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Civil Code Reform on Companies

July 2014

Special Alert

On 5 May 2014 the President signed Federal Law No. 99-FZ which introduces certain amendments to Chapter 4 of Part One of the Civil Code and removes certain provisions from Legislative Acts of the Russian Federation (the "Law").

The Law introduces significant amendments to Chapter 4 of the Russian Civil Code on legal entities. In this update we discuss those amendments relating to: (i) the introduction of new types of companies; (ii) the procedure for expelling a participant form a company, restoring corporate control and bringing class actions by the company's participants; (iii) the obligation of the company to certify the decisions of the general meeting of the participants; (iv) the types of the company's sole executive bodies; (v) certain aspects of the liability of the members of the company's management bodies; (vi) company reorganizations; and (vii) aspects of corporate agreements.

The Types (Organizational Forms) of Companies

According to the amendments, as of 1 September 2014, there will be three main types of companies in Russia *(Articles 65.1, 66, 66.3 of the Civil Code)*:

- LLC;
- non-public JSC (previously, a closed JSC);
- public JSC (previously, an open JSC).

The only foundation document of a company is its charter.

Existing companies must be transformed into one of the new types of companies at the time of introducing changes to their charters. Thus, reregistration of existing companies is not required. Until the relevant changes are made to the companies' charters, such charters will continue to apply insofar as they do not contradict the new provisions of the Civil Code.

The companies may independently and free of charge amend their charters in order to comply with the Law.

The provisions of the LLC Law and the JSC Law apply insofar as they do not contradict the Civil Code (Article 3(4) of the Law).

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The Rights and Obligations of the Companies' Participants

The Law introduces new provisions on the rights and obligations of the companies' participants. Among other things, these concern the following topics.

Expulsion of a participant/shareholder from the company

The participants of an LLC and shareholders of a non-public JSC may apply to court that a participant/shareholder is expelled from the company where such participant/shareholder **significantly aggravates** the company's activities and the attainment of the goals for which it was founded (in particular, where such actions cause substantial harm to the company, grossly violate its duties established by the law or the charter). The waiver of this right or attempts to limit its scope will be void *(Article 67(1) of the Civil Code)*. Previously, expelling a participant was only allowed in the case of LLCs and on grounds defined in the LLC Law.

The restoration of the rights of a company's participant

Following the amendments, if a participant against its will forfeited its participation rights (stock) in the company due to the bad-faith actions of third parties, it may apply to court seeking (i) restoration of its participation rights (the return of the stock) or (ii) compensation from the person liable for the loss of the participation rights (the stock).

Such participant is entitled to compensation only (i) if the return of the stock will result in the unjust deprivation of other persons' participation rights or (ii) on public policy grounds. However, the Civil Code does not clarify the specific circumstances when these limitations may apply *(Article 65.2(3) of the Civil Code)*.

A class action by the participants

If a company or its participant intends to file an action claiming compensation for loss suffered by the company or to challenge a transaction, the other participants (the company) must be notified in advance. If the other participants (the company) fail to join the action, as a general rule, they will lose the right to participate in it. The company's charter may set out the procedure for notifying the intention to file a class action (Article 65.2(2) of the Civil Code).

Certification of the Decisions of the Participants' General Meeting

The Law establishes a new requirement applying to the execution of the minutes of the participants' general meeting. The minutes must be certified (i) in the case of a public JSC – by the registrar simultaneously performing the functions of the company's counting committee (the "registrar")[1]; (ii) in the case of a non-public JSC – by the notarial certification or by the registrar; and (iii) in the case of an LLC – by the notarial certification or by another method provided for in the charter or established by the decision of the participants' general meeting adopted unanimously. The Law is silent on the legal effect of decisions of the general meeting which are not certified in one of the above-mentioned ways as well as other consequences which could ensue in cases of deviating from the obligation to certify the minutes of the general meeting *(Article 67.1(3) of the Civil Code)*.

The Company's Management and Executive Bodies

The amendments clearly distinguish between **management bodies** and **executive bodies** and define their authority *(Article 65.3, 67.1 of the Civil Code)*. In addition, the Civil Code explicitly stipulates that the company's bodies are its representatives and thus the general provisions in the Civil Code on representation apply to the representatives' actions *(Article 53(1) of the Civil Code)*.

Company's management bodies

The management bodies are the participants' general meeting (the company's superior body) and the collegial management body (the supervisory or other board).

The exclusive jurisdiction of the general meeting

According to the Civil Code (Article 65.3(2) and Article 67.1(2)), **the exclusive jurisdiction of the general meeting** includes the rights:

- to determine the company's business priorities, the principles relating to creating and disposing of its property;
- to adopt and amend the company's charter;
- to establish the procedure for the admission of new participants and the expulsion of existing ones (provided that such procedure is not established under general law);
- to decide on the company's reorganization and liquidation, to appoint a liquidator and approve the liquidation balance-sheet;
- to elect a supervisor and appoint the company's auditor;
- to distribute profits and losses;
- to change the amount of an LLC charter capital;
- to decrease the charter capital of a JSC;
- to decide on other subjects referred to its competence under general law or the charter.

1 According to Article 97(4) of the Civil Code, the keeping of the register of shareholders of a public JSC and performing the functions of the counting committee must be fulfilled by an independent licensed organization.

The exclusive jurisdiction of the collegial management body

The exclusive jurisdiction of the collegial management body includes the control of the actions of the company's executive bodies and other functions established under general law or the charter.

Alternative (joint) jurisdiction (general meeting, and/or collegial management body, and/or collegial executive body)

According to the Civil Code, unless the provisions of the general law or the charter grant authority to the company's collegial bodies, the participants' general meeting is responsible for taking decisions regarding:

- the formation of the company's bodies (except for the general meeting) and the early termination of their powers;
- the approval of the company's annual and financial reports;
- the establishment of other legal entities, branches or representative offices and the participation in other legal entities;
- the delegation of the powers of the company's sole executive body to the management company (external manager) and the approval of the agreement with such manager;
- the increase in the charter capital of a JSC.

Company's executive bodies

According to the Civil Code, the company's executive bodies are the *sole executive body* (general director) and the *collegial executive body* (management board).

The Civil Code permits the use of a sole executive body consisting of several persons acting jointly, or several sole executive bodies acting independently *(Article 65.3(3) of the Civil Code)*[2]. The Law does not prescribe the manner in which the responsibilities should be allocated between the independent sole executive bodies.

Formation of several sole executive bodies does not preclude the company from also forming a collegial executive body (Article 65.3(4) of the Civil Code).

Up to 1/4 of the members of the collegial management body may also be members of the company's executive bodies. However, such persons may not perform the functions of chairmen of the collegial management bodies *(Article 65.3 of the Civil Code)*.

According to the Civil Code, as a general rule, the jurisdiction of the company's *executive bodies* extends over matters falling outside the competence of the management bodies.

Liability of the Members of the Company's Bodies

The Law introduces the following provisions in the Civil Code covering the liability of the members of the company's bodies.

Liable persons

The Law establishes the liability of **a person who de facto controls the company's activities**, including giving mandatory instructions to persons acting on behalf of the company[3] *(Article 53.1 of the Civil Code)*. Any attempts to exclude or limit such person's liability will be void.

Conditions for and exemption from liability

A person entitled to act on behalf of the company (the sole executive body) must indemnify the company for any damage caused to it if such person, when implementing its rights or performing its duties, was acting in bad faith and unreasonably, in particular, if its actions (omission) contradicted the common conditions of the turnover or common business risk *(Article 53.1(1) of the Civil Code)*.

The members of the company's collegial bodies are exempted from liability if they voted against the decision which damaged the company or, acting in good faith, did not participate in the voting *(Article 53.1(2) of the Civil Code)*.

Any exclusion or limitation of liability of the person entitled to act on behalf of the company, as well the members of the company's collegial bodies for any bad-faith actions, (and in the case of a public company, bad-faith and unreasonable actions) is void *(Article 53.1(5) of the Civil Code)*.

The removal of inactive legal entities[4] from the State Register of Legal Entities (the "EGRUL") does not prevent the members of such entities' management from being held liable *(Article 64.2(3) of the Civil Code)*.

2 The same rule applies to the delegation of the power to act on behalf of the company to several persons *(Article 53(1) of the Civil Code)*.

3 These provisions apply to the relations between the company and its subsidiary.

4 Article 64.2 of the Civil Code provides for the features of an inoperative legal entity and requires its exclusion from the EGRUL.

Reorganization of the Company

Currently, the Civil Code, as a general rule, permits the process of reorganizing two and more companies via the simultaneous use of a combination of various types of reorganization *(Article 57(1) of the Civil Code)*.

A participant of the company may challenge its reorganization by filing a suit requesting: (i) the invalidation of the decision on the company's reorganization[5] or (ii) the frustration of the reorganization[6].

Even if the court invalidates the decision on the company's reorganization, this will not result in (i) the liquidation of the companies formed following the reorganization and (ii) the invalidity of any transactions entered into by such companies. However, if the court invalidates the decision on the reorganization **before** all newly formed companies have been registered, only registered companies will accede to the relevant rights and obligations. Otherwise the rights and obligations remain with the original companies (Article 60.1 of the Civil Code).

If the court declares the reorganization frustrated, (i) the original legal entities are to be restored and the legal entities established following the reorganization cease to exist; (ii) the transactions entered into with any good-faith counterparties by the companies established following the reorganization will bind the restored companies; (iii) as a general rule, the corporate rights of the participants of the original company are restored *(Article 60.2 of the Civil Code)*.

Corporate Agreement

Article 67.2 of the Civil Code provides that the company's participants may conclude a corporate agreement on exercising their rights and duties regarding the company's management, voting and disposal of shares.

Concluding the corporate agreement

A company's participant may conclude a corporate agreement with respect to its whole stock (all shares) or its (their) part. The Law makes the corresponding amendment in the provisions of the JSC Law regulating shareholders' agreements.

The company's participants who entered into the corporate agreement must notify the company about its conclusion.

The contents of the corporate agreement

Among other things, the corporate agreement may provide for the obligation of its parties to vote at the general meeting for including into the company's charter the provisions establishing the structure of the company's bodies and their jurisdiction. However, the corporate agreement itself may not establish the structure of the company's bodies and their jurisdiction.

In line with the corresponding requirement of the JSC Law established for shareholders' agreements, the corporate agreement may not provide for the parties' obligation to vote according to the instructions of the company's bodies.

The contents of a corporate agreement relating to a public company must be disclosed to the extent required by general law, whereas the contents of a corporate agreement relating to an LLC or a non-public JSC are confidential.

The parties to the corporate agreement may claim that it is invalid based on any contradiction with the company's charter.

Breach of the corporate agreement

The Civil Code states that the breach of the corporate agreement may be used as a ground for invalidating the decision of the relevant company's body provided that as at the day when the contested decision was made, all the company's participants were parties to the corporate agreement. At the same time, Article 32.1(4) of the JSC Law, establishing that the breach of the shareholders' agreement may not be the ground for declaring the decisions of the JSC's bodies invalid, remains in force.

The agreement with the company's creditors and the third parties

The company's participants may conclude an agreement similar to the corporate agreement with the company's creditors and investors in order to secure their legitimate interests.

These provisions of the Civil Code will enter into force on 1 September 2014.

5 This suit may also be filed by the third party if entitled by the law.

6 This suit may be filed by the company's participant who voted against the reorganization or did not participation in the voting, only.