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Challenging Major and Interested Party Transactions

On 16 May 2014 the Plenary Session of the Russian Supreme Commercial Court adopted Resolution No. 28 "On Certain Issues Related to Challenging Major and Interested Party Transactions."

In this Resolution, the Court summarized issues related to challenging major and interested party transactions, and set out a number of positions that had not previously been established by the Court. This alert analyses the provisions where the Court (i) has clarified the characteristics of the subject matter of the decision approving a transaction; (ii) set out certain grounds for the invalidation of (the refusal to invalidate) a transaction; (iii) indicated characteristics of challenging major and interested party transactions and clarified certain procedural issues; (iv) provided for some examples of the transactions that may be qualified as major and/or interested party transactions; and (v) listed other remedies available for a company or its participants in addition to the invalidation of a major and/or interested party transaction.

1. The Characteristics of Approving a Transaction

The Subject Matter of an Approval (Clause 7 of the Resolution)

Persuant to the company laws[1] major and interested party transactions must be approved by a general meeting of a company's participants[2] or the company's board of directors. The Court has clarified that a draft contract for a relevant transaction must be enclosed with the approval, or such approval must indicate the parties to the transaction and the beneficiary; it must also provide for the main terms of the transaction (including its price and subject) or set out their basic parameters (e.g. the cap purchase price of the property or its floor selling price). The approval may also provide for alternative basic terms, or allow the company to conclude a number of one-type transactions or several transactions simultaneously (e.g. the granting of credit along with concluding a pledge or suretyship agreement).

The alteration of the basic terms of an approved transaction constitutes a separate transaction and requires a new approval unless such alteration was evidently beneficial to the company (e.g. where the amount of penalty was lowered for a debtor or the rental value was lowered for a tenant).

The approval may provide for its duration. If the duration is not indicated, the approval will be valid for one year from the date of its adoption.

1 Federal Law No. 208-FZ "On Joint-Stock Companies" dated 26 December 1995 (as amended) and Federal Law No. 14-FZ "On Limited Liability Companies" dated 8 February 1998 (as amended).

2 Hereinafter a "participant" also means a company shareholder.

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No Approval Required (Clause 6 of the Resolution)

Under the company laws major and interested party transactions require *no approval*, in particular, if a transaction is concluded *in the course of a company's usual business*. In this regard the Court has clarified that *usual business* means any customary operations in the business of the company or other commercial entities engaged in similar business and having similar capital and turnover. A transaction meeting this criterion may be referred to *usual business* even if the company enters into it for the first time. Such transactions include, in particular, contracts for the purchase of commodities and raw materials required for production and commercial operations and obtaining credit to pay for current operations. However, no transaction will be considered the company's *usual business* on the grounds only if the transaction falls under the type of business indicated in the company's profile in the Uniform State Register of Legal Entities or in its charter as main type of the company's business or the one performed by virtue of a license.

2. Challenging Transactions

The Right to Sue (Clause 11 of the Resolution)

Under the company laws a company or its participant may challenge a major and/or interested party transaction of the company. In this regard the Court has clarified that the participant challenging the transaction acts in the company's interests. Accordingly, a person who was not the company's participant as of the date of the transaction may challenge the transaction[3]; and the court satisfying the relevant claim, shall adopt the decision in favour of the company.

According to the Resolution, if a company's charter limits the powers of the company's body, the company and its participants are considered to be the persons in which interests the limitations have been established. Therefore the company and its participants may file a suit challenging a transaction entered into by the company's body in prejudice of the company's interests. Other persons expressly listed in the law also have the right to sue (e.g., the members of the company's collegial management body (the board of directors)[4]).

The Limitation Period (Clause 5 of the Resolution)

The limitation period to challenge a major and/or interested party transaction is one year. It is assumed that a company's participants have learned or should have learned about a transaction in breach of the approval procedures no later than the date of the annual general meeting of the company's participants at the end of the year when the challenged transaction occurred, if the participants *could have learnt* from the provided documents about the transaction (for example, the company's balance sheet showed the capital assets change since last year).

Ultimate Facts When Challenging a Transaction (Clauses 2, 3 of the Resolution)

A person that has filed a suit challenging a transaction must prove, simultaneously: (i) the indicia of a major or interested party transaction; (ii) the breach of the approval procedure; and (iii) damages to the company or its participant who filed a suit, or potential damages, or other unfavorable consequences for the company and the participant. The claimant does not have to prove the exact amount of damages; but the mere fact that they have occurred is sufficient.

If the unprofitability of a transaction only became clear later (i.e., it was not obvious as at the date of its conclusion), for example, due to the counterparty's breach of contract, such transaction may be invalidated only if the claimant proves that the transaction from the outset was concluded with the intention not to perform it or perform improperly[5].

A court may invalidate a duly approved major and/or interested party transaction if it was concluded in prejudice of the company's interests, provided that (i) the counterparty knew or should have known[6] about the patent damage to the company, or (ii) the company's representative (body) and its counterparty had colluded or otherwise collaborated in prejudice of the company's interests[7]. It is assumed that the patent damage exists if the transaction has been concluded subject to clearly and substantially unfavorable conditions for the company (e.g., the performance of the company's counterparty is twice or more than twice cheaper than the company's performance in favor of its counterparty)[8].

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3 The same legal view is set up in the July 2013 Resolution of the SCC Plenary Session No. 62 "On Certain Matters of Indemnification of Damages by Members of a Company's Governing Bodies" (hereinafter – **Resolution No. 62**). This represents the transformation of the Court's earlier legal view to the opposite: prior to these new clarifications a person who was not the company's participant as of the date of the transaction could not challenge it because such transaction could not have breached a participant's interest then (*the SCC Presidium resolutions No. 9736/03 dated 2 December 2003 and No. 9688/05 dated 6 December 2005*).

4 Article 65.3(4) of the Civil Code.

5 The same legal view is set up in Resolution No. 62.

6 The counterparty should have known about the patent damage if, among other things, it was obvious for any ordinary counterparty at the conclusion of a transaction.

7 For more information refer to the SCC Presidium Resolution No. 17089/12 dated 13 May 2014.

8 The same legal view is set up in Resolution No. 62. For more information also refer to the SCC Presidium resolutions No. 76/12 dated 5 June 2012 and No. 1795/11 dated 13 September 2011.

The Reasons for Refusal to Invalidate a Transaction (Clauses 3, 4 of the Resolution)

The Court in any case will refuse to invalidate a transaction if such transaction has not breached and cannot breach the company's and its participants' interests. According to the Resolution, the interests are not breached, in particular, if:

- The counterparty's performance and the alienated property were of equal worth;
- The unprofitable transaction was concluded to prevent greater harm to the company's interests; and
- The unprofitable transaction was part of a series of related transactions having the same commercial goal that altogether should have become profitable for the company[9].

Under the company laws the court must refuse to invalidate a transaction if, in particular, *the counterparty or beneficiary of a transaction acted in good faith*, i.e., did not know and should not have known that it was concluded with the breach of the approval procedure established by the law[10].

In this regard, as far as *major* transactions are concerned, the Court has clarified that the counterparty *should have known* that the transaction required the approval, in particular, if this had been obvious for any reasonable participant from the transaction's nature, e.g., the alienation of one of the company's basic assets (real estate, expensive equipment, etc.).

As far as *interested party* transactions are concerned, the Court has pointed out that the counterparty *should have known* about the interest in the transaction if the counterparty itself or its affiliated persons were interested in the transaction (obvious affiliation).

It is assumed that the counterparty acted in good faith if the interest (affiliation) was not obvious for an ordinary participant of the turnover. However, the circumstances of the specific case may evidence that the counterparty knew or should have known about such concealed affiliation. (For example, if the counterparty concludes a pledge (or suretyship) agreement with the company (pledger), aiming to secure the performance by the debtor company, and the CEO or a member of the board of directors of the pledger company owns the shares in the debtor company, the counterparty's actions may be considered careless provided that in ordinary circumstances the counterparty checks for the debtor's participants.)

The warranties (representations) provided for in the contract on behalf of the company and stipulating that all necessary corporate procedures have been honored for the transaction etc. are not enough to conclude that the company's counterparty acted in good faith.

Challenging Major Transactions – Certain Characteristics (Clauses 3, 8 of the Resolution)

Under the company laws several related transactions may be considered a major transaction if their total value meets the criterion of a major transaction. The Court has clarified that the transactions may be considered *related* if, in particular, they meet the following indicia: (i) pursuing the same business objective; (ii) the common economic purpose of the sold property; (iii) all alienated property is in the ownership of one person; and (iv) a short period time between the transactions.

According to the Resolution, the contact which provides for the transfer of the company's property to temporary possession and/or use, may be considered a major transaction if, simultaneously, (i) the value of the transferred property constitutes more than 25 percent of the company's assets value; (ii) the company has been using the property in its main production activities; and (iii) the company has lost the opportunity to use the property for a long time (e.g., for more than five years) as a consequence of concluding the contract.

As for major transactions on alienating a company's property in favor of its subsidiary, the Court has clarified that they may evidence the breach of the rights and legitimate interests of the company's minority participants if the transactions are aimed to deprive the participants for the future of the possibility of making management decisions regarding such property and benefiting from its use in their best interests.

A company's charter – in addition to the events provided for in the company laws – may establish the events when the approval procedure extends over other company's transactions. When challenging such transactions it is necessary to take into account that, as a general rule, counterparties are entitled to rely on the absolute powers of the CEO (except when they knew or should have known about the limitations established in the charter). In this regard the Court has clarified that the counterparty should have known about the limitations if in the given circumstances any reasonable person would immediately discover the excess of powers by the CEO.

The Court has also clarified certain characteristics of determining the balance sheet value of the company's assets and the transaction value for the purposes of a major transaction.

Challenging Interested Party Transactions – Certain Characteristics (Clause 9 of the Resolution)

The Court has clarified that *the beneficiary in an interested party transaction*, is a non-contracting person which, as a result of the transaction, (i) may be released from the obligations to the company, or (ii) acquires the contractual rights (such as the

9 The same legal view is set up in Resolution No. 62.

10 For more information refer to the SCC Presidium Resolution No. 17089/12 dated 13 May 2014.

insurance beneficiary, the beneficiary under the contract for the management of assets, the beneficiary under the bank guarantee), or (iii) otherwise gains material advantage (e.g., is a debtor under the obligation which the company secures by the suretyship or pledge). The court may invalidate the transaction only if the interest of the relevant beneficiary occurred as at the conclusion of the transaction.

The Court stressed that the list of the events established in the company laws, when the preliminary approval of interested party transactions is not needed, is exhaustive and may not be extended by a company's charter.

3. Classification of Transactions as Major and/or Interested Party *(Clause 10 of the Resolution)*

The Court has clarified that, in particular, the following agreements may be considered major and/or interested party transactions:

- *An employment contract* – if the amount of payments to the employee in case of dismissal (occurrence of other events) or the salary for the term of the employment[11] constitutes 25 or more percent of the balance sheet value of a company's assets. When considering the breach of the company's interests by the employment contract the court must take into account (i) the correspondence of its conditions with usual conditions of employment for the professionals of a similar qualification/professional level; (ii) the nature of the employee's duties (including obligations on non-disclosure of information and non-competition after the dismissal); and (iii) the market size of the business.
- *A settlement agreement.*[12] The court may refuse to approve a settlement agreement concluded with the breach of legal provisions on major and interested party transactions only if the parties committed obvious abuse which may result in the nullity of the transaction.[13]
- *An acceptilation* (forgiveness of debt) – if as a result the company loses property rights valued at 25 percent or more of its balance sheet net assets value or the debtor meets the indicia of an interested person (is affiliated with such person).

The decisions on appointing the CEO, electing the members of the collective bodies and on transferring the powers of the CEO to an external manager do not require the approval established for major or interested party transactions.

4. Other Remedies *(Clauses 1, 12 of the Resolution)*

If the court refused to invalidate a major and/or interested party transaction, a company's participant or a company may claim for (i) the indemnification of damages by the members of the company's bodies; and (ii) the expulsion of the participant who concluded the transaction (including in the capacity of the CEO) or voted for its approval at the general meeting of the participants.

A transaction that is neither a major nor interested party transaction and is concluded (i) without the necessary approval by a company's body or (ii) by the CEO in his/her own interest or in the interest of a person which he/she concurrently represents, may be challenged under the general rules of the Civil Code on challenging transactions concluded without the due approval or on the prohibition for the representative to carry out transactions in his/her own interest or in the interest of another person whom he/she is concurrently representing on behalf of the represented person.[14]

Despite the abolishment of the Russian Supreme Commercial Court, the Resolution will remain effective because, under the Law,[15] clarifications of the SCC Plenum shall remain in force until they are repealed by the Plenum of the newly established Russian Supreme Court.

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11 In case of a termless contract – for one year.

12 For more information refer to the SCC Presidium Resolution No. 9597/12 dated 15 January 2013.

13 Challenging a cognovit and abandonment of action is carried out according to the rules established for a settlement agreement.

14 For more information regarding challenging transactions concluded by the representative in his/her own interest on behalf of the represented person, refer to the SCC Presidium Resolution No. 17580/08 dated 16 June 2009.

15 Article 170 (4, Para. 7) of the Commercial Procedure Code of the Russian Federation of 2002 (as amended); Article 3 (1) of Federal Constitutional Law No. 8-FKZ, dated 4 June 2014, "On Amending the Federal Constitutional Law 'On Commercial Courts in the Russian Federation' and Article 2 of the Federal Constitutional Law 'On the Supreme Court of the Russian Federation.'"