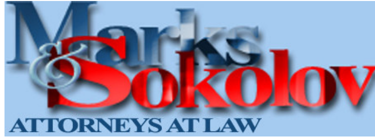

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PANEL: Corporate Social Responsibility

FIRST CIS LOCAL COUNSEL FORUM
29 – 30 June 2006
Radisson SAS Hotel
Kiev, Ukraine

CORPORATE SOCIAL RESPONSIBILITY: IF YOU WANT IT DONE RIGHT, DO IT YOURSELF

DERIVATIVE ACTIONS IN UKRAINE, RUSSIAN, AND THE UNITED STATES

Corporate social responsibility ("CSR") has been defined as the "obligations of business enterprises to adhere to a common set of rules on ethical, social, and environmental issues." CSR recognizes that business enterprises should owe duties to their stakeholders -- those affected by their operations such as the communities in which they operate -- and be accountable to them. CSR is often directly proportional to the power which stockholders have to compel it. This presentation will survey the law of Ukraine, Russia, and the United States, using Delaware as its model, on derivative actions.

WHAT IS A DERIVATIVE ACTION?

A derivative suit is one that is brought by a stockholder, on behalf of the corporation, to recover for harm done to the corporation. This legal device was originally construed in common law countries as a special and ingenious accountability mechanism. Derivative suits were conceived of as "double suits", i.e. two suits in one: (1) a suit in equity against the corporation seeking an order compelling it (2) to bring a suit for damages or other relief against some third person who had caused legal injury to the corporation. Today, derivative actions have been transformed in a suit, where the shareholder sues on behalf of the corporation for *harm done to it*. Therefore, any damages recovered in the suit are paid to the corporation.

SUMMARY OF UKRAINIAN, RUSSIAN, AND DELAWARE LAW

Ukrainian law does not have a general provision providing for derivative actions. One exception to the general rule permits shareholders to bring actions to invalidate "malevolent (bad-faith) agreements". Such agreements would include, for example, self-dealing contracts between a corporation and its management or controlling shareholder. Russian law provides for derivative actions in many contexts. These include a right to bring derivative actions by holders of 1% or more of a corporations shares against management for causing damages, and rights by all shareholders to invalidate certain large scale or "interested party" transactions. Delaware law provides the right to bring derivative actions for all shareholders.

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UKRAINE

GENERAL LAW

There are no general provisions in Ukrainian law allowing a shareholder to bring claims in the interests of a Joint Stock Company. In Ukraine, a shareholder generally can **only** bring **direct claims**, i.e. the claims concerning violations of **the shareholder's** rights and legitimate interests. *See The Resolution of the Economic Affairs Chamber of the Supreme Court of Ukraine dated September 30, 2003 (Economic Proceedings in Ukraine, Kiev - 2004); the Resolution of the Supreme Court of Ukraine dated May 18, 2004 (Practical Consideration of Economic Disputes by Ukrainian Courts, Yuridicheskaia Praktika, 2005).* In the May 18, 2004 Resolution, the court stated:

- the shareholder is **only the owner of shares** (while the joint-stock company is the owner of the property acquired on the grounds not prohibited by the law), and according to the law[1] he only has the right:

  - to participate in the management of the company...;
  - to participate in distribution of the company's profit and to receive a portion thereof (dividends);
  - to withdraw from the company in compliance with the established procedure;
  - to receive information concerning the company's activity in compliance with the procedure established by a founding document;

SPECIFIC EXEMPTIONS TO THE GENERAL RULE

Although there is no general provision for derivative actions, a shareholder may seek to recover damages, inflicted by management engaged in ill-intended, self-dealing transactions. Such transactions can be invalidated by the shareholders as transactions entered in violation of general requirement of the Ukrainian Civil Code to validity of the transactions.

Specifically Article 203 of the Civil Code, entitled **"***General Requirements Necessary for Validity of a Transaction", *provides:

> *1. Contents of a transaction <u>cannot contradict this Code, other acts of civil legislation</u> and moral principles of the society.*
> ...
> *3. Expression of the will of a participant to a transaction shall have to be free and shall correspond to his/her inner volition.*

[1] Article 10 of the Law "On Economic Societies", Article 116 of the Civil Code

Pursuant to Article 232 of the Civil Code, entitled *"Legal Consequences of Transaction Conclusion as a Result of Malevolent Agreement of a Representative of One Party with the Other Party"*

> *1. A transaction concluded due to malevolent agreement of a representative of one party with the other party shall be invalidated by a court.*
>
> *2. A principal shall have the right to demand from his/her representative and the other party joint compensation for the losses and the moral damage caused to him/her by transaction conclusion due to malevolent agreement between them.*

In case of ill-intended, self-dealing transactions, these transactions are invalid by virtue of the violation of general provisions of Article 203 and specific provisions of Article 232 of the Civil Code above. A Shareholder acquires standing by acting as "interested" person within the meaning of the Article 215 (3) of the Civil Code entitled *"Invalidity of a transaction"*, which provides:

> *1. A ground for invalidity of a transaction shall be non-compliance of a party (parties) with the requirements established in paragraphs 1-3, 5 and 6 of Article 203 of this Code at the moment of the transaction concluding.*
>
> *2. A transaction shall be invalid if its invalidity is established by the law (void transaction). In this case, invalidation of the transaction by the court shall not be required.*
>
> ……..
>
> *3. Where the invalidity of a transaction is not directly established by the law, but one of the parties or any other interested person denies its validity on the grounds established by the law, such transaction may be invalidated by the court (voidable transaction).*

The position that a shareholder can seek invalidation of the transaction entered into by a company is supported by the Regulation of the Supreme Court of Ukraine No. 3 dated April 28, 1978 to Article 57 of the Old Civil Code (Article 57 of the Old Civil Code contained provisions similar to Article 232 of the Civil Code):

> *Agreements, that can be recognized as invalid only in court proceedings initiated by the claim brought by an interested person,*

prosecutor or his deputy, constitute a separate category. If such an agreement is not recognized as invalid pursuant to the above stated procedure, it has the same legal consequences as any valid agreement. The above referenced agreements, in particular, include agreements concluded as a result of mistake, deceit, coercion, ill-intended agreement between a representative of one party an the other party (article 56, 57 of the Civil Code).

Pursuant to Article 216 of the Civil Code, entitled Legal Consequences of Invalidity of Transaction, a shareholder can seek application of the consequences of an invalid transaction.

1. An invalid transaction does not entail legal consequences, except for those related to its invalidity.

In case of invalidity of a transaction, each party shall be obliged to return in kind to the other party everything it has acquired in pursuance of the transaction, or, if such return is impossible, including in cases where the acquisition consists in the use of property, work performed, or services provided, to reimburse the value of the acquired at the prices existing at the moment of reimbursement.

2. Where, in connection with conclusion of an invalid transaction the other party or a third person incurred losses, they shall be subject to reimbursement by the guilty party.

3. Legal consequences envisaged by paragraphs 1 and 2 of this Article shall apply, unless special requirements of their application or special legal consequences of certain types of invalid transactions are provided by law.

4. Legal consequences of invalidity of a void transaction established by the law cannot be changed by the agreement of the parties.

5. Any interested person can require to apply the consequences of invalidity of a void transaction

A court can apply the consequences of an invalid void transaction on its own initiative.

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RUSSIA

Generally, Russian law provides for possibility of derivative action. Specifically, pursuant to Article 71 (5) of the JSC Law:

> *5. Company or shareholder (shareholders), who in aggregate own not less then 1% of placed commons shares of the company, have the right to bring an action against member of the board of directors (supervisory board) of the company, sole executive body of the company (director, general director), member of a collegiate executive body of the company (management, panel of directors), as well as against managing company or the manager for damages, inflicted on the company, in case, provided for in item 2 of the present article.*

Item 2 of Article 71 provides:

> *2. Member of the Board of directors (supervisory board) of the company, sole executive body of the company (director, general director), temporary sole executive body, members of a collegiate executive body of the company (management, panel of directors), as well as managing company or the manager for damages are responsible for damages, inflicted by their guilty actions (inactions), unless other grounds and amount of damages is not provided for by federal laws.*

There are other provisions in the JSC law, which provide that a shareholder has standing to bring an action in the interests of the company.

Article 79 (6) (version August 7, 2001, current version) of the JSC law provides:

> *A large scale transaction, entered into with violations of the provisions of the present article, can be declared invalid in an action brought by the company of a shareholder.*

Article 84 of the JSC law provides:

> *1. An interested party transaction, entered into with violations of the requirements provided for in the present Federal law, can be declared invalid in an action brought by the company or a shareholder. (version of August 7, 2001, current version).*

2. Interested person is liable to the company in the amount of damages inflicted by him on the company. In case several persons are liable, their liability to the company is joint and several.

DELAWARE

Delaware law expressly recognizes derivative actions.

Pursuant to the Delaware law:

- Plaintiff must be a shareholder at time of challenged transaction;
- Plaintiff must establish that it has made demand on the corporation to take action, unless Plaintiff can establish demand would be futile;
- Relief inures to the benefit of the corporation.

The only statutory provision in Delaware dealing with the derivative action is 8 Del.C. §327, which provides :

> *"In any derivative suit instituted by a stockholder of a corporation, . . . it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which he complains or that his stock thereafter devolved upon him by operation of law."*

Delaware procedural law, Rule 23.1 of the Court of Chancery of the State of Delaware, specifically provides:

> Rule 23.1. Derivative actions by shareholders
>
> *In a derivative action brought by 1 or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort. Subject to the provisions of Rule 15, the action shall not be dismissed or compromised without the approval of the Court, and notice by mail, publication or otherwise of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the Court directs; except that if the dismissal is to be without prejudice or with prejudice to the plaintiff only, then such dismissal shall be ordered without notice thereof if there is a showing that no compensation in any form has passed directly or indirectly from any of the defendants to the plaintiff or plaintiff's attorney and that no promise to give any such compensation has been made.*