reference confined to business and economic activities. The court also has a supervisory role in respect of the lower courts and has the right of legislative initiative. As a court of final appeal, it can set aside decisions of the lower courts, though it will do so on points of law rather than the facts or circumstances involved in the relevant case.

**(b)** The doctrine of judicial precedent is a feature of common law systems, such as the USA and the UK. Under the common law system, judges can create laws by making judgements on cases that then become standards for future decisions that require the application of the same or very similar principles.

As the Russian Federation has a codified law system in which legislation is the main source of law, judicial precedent has no formal place in the system. As a consequence, the primary role of judges is to interpret and apply the law. Judges do not create new laws.

This does not mean that previous cases are wholly irrelevant once decided. The decisions of courts are formally documented and there is a vast archive of material available for perusal by judges and legal professionals. In order to foster consistency in the application of the law, the courts will inevitably need to refer to previous decisions. The rationale applied in previously decided cases may also influence the content of the occasional information letters issued by the High Arbitration Court.

**2** The question asked candidates to state and explain the circumstances under which an individual or entity that is not a party to a contract can enforce obligations under the contract.

The law relating to contract is set out in articles 420 to 431 of the Civil Code. Article 420 defines a contract with reference to the mutual agreement of rights and obligations between two or more parties. In the majority of cases, therefore, it is only the parties to the contract that can enforce its provisions. This concept is sometimes described as 'privity' – only those who enter into the contract can rely on its provisions.

There are numerous exceptions to the principle of privity.

Article 430 makes specific provisions in respect of contracts that benefit third parties. It recognises the right of a third party to benefit from a contract and gives the third party a right to claim under it. If the third party expresses a desire to benefit from the contract, it cannot be dissolved or amended without the third party's consent. If the third party renounces rights under the contract, the creditor may avail himself of the rights, provided that this is consistent with the provisions of law. The debtor under contract can put forward any objections to the claims of the third party that could have been put to the creditor.

The various forms of voluntary representation are all examples of cases in which an agent binds a principal. These include contracts of agency (article 1005, Civil Code), contracts of commission (article 990, Civil Code) and contracts of mandate (article 971, Civil Code).

In a similar manner, those entering into a power of attorney bind the person or entity they are representing.

Chapter 53 of the Civil Code relates, *inter alia*, to the role of trustees. Where a trustee enters into a contract on behalf of a beneficiary, the latter can enforce the obligation.

Some types of contract may be legally assigned, which means that the benefits and obligations under the contract are transferred to a third party. An example of this is a lease on real estate and also a life assurance policy.

Contracts of general (non-life) insurance policies may likewise confer benefits on third parties in the event of an insured peril arising (article 965, Civil Code).

Consumer contracts for the purchase of goods by private consumers may be enforced against the manufacturer and the retailer (article 1096, Civil Code).

Some contracts that have been entered into by persons who subsequently die can be enforced by the successors to the estate.

**3** The question asked candidates to explain the provisions of the Labour Code in relation to definite term labour contracts and probationary employment.

**(a)** The Labour Code sets out extensive provisions that protect persons employed under contracts of service. The Code does not apply to external contractors, whose agreements are regulated by the general provisions of the Civil Code relating to contracts.

Article 58 of the Labour Code states that contracts may be for an indefinite term or for a definite term not exceeding five years, unless another term is set by the Code or other laws. The fixed term contract may be concluded for a fixed term when the nature of the job or conditions of its performance render an indefinite term contract inappropriate.

The protection afforded to employees could not be put into effect if fixed term contracts were completely unregulated. Otherwise, any employer would be able to engage all workers on short-term fixed term contracts, thereby avoiding the obligations imposed by the Labour Code. Therefore, the Code makes specific rules that apply to fixed term contracts. Some labour contracts must be concluded on a fixed term basis while others may take this form, subject to the agreement of both parties.

A fixed term labour contract must specify the term applicable. If this is excluded from the contract, then the contract is automatically deemed to be for an indefinite period of time. In addition, any employer who continues to provide work for the employee after the expiry of the fixed term is considered to have converted the contract to one of an indefinite term. If a fixed term contract is concluded without due reasons, this is also regarded as a contract for an indefinite term.

The categories of employee who may be engaged under fixed term contracts are set out in article 59 of the Labour Code.

The instances in which a contract must be concluded for a fixed term are:

Employment that has a defined beginning and end, such as seasonal jobs, those acting as replacements for temporary absentees such as women on maternity leave, and in organisations that will exist for a fixed period of time.

Employment that will not exceed two months in total.

Persons required to work outside the Russian Federation.

Employment that does not include the ordinary work of the enterprise.

Fixed term labour contracts may be concluded by agreement with the employee under several circumstances:

Retail trade and public service appointments in organisations with up to 35 employees.

Other small businesses with up to 20 employees.

Retired persons.

Those who may only be employed temporarily on medical grounds.

Those employed in the Polar North of the Russian Federation.

Those employed for a fixed term in order to avoid accidents or *force majeure* circumstances.

Senior employees of companies, such as the sole executive body, deputies to the sole executive body and chief accountants.

Certain employees in the arts and creative professions, such as mass media, film and theatre.

Certain employees in educational and training establishments.

Some students.

Once a fixed term contract expires, it may be cancelled, renewed on the same or revised terms or recognised as renewed on an indefinite basis.

**(b)** A probationary period of employment is usually set for a specified number of weeks or months commencing at the start date of the labour agreement. During this period, the employee is engaged on a trial basis. The purpose of the probationary period is to test the employee's skills and abilities in order to decide whether the employee is suitable for the position. Probationary periods are a feature of many types of employment, including positions in the professions.

Probationary periods are governed by articles 70 and 71 of the Labour Code.

If a probationary period applies to a position, this must be stated in the labour agreement, and the absence of such a provision excludes the possibility of the employer insisting on a probationary period.

Article 70 forbids the inclusion of a probation clause in a labour agreement for several categories of employee. These include persons under 18 years of age, expectant mothers, mothers of children of up to 18 months old, those who have graduated from professional education and are being employed in their first position in their chosen specialism within one year of graduation, those appointed following a competition for the position, transferees from other jobs and those elected to a paid position.

For chief executives and their assistants, chief accountants and their assistants and chief executives of branch and representative offices, the period of probation cannot exceed six months. For other positions the maximum probationary period is three months.

If the employee's performance is considered to be unsatisfactory during the probationary period, the employee may be dismissed subject to a minimum of three days written notice and agreement with the trade union (article 71, Labour Code). The employee is entitled to be informed of the reasons why the performance is considered to be unsatisfactory. No severance pay may be claimed in the event of dismissal during the probationary period. Dismissal during the probationary period may however be appealed through the court.

If the employee is engaged beyond the end date of the probationary period, he or she is deemed to have satisfied the conditions necessary to pass the probation.

**4** The question asked candidates to explain what is meant by a major transaction, the process through which a major transaction is approved and the protection provided by law for shareholders in the event of a major transaction being proposed or concluded.

**(a)** The major transaction is a concept defined by article 78 of the Federal Law on Companies Limited by Shares.

A major transaction is any transaction, or series of related transactions, connected with the acquisition or disposal, or possibility of acquisition or disposal, directly or indirectly of property comprising more than 25% of the balance sheet value of the assets of the company. The value is taken with reference to the balance sheet appraised as at the last accounting date.

The definition includes any transaction or series of related transactions concerned with the issue of ordinary shares or convertible preference shares comprising more than 25% of the ordinary shares already issued by the company.

Article 78 provides a list of examples of transactions that may fall into the category of the major transaction. They include contracts of loan, credit, pledge and suretyship.

Transactions made in the ordinary course of business are excluded from the definition of a major transaction. Placements of ordinary shares by subscription and placements of securities convertible into ordinary shares are also excluded.

The Charter of the company may make additional stipulations as to what transactions may be regarded as major transactions.

**(b)** Article 79 of the Federal Law on Companies Limited by Shares sets down specific procedures for the approval of major transactions in order to protect the shareholders. The procedures are laid down in order to ensure that the shareholders, or those who are entrusted to act on their behalf, have the opportunity to sanction or decline the right to carry out the transaction.

If the value of the transaction is between 25% and 50% of the balance sheet value of the assets of the company, it requires the unanimous agreement of the board of directors of the company. If the board do not agree to conclude the transaction on a unanimous basis, the decision passes to the general meeting of shareholders. In this case, it is necessary to secure the agreement of at least 75% of the shareholders present at the meeting.

If the value of the transaction exceeds 50% of the balance sheet value of the assets of the company, the decision falls to the exclusive competence of the general meeting of shareholders. Again, at least 75% of the shareholders present at the meeting must sanction the transaction if it is to proceed.

**(c)** If the general meeting of shareholders sanctions a major transaction, the shareholders who did not participate in the meeting or voted against the transaction have the right to redeem their shares in the company at the market value.

Any shareholder wishing to take up this right must inform the company of this within 45 days of the meeting at which the decision was taken. The company is then obliged to redeem the shares within 30 days of expiry of the 45 day period.

The redemption of shares must be at a market price struck with reference to a professional opinion of a licensed auditor or appraiser. The market price is the price at which a seller, having full information about the property and not obliged to sell it, would have agreed to sell it, and the purchaser, having full information about the property and not obliged to acquire it, would have agreed to acquire it.

A major transaction carried out in breach of the provisions of the law may be declared as null and void. In the event that a third party may hold the company responsible for the transaction or compensation, the directors may bear subsidiary liability for the transaction. They may also be liable for moral damage to the company.

**5** The question required candidates to explain the main characteristics of ordinary shares and preference shares and to explain the processes through which the capital of a company may be increased or reduced.

The law on capital and financing in relation to companies limited by shares is set out in the Civil Code. Article 99 refers to raising the stock or fund of the company by issuing shares that will comprise Charter capital.

**(a)** Ordinary (common) shares and preference shares are the two main sources of share capital to companies limited by shares. The Federal Law on Companies Limited by Shares provides extensive regulations in relation to the duties of a company and obligations of the company and its shareholders. The statute is supported by edicts of the President and amending legislation, which from time to time reinforce the rights of shareholders.

The characteristics of the two types of share may be described as follows:

Securities:

Both types of share are securities that represent a claim by the owner against the company. The relationship between the owner and the company resembles a contract of membership. The rights and obligations of the two parties are set out in the Charter of the company but are constrained by the provisions of the Federal Law on Companies Limited by Shares.

Both types of share are registered securities in that the company has a duty to register their ownership. Both types of share are transferable securities, but confirmation of a transfer of ownership is concluded by the name and other personal details of a new holder being registered by the company. Companies limited by shares cannot issue bearer shares (shares that are transferable by physical transfer without registration).

Dividends:

Both types of share carry a right to a dividend if declared, but in both cases there is no automatic right to a dividend if the company's financial position dictates that none can be paid.

The preference shareholders have a right to an annual fixed dividend, expressed usually as a percentage of nominal value of the share or as a fixed monetary sum. This dividend is often cumulative, so if the company cannot pay the dividend due to the preference shareholder in one year it is carried forward to the next year. The preference shareholders' claims have priority over those of ordinary shareholders. Therefore, preference shares are less risky, though the fixed nature of the dividend precludes holders from benefiting from greater returns when the company is more profitable.

By contrast, ordinary shareholders receive a dividend at a rate recommended by the board of directors each year, so the return on the investment to the shareholder is unknown and quite often unpredictable.

Permanent capital:

Both types of share represent permanent capital of the company unless the Charter specifies that the share is redeemable. It is also possible for shareholders to demand redemption of shares if certain constitutional decisions are taken to which they object or on which they abstain from voting (such as sanctioning a major transaction, s.79, Federal Law on Companies Limited by Shares).

Limits:

The number and aggregate nominal value of shares is set out in the Charter of each company. However, the total value of preference shares issued by the company may not exceed 25% of total share capital (Article 102, Civil Code).

Power of management and voting:

The general meeting of shareholders is the supreme decision taking body of a limited company and the shareholders have extensive rights to direct and control the company. The rights of shareholders to take decisions are set with reference to voting thresholds (mainly simple majority or 75%, depending on the decision to be taken) and the percentage of shares held by those making formal proposals to a meeting.

As a general rule, ordinary shareholders may vote on all constitutional matters of the company while preference shareholders may not vote. However, the preference shareholder is entitled to vote on certain matters, mainly those affecting the rights attached to the share, amendments to the Charter, reorganisation and liquidation.

The Charter may include additional voting rights for the preference shareholders.

Convertibility:

Ordinary shares may not be converted into other types of security. Preference shares may be convertible into ordinary shares or preference shares of other types.

Liquidation:

Subject to the provisions of the Charter, the preference shareholder may have priority rights over ordinary shareholders in the event of liquidation of the company.

**(b)** The Charter capital of a company may be increased or decreased at any time, though both actions are subject to restrictions imposed by the Civil Code. Increases and decreases cannot be implemented without approval by the general meeting of shareholders. Generally, the law is less permissive in respect of decreases in capital than for increases in capital. This is consistent with the principles of capital maintenance, which suggest that creditors should be entitled to regard the capital of the company as a 'buffer' against losses.

Increasing capital:

The rules relating to increasing share capital are set out in article 28 of the Civil Code.

The capital of a company may be expedited in two ways. The company may choose to increase the nominal value of existing shares or alternatively it may place additional shares.

A decision to increase the nominal value of existing shares is taken by the general meeting of shareholders, though provisions contained in the Charter may permit delegation of this to the directors. This implies that the shareholders will also have to sanction amendments to the Charter. An increase in capital facilitated by the placing of additional shares is subject to the maximum value of authorised capital as stated in the Charter of the company. This does not require an amendment to the Charter unless the value of the increase in placed shares exceeds the value of (unplaced) authorised capital in the Charter.

When the capital is increased by issuing additional shares, the existing shareholders of the company have a pro rata pre-emptive right to the additional shares to prevent indiscriminate dilution of their rights.

Although the law is relatively permissive in respect of increases in capital, certain limits apply. The increase cannot exceed the difference between the net assets of the company and the sum of its Charter capital and reserve fund.

It is forbidden to increase the share capital of the company for the sole purpose of dealing with losses (article 100, Civil Code).

Decreasing capital:

The rules relating to decreasing share capital are set down in article 29 of the Civil Code.

Consistent with the principles of capital maintenance, the company may be required to reduce its capital under certain circumstances. For a new company, 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. Thereafter, if the net assets of the company are less than the Charter capital at the end of the second or subsequent accounting year, the capital must be reduced to reflect this. If the capital falls to below the minimum limits, the company has to be reorganised or wound up.

Notwithstanding these mandatory requirements, the company may decide to reduce its capital for several reasons. Firstly, it may decide that the financial accounts of the company do not give an accurate portrayal of the company's worth. Secondly, the company may choose, with his or her agreement, to extinguish the interest of a shareholder. Thirdly, it may be decided that the best interests of the company may be served by higher gearing.

In such cases, the reduction in capital may be effected by reducing the nominal value of shares or by reducing the number of shares.

A reduction in capital by changing the nominal value of shares must be proposed by the directors and sanctioned by a general meeting of shareholders. In order to approve this it is necessary for at least 75% of shareholders to vote in favour. The diminution in value must be implemented on a *pro rata* basis.

When a decision has been taken to reduce the capital of a company the creditors must be notified in writing within 30 days of the decision (article 30, Civil Code). The notice must specify the amended value of Charter capital. This notification must be supported by a press announcement. The creditors are then entitled to demand the discharge of obligations within 30 days of receipt of the notice.

**6** The question asked candidates to explain the conditions that must be fulfilled in order for insolvency proceedings to be instigated against a company, and to explain the protection provided by law for creditors during the insolvency process.

**(a)** The laws on insolvency are set out in the Law on Bankruptcy and the broader provisions of the Civil Code.

Article 2 of the Law on Bankruptcy states that a legal entity is considered to be bankrupt when the Court of Arbitration recognises that it cannot fully meet the claims of creditors. This supports the provisions under articles 25 and 65 of the Civil Code, which state that any individual entrepreneur or legal entity may be regarded as bankrupt if it is incapable of satisfying creditors' claims.

Both of these legal sources are somewhat broader in definition than the stricter accounting concept of insolvency, which considers insolvency to occur when total liabilities exceed total assets. Under either the Civil Code interpretation or the Law on Bankruptcy interpretation, the court may regard the entity to be bankrupt if it cannot meet its obligations within a reasonable period of them falling due. This may occur if the entity is not bankrupt at all, but simply illiquid.

Article 3 of the Law on Bankruptcy refers to 'signs of bankruptcy'. It states that the entity shall be considered to be incapable of meeting the claims of third parties if it does not discharge these obligations within three months of the date on which they fall due. The obligations that may be considered as relevant to the entity's financial position are debts for delivered goods, completed works and services, outstanding loans (capital and interest) and debts arising from damage to property and under non-grounded enrichment. Certain obligations are disregarded for the purposes of assessing whether the entity is insolvent, including forfeits and other penalties, interest for deferred obligations and liabilities arising from inflicting harm to third parties.

If the sum total of the obligations exceeds the value of property owned by the entity, the court will regard it as insolvent.

**(b)** The Law on Bankruptcy protects creditors of insolvent organisations in numerous ways:

Oversight and management:

When an organisation is declared bankrupt its affairs are placed in the hands of an arbitration manager. The rules issued by the High Arbitration Court lays down specific minimum requirements in respect of this official, who must be registered as an individual entrepreneur and have higher educational qualifications. The manager must have a specified minimum level of experience and no criminal record. Professional indemnity insurance is mandatory.

The court ensures that the arbitration manager is independent in respect of monies due to any of the creditors of the organisation for which he or she is accountable. In this way, the process ensures that the arbitration manager should act objectively at all time, in the best interests of the creditors.

Once the procedure commences, the Law on Bankruptcy requires a specific monitoring procedure to be followed which ensures the involvement of creditors at key stages.

Restrictions on transactions:

During the process of insolvency the arbitration manager is limited in respect of transactions that may be carried out on behalf of the company. This serves as a safeguard for the assets of the company and provides short-term protection for creditors, even though their claims are frozen for the time being.

Accountability to the court:

The Court of Arbitration has both a regulatory and administrative role in the entire bankruptcy process. For example, if at any stage of the proceedings it is considered to be in the best interests of all to conclude a composition, this requires the sanction of the court.

Creditors' meeting:

The creditors' meeting has several functions. It can decide to introduce and subsequently approve financial sanation, adopt an external management plan, initiate receivership or conclude an amicable settlement.

The creditors' meeting represents creditors of all categories, with decisions vested in the creditors *pro rata* the monetary sums due to them. The meeting can also elect a creditors' committee.

Creditors' committee:

If there are more than 50 creditors, a committee may be formed to represent the interests of the broader body of creditors, control and monitor the insolvency process and discharge any other duties delegated to it by the creditors' meeting. The committee is elected by the meeting and comprises between three and eleven persons. The committee may appoint one of their number to act as its representative in litigation.

External management:

External management seeks to restore the solvency of the business. As in the case of the arbitration manager, the High Arbitration Court lays down duties and obligations of the external manager whilst offering several discretionary options to enable the company to recover.

Receivership and settlements:

Article 134 of the Law on Bankruptcy lays down a strict order for the settlement of the obligations of the insolvent company.

**7** The purpose of this question was to test the candidates' knowledge of the meaning and significance of separate legal personality and its implications for effective corporate governance.

**(a)** The term 'separate legal personality' refers to the nature of a legal entity as having its own identity, separate from those who own it (the shareholders) and those who manage it (the directors and other executives). As such, the entity becomes an artificial 'person' once it is registered with the State authorities, and as such it has most of the attributes of a natural person (article 51, Civil Code). Just as a natural person is born, a company is born once it is registered. Just as a natural person can own assets and incur liabilities, so too can an artificial person. Extending the analogy, an artificial person can marry (merge), divorce (demerge), become bankrupt (insolvent) and eventually die (be liquidated).

The creation of separate legal personality is rooted in the provisions of article 48 of the Civil Code which defines three models of legal entities, categorised according to their rights of estate, the extent of their powers and whether their operations are commercial or non-commercial in nature.

There are several significant features that emerge from the creation of bodies with a separate legal personality.

Firstly, the legal entity owns its own property and incurs its own obligations. Therefore, those who do business with the entity should be aware that any contracts entered into can usually only be enforced against the entity itself and not the individuals who take the decisions.

Secondly, many types of legal entity have limited liability. Although the entity itself actually has unlimited liability for the obligations it incurs, the owners (shareholders) are only liable to the extent of their monetary contributions to the capital. This is an important advantage for shareholders, who can be confident that they can incur no further obligations, even if their shares eventually become worthless.

Thirdly, the entity has perpetual succession. Although those who run the company may leave, retire or die, the entity has an ongoing existence until steps are taken to bring this to an end. One implication of this is that investments such as shares in a company represent potential wealth and income for future generations.

Fourthly, the capacity of a legal entity is dictated by a constitution, such as the Charter of a company. This may be permissive or restrictive in nature, depending on the wishes of those who originally draft it or subsequently choose to amend it.

Fifthly, accountability for the actions of management and their consequences lie with the entity and not the decision takers. If a third party wishes to litigate, it must do so against the entity and not the directors.

**(b)** Corporate governance is the system through which a company is directed and controlled (Cadbury Report, 1992).

The Organisation for Economic Cooperation and Development (OECD) elaborates by stating that it is:

'…a set of relationships between a company's directors, its shareholders and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of achieving those objectives and monitoring performance, are determined.'

This answer adopts the OECD framework for discussing the implications of separate legal personality for corporate governance. It should be noted that the points made in this answer could be discussed using any alternative framework or approach that identifies the key factors.

**Rights of shareholders:**

The corporate governance framework should protect shareholders and facilitate their rights in the company. Companies are obliged to generate investment returns for the risk capital put up by the shareholders. Directors should be accountable to shareholders in this respect.

The fact that a company is a separate entity exposes the shareholders to some degree of risk. Generally, the degree of separation increases as the size of the shareholder base increases. Historically, in the Russian Federation this separation has been less important in the past as companies tended to be directed and controlled by their owners. This is reflected in the relatively powerful position of the general meeting of shareholders in the decision taking hierarchy in comparison with western European countries. However, this is changing rapidly and it is unlikely that the dominance of concentrated ownership and complex holding structures will persist in the longer term.

The rights of shareholders are protected by provisions in the Civil Code relating to formation, organisational models and liquidation, and also by the detailed provisions of the Federal Law on Companies Limited by Shares (and parallel legislation for limited liability companies).

**Equitable treatment of shareholders:**

All shareholders should be treated equitably (fairly), including those who constitute a minority, individuals and foreign shareholders. Shareholders should have redress when their rights are contravened or where an individual shareholder or group of shareholders is oppressed by the majority.

In the Russian Federation it is recognised that the majority have the right to exert power but due regard should also be paid to the minority. Therefore, the law protects shareholders in numerous ways including major transactions, interested transactions, reorganisation and constitutional rights (such as the right to propose items for the agenda of general meetings).

**Stakeholders:**

The corporate governance framework should recognise the legal rights of stakeholders. The company should facilitate cooperation with stakeholders in order to create wealth, employment and sustainable enterprises.

There are several examples of how separate legal personality impacts on stakeholders, particularly creditors and employees. For example, a supplier to a company may be dealing with an extremely wealthy individual who is responsible for the operations of the company, but it is the company and not the individual that will incur the obligation.

**Disclosure and transparency:**

Companies should make relevant and timely disclosures on matters affecting financial performance, management and ownership of the business.

As the entity is a separate person, its true financial position at any given time will only be known to a relatively small group of persons. Existing laws require companies to prepare accounts on an annual basis and make reports on significant issues to the shareholders. There is increasing pressure for disclosures to be more frank, more full and more frequent, especially in respect of issues that impact on the community and the environment.

**Board of directors:**

The board of directors is responsible for setting the direction of the company and monitoring the management of the company in order to achieve its stated objectives. The corporate governance framework should underpin the board's accountability to the company and its members.

Directors act as agents of the owners. This exacerbates the problem of separation as the shareholders are reliant on the actions of the directors to act in their best interests. It should also be remembered that supervisory boards are a relatively new concept in the Russian Federation.

**8** The question tested the candidates' ability to apply their understanding of legal capacity to a scenario.

The Civil Code sets down detailed and prescriptive rules in relation to legal capacity. Article 17 of the Civil Code states that all citizens have a right to civil passive capacity from birth until death. This confers only basic rights, such as the right to a name and the right to own property. In turn, the active capacity may be limited by statute or by decisions of the courts. For example, a very young person may own a piece of land but may be able to do little with it except with the consent of others.

The extent of the individual's active capacity is determined mainly with reference to the age of the citizen. Article 26 of the Civil Code makes specific provisions in respect of those between 6 and 14 years of age and those between 14 and 18 years of age. The latter provisions are relevant to part (a) of the scenario in which a 17-year-old wishes to marry.

Further provisions of the Civil Code dictate how an adult's legal capacity can be affected by circumstances confronting the individual or the individual's family. This is relevant to part (b) of the question in which an individual's addictions and lifestyle are adversely affecting the family.

**(a)** Anna is currently 17 years old and therefore enjoys partial active capacity under the provisions of the Civil Code. Article 26 enables her to manage her own income if applicable, make transactions through financial institutions in her own right (unless prevented from doing so by the terms and conditions of the relevant institution) and exercise certain rights, such as those of an author or an inventor. She can also bear liability for inflicting injuries on others. Some transactions may be carried out with the prior approval of her parents. Therefore, if Rosa and Dimitri deny her permission to marry, she will continue to have partial active capacity for the next 11 months, after which she will attain full active capacity.

The Civil Code states exceptions to the rules relating to partial active capacity. One of these is on marriage before the age of 18 years (article 21(2), Civil Code). If Rosa and Dimitri permit the marriage, this will automatically mean that she attains full active capacity on the change in her civil status. She will then acquire all the rights of an adult citizen. Article 30 of the Civil Code makes further provisions through which a person between 14 years and 18 years of age may attain full active capacity.

**(b)** Peter is an adult and as such already has full active capacity. However, his lifestyle suggests that he is causing harm and financial difficulties for his family. In such cases, the Civil Code enables active capacity to be withdrawn.

Rosa and Dimitri can apply to the court to restrict Peter's capacity. The outcome of this is that his affairs will be placed in the hands of a trustee. Articles 31 and 33 of the Civil Code specify cases in which such an appointment would be appropriate, of which addiction is one such instance.

Even though his affairs will be supervised by a trustee, Peter will still be able to receive an income and execute deals of a limited value, but for significant transactions he will need the consent of the trustee.

The appointment of a trustee by the court does not restrict Peter's accountabilities under the law. He continues to be responsible for his actions, including any damage caused to others.

The duties of the trustee are defined in detail in articles 36 to 40 of the Civil Code.

The court is able to set aside the trusteeship should Peter's circumstances change in the future, in which case he would once again attain full active capacity (article 31, Civil Code).

**9** The question required an understanding of methods of securing contractual obligations. The laws relating to securing obligations are set out in chapter 23 of the Civil Code, and the general laws on obligations.

**(a)** A mortgage is a form of security for a loan. It is one of the methods of securing obligations laid down in chapter 23 of the Civil Code. Specific provisions relating to mortgage/pledge are set out in articles 334 to 358 of the Civil Code.

A mortgage is a contract that creates obligations of a borrower (mortgagor) and rights in favour of a lender (mortgagee). Under a mortgage contract, the owner of the property remains the legal owner, but confers various rights on the counterparty. The main right is to demand that the borrower makes regular payments of either capital and interest, or interest only with the capital repaid at the end of a specified term.

Additional obligations of the mortgagor may include requirements to insure the property, to keep it in good repair and to inform the mortgagee of any material adverse changes in circumstances. It is common for commercial mortgage contracts such as the arrangement contemplated by Vladimir to include detailed financial and non-financial covenants (promises) in order to protect the lender's interests.

If the company enters into a mortgage, it will be unable to sell or repledge the property without the prior consent of the first mortgagee.

If Vladimir's company enters into a mortgage, the company as a separate legal entity would be the mortgagor.

A personal guarantee is a separate contract from a lending agreement. It is referred to as a surety in article 361 of the Civil Code. Further detailed provisions are set down in articles 362 to 367.

The guarantee is sometimes referred to as an ancillary (or collateral) contract. Therefore, two contracts are created. The first is a contract between the lender and the borrower and the second is a contract between the guarantor and the lender. In the event that the borrower fails to meet the conditions of the lending contract, the guarantee contract obliges the guarantor to pay.

If Vladimir secures his father's agreement to this, he or his family would be guaranteeing the debt on behalf of the company.

**(b)** The risk associated with the mortgage is that it is a secured debt. If the company cannot meet its financial and other obligations, it may lose the head office building. The most efficient way of recovering a loan is to realise the security for the loan (as envisaged in article 350, Civil Code). The bank would do this by selling the property on behalf of the owner through a public auction, and though obliged to act in the mortgagor's best interests, this would almost certainly close down the company.

The risk attached to the guarantee arrangement falls to Vladimir's father. If the company does not meet the conditions of the loan, it will retain its asset (the factory), but Vladimir's family will be legally obliged to make good the debt on which the company has defaulted. Therefore, the business of the company is not threatened, though Vladimir's family would have a right of subrogation against the company – it would be able to pursue action against the company for recovery of the monies paid in respect of the guarantee.

Vladimir therefore has to consider the risk of exposing the assets of the company against the personal risks to family wealth. One determining factor might be the amount of capital needed and the extent to which each lender is prepared to meet these requirements.

**10** The purpose of this question was to test the candidates' understanding of the rights of shareholders to oppose activities that are outside the constitutional objectives of the company and the accountabilities of management for such actions.

**(a)** All companies must have a Charter which will always include the purposes and objectives of the company (article 11(3), Federal Law on Companies Limited by Shares). In the case study scenario, we are informed that the company's objectives are narrowly defined.

When a company is changing its fundamental mode of operation, such as the transition from traditional retail sites to internet and direct mail operations, this will inevitably involve carrying out transactions that may not be entirely consistent with the stated objectives of the company. Most often, this is because such changes were not envisaged when the company was originally formed, but it is also because the Charter would have to be extremely detailed to accommodate all necessary actions.

The question turns on whether the actions of management fall outwith the terms of reference in the Charter. In legal parlance, actions that fall within the objectives of the company are referred to as *intra vires* while those that do not are termed *ultra vires*.

All shareholders of the company are entitled to a copy of the Charter and to inspect copies of the minutes of general meetings and resolutions. If decisions are taken that violate the rights of the shareholder or are inconsistent with the provisions of the Charter, any shareholder can petition the court to render the transaction invalid. However, in this scenario it appears that the directors have acted without bringing the transactions to the attention of the members in a general meeting.

Shareholders are entitled to rely on the statement of objectives in the Charter in order to protect their investments. Therefore, if the actions of the directors are clearly at odds with the provisions of the Charter, they can refer the matter to the courts, who will then decide on the appropriate action to take against the perpetrators (see section (b) below).

Depending on the percentage of shares in the company owned by the dissenting shareholders, they could also contemplate other courses of action. They could call a special meeting to propose a resolution restricting the specific or general actions of the directors, precluding deals of a specific nature or in excess of a specified monetary value. They could also propose the removal of individual directors and if deemed appropriate nominate persons of their own choice. Most importantly, any shareholder or groups of shareholders with 1% or more of the shares in the company may litigate against individual directors to reimburse losses brought about by their actions.

**(b)** Consequences to the company:

If the deals have already been concluded there is no possibility of setting them aside. The land deals will have been conducted with third parties who had no obligation to satisfy themselves of the power or otherwise of the company to enter into such deals. To reverse the land deals that have already taken place would be impractical.

Consequences to the directors:

The directors who sanctioned the transactions are in a more precarious position if it is proven that the transactions were *ultra vires* and that they did not act in the best interests of the company.

Article 183 of the Civil Code states that if a transaction is carried out without the backing of relevant powers, or where the individual exceeded his or her powers, then the transaction is considered to have been made on behalf of the individual and not the company. Therefore, the individual director would be liable for the transactions made.

In addition, the directors may be liable for any damage or losses (including moral harm) sustained by the company.

Therefore, in order to avoid personal liability, the directors would have to persuade the shareholders that their transactions were for the purposes of supporting the company's operations and not for speculative reasons.

Consequences to the counterparties:

Unless they had actual knowledge of the directors' restricted powers, the counterparties were entitled to enter into the land deals and are therefore unaffected by any action against the directors. They would have bought or sold land in good faith.

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| **1** | **(a)** | Purposes relating to economic disputes | Up to 2 marks |
| | | Examples, distinctions from jurisdictions of other courts | Up to 2 marks |
| | | Levels of the courts and terms of reference | Up to 3 marks |
| | | | (7 marks) |
| | **(b)** | No formal system of judicial precedent | 1 mark |
| | | Reference to records/database of past cases | 1 mark |
| | | Role of judges and right to consult past cases | 1 mark |
| | | | (3 marks) |
| | | | **(Total 10 marks)** |
| **2** | | Exceptions to principle of privity | Up to 2 marks per exception |
| | | | **(Total 10 marks)** |
| **3** | **(a)** | Basic Labour Code definition | 1 mark |
| | | Five year rule | 1 mark |
| | | Examples of fixed term contracts | Up to 2 marks |
| | | Expiry of fixed term contracts | 1 mark |
| | | | (5 marks) |
| | **(b)** | Definition of probation | 1 mark |
| | | Time limits | 1 mark |
| | | Examples of occupations where permitted/not permitted | Up to 2 marks |
| | | Expiry of probationary period | 1 mark |
| | | | (5 marks) |
| | | | **(Total 10 marks)** |
| **4** | **(a)** | Definition of major transaction | Up to 3 marks |
| | | Exclusions | 1 mark |
| | | | (4 marks) |
| | **(b)** | Thresholds for major transactions | Up to 2 marks |
| | | Decision taking on major transactions | Up to 2 marks |
| | | | (4 marks) |
| | **(c)** | Right of redemption of shares | 1 mark |
| | | Liability of directors | 1 mark |
| | | | (2 marks) |
| | | | **(Total 10 marks)** |
| **5** | **(a)** | Nature as securities | 1 mark |
| | | Dividend rights | 1 mark |
| | | Voting rights | 1 mark |
| | | Other constitutional rights | 1 mark |
| | | Rights on liquidation | 1 mark |
| | | | (5 marks) |
| | **(b)** | Procedure for increasing capital | 2 marks |
| | | Procedure for reducing capital | 2 marks |
| | | Rights of creditors | 1 mark |
| | | | (5 marks) |
| | | | **(Total 10 marks)** |

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| **6** | **(a)** | Inability to pay debts | 1 mark |
| | | Time limit | 1 mark |
| | | Court procedure and establishing claims | Up to 2 marks |
| | | | (4 marks) |
| | **(b)** | Role of court/oversight | Up to 2 marks |
| | | Role of arbitration manager | 1 mark |
| | | Creditors' meeting/committee | 1 mark |
| | | External management | 1 mark |
| | | Receivership and settlements | 1 mark |
| | | | (6 marks) |
| | | | **(Total 10 marks)** |
| **7** | **(a)** | Separation of owners and managers | 1 mark |
| | | Entity has own assets/liabilities | 1 mark |
| | | Entity can sue and be sued | 1 mark |
| | | Limited liability | 1 mark |
| | | Perpetual succession | 1 mark |
| | | | (5 marks) |
| | **(b)** | Shareholders' rights | 1 mark |
| | | Equitable treatment | 1 mark |
| | | Stakeholder interests | 1 mark |
| | | Disclosure and transparency | 1 mark |
| | | Directors' responsibilities | 1 mark |
| | | | (5 marks) |
| | | | **(Total 10 marks)** |
| **8** | **(a)** | Civil Code provisions on minority | Up to 2 marks |
| | | Application to scenario | Up to 2 marks |
| | | | (4 marks) |
| | **(b)** | Civil Code provisions on withdrawing legal capacity | Up to 2 marks |
| | | Trusteeship | 2 marks |
| | | Application to scenario | Up to 2 marks |
| | | | (6 marks) |
| | | | **(Total 10 marks)** |
| **9** | **(a)** | Legal mortgage – characteristics | Up to 3 marks |
| | | Personal guarantee – characteristics | Up to 3 marks |
| | | | (6 marks) |
| | **(b)** | Risks – mortgage | Up to 2 marks |
| | | Risks – guarantee | Up to 2 marks |
| | | | (4 marks) |
| | | | **(Total 10 marks)** |
| **10** | **(a)** | Relevance of Charter | Up to 2 marks |
| | | Minority rights to petition court | 1 mark |
| | | Right of shareholders to move resolutions | 1 mark |
| | | Right to remove/nominate directors | 1 mark |
| | | Right to litigate against directors | 1 mark |
| | | | (6 marks) |
| | **(b)** | Consequences to company | 1 mark |
| | | Consequences to directors | Up to 2 marks |
| | | Consequences to counterparties | 1 mark |
| | | | (4 marks) |
| | | | **(Total 10 marks)** |