CORPORATE TAKEOVERS, RUSSIAN STYLE, AND NECESSARY LEGAL REFORM*****

Derek A. Bloom*, Kirill Y. Ratnikov**, Konstantin A. Osipov, Sergei M. Areshev*****

We need justice that is respected within and without this country... An effective system of courts ... is required so that neither domestic nor foreign companies have any doubt about its authority and effectiveness.

V.V. Putin, in his 2002 Presidential Message
to the Russian Federation Federal Assembly

An unprecedented wave of hostile takeovers is sweeping over Russia. Individual industrial companies and holding companies controlling sometimes entire sectors of the national economy are being attacked and taken over. Such transactions amount to second privatization or the re-division of ownership of enterprises formerly privatized. The new wave of transactions is being undertaken in shady transactions by certain oligarchic groups, rather than by the government. Shares in previously privatized companies are seized from their legal owners. On occasion, shares in strategic companies are seized from the government itself, including companies in sectors of the national economy yet to be restructured.

The main tool employed in the recent wave of hostile takeovers in Russia is the judicial branch of government, plus "administrative resources." In these transactions, the owners of controlling stakes in many Russian enterprises have discovered that court orders have been issued on a number of alternative grounds summarized below that result in the forced sale of a controlling interest in their companies, together with the loss of all investments made into such companies. A group of specialist consulting firms has emerged that has invented a unique brand of "know-how" in structuring hostile takeover attacks and motivating members of the judiciary and regulatory branches of government to make expedited decisions that are favorable to their clients. These practices have obvious and grave consequences for Russia, making the country far less attractive to Russian and foreign strategic investors, discrediting the legal system, and discrediting market-oriented reforms carried out by President Putin.

This article discusses how mergers and acquisitions are intended to be carried out under applicable Russian law, and contrasts these requirements of Russian law with how mergers and acquisitions of major enterprises are more frequently carried out in practice. The article also makes preliminary recommendations for legal reform to address this phenomenon, the organized theft of ownership of Russian corporate entities, and the property belonging to these companies.

1. Mergers and Acquisitions Contemplated by Russian Law

The Russian Law on Joint Stock Companies contemplates four methods for combining businesses in Russia:

(1) the merger of one company into another company [under Article 17 of Russia's Federal Law on Joint Stock Companies (the "JSC Law"), etc.];

(2) the consolidation of one company with another company (under Article 16 of the JSC Law, etc.);

(3) the acquisition of all shares of stock, or a controlling interest in shares of stock in a company [under Article 80 of the JSC Law (acquisition of 30% or more of a company's common stock), etc.]; and

(4) the acquisition of all, or substantially all, of a company's assets.

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* Derek A. Bloom (Partner) works in Coudert Brothers LLP's offices in Moscow and St. Petersburg.
** Kirill Y. Ratnikov (Associate) works in Coudert Brothers LLP's Moscow office.
*** Konstantin A. Osipov (Associate) works in Coudert Brothers LLP's St. Petersburg office.
**** Sergei M. Areshev (Associate) works in Coudert Brothers LLP's St. Petersburg office.

All such business combinations require compliance with legal requirements for:

(I) "major transactions", as defined by law;

(II) "interested party transactions", as defined by law;

(III) the right of shareholders to demand the appraisal of their shares;

(IV) the preemptive right of shareholders to purchase additional stock;

(V) the right of shareholders to demand the purchase of their shares;

(VI) compliance with Russian anti-monopoly law; and

(VII) compliance with Russian securities law.

The protections set forth in the above laws are designed to ensure, among other things, that the shareholders of a target company receive payment of the fair market value of their shares of stock in a company, even if a company is acquired in a "hostile" takeover. This expectation, that shareholders shall receive a payment of the fair market value of their shares in any such transaction, is of critical importance for investors. Mergers and acquisitions, including squeeze-out mergers, are in no way prohibited and are quite common in other countries in the world, including, for example, the United States. A squeeze-out merger is one in which dissenting minority shareholders opposed to a merger may be compelled to sell their shares, however, such dissenters receive a payment of the appraised fair market value of their shares ("dissenters' rights").

In the market in Russia today for controlling interests in Russian corporations, acquirers far too frequently find that it is unnecessary, in practice, to pay the fair market price of desired corporate assets. Such assets may be acquired, instead, by forceful, intimidating and apparently corrupt methods for only a fraction of their actual value. Accordingly, acquirers frequently seek to take possession of another group's property, its shares of stock in privatized entities, or assets belonging to a targeted company, by paying only a fraction of their actual value, not to the targeted group, but to strong-armed intermediaries who will appropriate the desired property by the use of "administrative resources" and then sell it to their client, the intended acquirer. (See section 2 below). The methods used in these widespread hostile takeovers bear all the hallmarks of organized crime, assisted by certain government and judicial figures ("administrative resources").

1.1. Mergers and Acquisitions

THE JOINT STOCK COMPANY LAW

Under existing Russian law, any merger or acquisition is a reorganization that requires the prior approval of the boards of directors of both companies involved, and approval by a three-quarters majority vote of shareholders of both the acquirer and the target company.

The terms and conditions of reorganizations and the related agreement of merger or consolidation require approval. In the event of a merger, the charter of the surviving company should be amended accordingly. In the event of a consolidation, a new board of directors should be elected. If the reorganization is a major transaction, or an interested party transaction, as defined under Russian law, additional legal requirements need to be complied with.

THE ANTI-MONOPOLY MINISTRY

Under Article 17 of Russia's Federal Law on Competition and the Restriction of Monopolistic Activities, any merger or consolidation of companies is subject to ***prior approval*** by the Russian Ministry for Anti-Monopoly Policy, if such companies' total assets exceed 200,000 minimum statutory wages (about US$650,000). Within 45 days after the shareholders meeting that approves a merger or consolidation, any shareholder of the company involved in such merger or consolidation may demand that the company purchase his shares for a price equal to their fair market value, if such shareholder has not voted for the merger. Upon such demand, the company is required to purchase the dissenting shareholder's shares within thirty days after expiration of the above-mentioned 45-day period.

1.2. Acquisition of Shares

Under Russian law, any purchaser of a controlling stake in a joint stock company with more than a thousand shareholders incurs certain obligations including the obligation to honor the rights of existing shareholders.

Such rights include the right to receive notice of the proposed purchase, and an opportunity to exercise their right to demand payment of the fair market value of their respective shares.

If an acquisition is a major transaction or an interested party transaction within the meaning set forth in applicable law, a special approval procedure for the purchase and sale of shares applies. In addition, special provisions of the anti-monopoly law apply to the acquisition of shares or assets from a controlling shareholder or in the event of an additional issuance of shares if such transaction meets certain criteria. If so, the prior approval of, or subsequent notice to, the Russian Ministry for Anti-Monopoly Policy is required.

Any joint stock company acquiring more than 20% of all voting shares in another joint stock company must publish a notice of such acquisition and information on each subsequent acquisition of shares in the other company, if such subsequent acquisition involves more than 5% of all voting shares.

In sum, a merger, consolidation, or acquisition of at least 30% of the common stock of a joint stock company in Russia is a complex process, but not in excess of the requirements for comparable transaction in other Western economies. Since the fair market value of the property to be acquired is supposed

to be paid or a transaction would not be approved, a merger or acquisition, accomplished legally, can be relatively expensive and time-consuming for the acquirer.

2. Abusive hostile takeover schemes common in Russia

A great many abusive methods and schemes have been developed to circumvent the above-described requirements of existing Russian corporate law and to drastically reduce acquisition costs. Such abusive methods and schemes are employed in nearly all acquisitions in Russia today, and, in practice, provide a real and attractive alternative to the complex and expensive procedures described in Russian law for mergers and acquisitions.

Most of the abusive methods and schemes involve abuse of the Russian judicial system and the enlistment of governmental officials who are used by corporate raiders as tools to obtain shares of stock or assets from their legal owners against their will and for a small fraction of their actual value. The abusive hostile takeover scenarios most widespread in Russia at present are characterized by elements of organized crime.[1] Such practices are a clear threat to the Russian economy and to Russia's reputation. The widespread nature of these abusive practices is a significant impediment to foreign direct investment and portfolio investment in Russia, as well as to domestic investment in a number of sectors of the economy that seem to be likely targets for corporate raiders. It is almost illogical today for investments to be made into Russian companies that may easily be stolen from their rightful owners, if such companies do not become adequately prepared to meet this threat and safeguard investments.

Scenario 1. An Abusive Corporate Takeover Involving: Preferred Shares Used to Obtain a Controlling Interest, Dual Management, a Second Register, Judicial Decisions and "Administrative Leverage"

- *Problem Presented to Corporate Raider: How to acquire a controlling stake in the shares of stock of a target company if the corporate raider already owns a block of common stock and some preferred shares? How to get rid of the shareholder that owns the controlling interest?*

The strategy the attacker would implement typically involves eight steps.

The attacker would convene an extraordinary meeting of shareholders (an "ESM") without the controlling shareholder's prior knowledge: (i) to approve conversion of the attacker's preferred shares into shares of common stock (voting shares); and (ii) to elect a new board of directors consisting of the attacker's representatives.[2]

Under Russian law an ESM may be called by the board of directors (the "Board") at the request of any shareholder(s) owning 10% of the company's shares. Notice of such an ESM and its agenda must be given to all shareholders. However, in practice, no notice of the ESM will be given to the existing Board or the controlling shareholder who will, accordingly, be unable to vote against the resolutions proposed for approval at the ESM. Another method to prevent the controlling shareholder from voting at the ESM involves the attacker obtaining a court order or judgment prohibiting the controlling shareholder from voting at the meeting. (Details of this method are described below.)

The attacker would also make arrangements for a court to confirm the legality of the resolutions approved by the ESM, which confirmation would be embodied in an order or judgment of a regional court. (The underlying case may be commenced pursuant to the claim of a minority shareholder; such shareholder may be a special legal entity organized by the attacker through one or more intermediary companies and owning one or more shares in the target company.) The ESM and the resolutions approved by the ESM will appear to be legal until such order or judgment is cancelled or suspended. The attacker may apply "administrative leverage" to postpone the hearing of appeals to supervisory authorities of such judicial decision for many months.[3]

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[1] An abusive hostile takeover achieves results that appear to involve improper incentivizing of judges and regulatory officers (for action or inaction, or failure to perform their official duties), and/or bailiffs; intimidation; threats and even physical violence, etc. Such practices have been discussed in both the Russian and foreign press. We know of several criminal proceedings related to such takeovers. According to publications in the press, RICO suits have been brought in the United States against companies that carried out such attacks; their managers – Russian nationals – and representatives (and related persons) of the "attackers" have been denied entry visas to certain foreign countries.

[2] Under such scenario the attacker may initiate the special shareholders meeting after it takes several additional steps as may be necessary in light of the number of shares of common stock held by the attacker or other circumstances such as special approval rules applicable to conversion as may be set forth in the charter.

[3] In one case pending before a regional court in Russia (before the new procedural law was effective), a new review was delayed under various pretexts for six months. Initially, the chairman of the court who submitted a protest took annual leave (which caused the postponement of the review for one month). The same judge then took a lengthy sick leave (and the court refused to review the case in his absence). When the chairman was back after sick leave he revoked his protest. After that, a protest against the same judgment was submitted by the prosecutor. Such practice may soon become impossible since Russia's new Code of Arbitration Procedure and Code of Civil Procedure (the latter has been effective from February 1, 2003)

The ESM will produce a second board of directors controlled by the former minority shareholder.

The second board elects a new General Director for the target company and may even establish a new office for the company's management.

The attacker, acting through intermediary individuals not directly traceable to the attacker, causes additional lawsuits to be commenced, and court decisions and orders to be obtained confirming the legality of the appointment of the new General Director. Until these additional judicial decisions are challenged and overturned successfully, the attacker is able to contend that all of its actions, and the actions of the intermediary figures, are legal, and, if Russia is a law abiding society, ought to be immediately enforced.

The attacker typically attempts at this point to obtain physical control over the target company and to seize the company's premises using armed personnel hired from a private security firm or a special police force, possibly obtaining an additional court order as the formal basis for such actions. We know of attempts to seize a company's premises without a court order. Multiple attempts of the alleged new management to seize the company's premises by force are possible, creating the scene frequently seen in the Russian news of armed standoffs outside the gates of numerous corporate headquarters.

The attacker may attempt to disrupt the supply of raw materials to the target company based on various judgments and orders, most frequently obtained in new lawsuits filed by unknown minority shareholders in extremely remote Russian regions, or in Russian regions abutting to Chechnya. If successful, such an approach may "paralyze" the target company's business operations.

The attacker may attempt to have the target company's bank accounts seized, and to obtain additional court orders blocking the shipment of the target company's products. Additional court order would be obtained for these purposes.[4]

The attacker will often attempt to obtain control over the company's share register and to appoint a new registrar. The attacker may also obtain a court order and, sometimes, a judgment to make the selection of a new share registrar appear to be legal.[5]

The attacker would continue its efforts to obtain actual control over the target company. To break down the company's resistance, the supply of raw materials and the export of products will be blocked or interfered with, and production discontinued for several months.

The above "acquisition" process is typically accompanied by an intensive negative public relations campaign depicting the target company's "old" shareholders and management as useless and as the alleged cause of the company's allegedly poor financial condition. An attacker will typically hire a "black PR" firm that specializes in attacking the reputation of members of management of the target company, including anonymous publications on the Internet.)[6]

If successful, the cost of the acquisition strategy described in Scenario 1 would be relatively low as compared to the cost of an acquisition carried out in full compliance with the JSC Law. If the target company is a medium-size business (shares in which are not typically traded on an exchange and may be undervalued significantly) the acquisition costs incurred by the attacker may be less than the cost of acquisition in compliance with law by a factor of many thousands. Various participants in these types of takeovers have boasted in various venues of the cost-effectiveness of their efforts, and the relative unattractiveness of a takeover accomplished through arms-length negotiations and fulfillment of the requirements of black letter law that are regarded as unnecessary to observe and as a waste of time and resources.

permit a party to proceedings to appeal to supervisory authorities any judgment that has taken effect in respect of such party (under Chapter 36 of Russia's Code of Arbitration Procedure), or to submit an appeal regarding the relevant judgment to supervisory authorities (under Chapter 41 of Russia's Code of Civil Procedure) and establish deadlines for the review of such appeals.

4 In one such case several judgments and orders prohibited railway companies from transporting the relevant Russian target company's products and prohibited customs authorities from clearing the company's products for export. There was even an incident involving the arrest of vessels exporting the company's products in the Black Sea.

5 The attacker may directly or indirectly file more than fifty complaints through minority shareholders (whose claims may sometimes be absurd) in different Russian regions, including, for example, Chechnya. The target company may have no idea about such complaints. Such complaints are often necessary to obtain a court order issued as a provisional remedy (such as an injunction prohibiting the functioning of a legally elected board of directors or general director). After the order issued by a regional court is presented for enforcement the underlying case can be closed. It is obvious that the minority shareholders involved conspire with the attacker.

6 This Article does not discuss "information-related corruption" such as mass media "blocking", which is frequently used by attackers. Such blocking is an agreement between the attacker and a specific newspaper or television station regarding the latter's refusal to publish any information reflecting the position of the target company's management, etc. Nor does this article discuss the techniques involving breaking into the target company's Website by the attacker or an organization hired by it. In a recent case, a target company's Website was entered without authorization for the purpose of posting the attacker's press releases.

Scenario 2. An Abusive Corporate Takeover Involving Russian Bankruptcy Law to Acquire the Assets of a Target Company

A strategy often employed to take over a company with or without a government-owned stake has been the taking of its assets by purchasing its debt, creating a situation whereby the company is unable to pay its debt, commencing bankruptcy proceedings against the company and receiving assets in satisfaction of the debt. In particular, the attacker may artificially increase amounts owed to it (by using various schemes involving fictitious promissory notes or otherwise). Individual managers (or government representatives in the target company's governing bodies) may switch allegiance and conspire with the attackers. The new Russian bankruptcy law will, among other things, allow debtors to pay off debts and avoid bankruptcy proceedings.

Due to the fact that the new bankruptcy law is unfortunately far from being perfect and contains many internal contradictions it is difficult to say how effective this strategy will be in the future. We should wait and see how the law is applied in practice.

Scenario 3. A Hostile Corporate Takeover Using Minority Shareholder Lawsuits to Allege Defects in the Target Company's Privatization Law, Requiring the Shares to be Re-Sold to the Attacker

- *Problem Presented to Attacker: How to obtain control over a company in which a 95% controlling interest has been held by a well-known holding company since soon after the target company's privatization 10 years ago?*

The strategy that an attacker may follow in this scenario challenges the very fact of the target company's privatization. This form of hostile takeover potentially de-stabilizes all privatized, former Soviet enterprises that may become the target of similar attacks.

As a first step in this form of attack, an entirely unknown individual in a remote region of Russia as distant as possible from the target company will buy, or purport to have bought, a few shares of stock in the target company. The new minority shareholder will then file a claim with the local court in the place of his or her residence alleging that the controlling shareholder in the target company failed to fulfill its obligations in connection with the target company's privatization ten years earlier. The lawsuit will claim that the seizure and sale of a controlling interest in the shares of the target company held by the current controlling shareholder is warranted to compensate the privatized company for its losses attributable to the manner in which it was privatized ten years earlier. Arrangements will be made to assure that companies affiliated with the attacker will then purchase the controlling block of stock from the Russian Federation Property Fund, and that no other potential bidders are informed of this opportunity, or that the existing controlling shareholder is informed that its shares in its subsidiary are to be re-sold. The preparation of all court filings made on behalf of the unknown minority shareholder is coordinated by the attacker. The minority shareholder is used as a "tool" to implement the strategy. He or she may or may not ever appear in court, but will grant a power of attorney to selected lawyers authorizing them to file the intended claims against the target company. The minority shareholder will then disappear and become impossible to locate for the remainder of the hostile takeover.

The minority shareholder's suit may allege that the controlling shareholder failed to comply with the investment obligations assumed by it during the privatization of the company several years ago. The court will rule that the controlling shareholder's investment obligations were not been fulfilled. Such rulings have been made in cases we are familiar with even where the Russian government (represented by the Russian Federal Property Fund, the Accounts Chamber of the Russian Federation, etc.) had previously confirmed, in writing, that the controlling shareholder had fulfilled all of its investment obligations in a timely manner.

The court involved may render its judgments *in absentia*, without the review of any evidence and without giving any notice to the defendant, the existing controlling shareholder, of commencement of the proceedings.[7] During the hearing of the case, the plaintiff would be represented by the attacker's counsel or other experts in hostile takeovers hired by the attacker.

Contrary to the Constitution of the Russian Federation and Russian procedural law, the defendant is deprived of the opportunity to appear in court and present its defenses. If the court had heard the defendant (i.e., the controlling shareholder of the target company) all of the plaintiff's arguments would have been determined to be false. Thus, a necessary component of the attacker's strategy is the prevention of any possible appearance by the defendant at the hearing and delaying tactics in the event of any appeal from, or protest against, the court's judgment (to postpone the review of such appeal as long as possible so as to allow the attacker to obtain control of the target company before the appeal or protest is reviewed).

Immediately following the completion of the foregoing carefully arranged legal proceedings, judgment will be rendered in favor of the unknown

[7] In one case, "notice" of the proceedings to the defendants involved an empty envelope being sent by the court and delivered to the staff of the defendant's office against receipt. In another case, the summons was knowingly delivered to a wrong address. Confirmation that such a registered mail letter has been delivered is sufficient proof for the court that the defendant has been given "due notice" of the proceedings.

minority shareholder, i.e., in the attacker's favor, the shares held by the controlling shareholder will be sold promptly to a pre-determined purchaser related to the attacker. The attacker would secure the support of the relevant bailiff service and/or office of the Russian Federal Property Fund and arrange for the sale of the shares to a friendly entity without public notice or auction or even a notice to the existing controlling shareholder (by way of direct sale through an agent). It should be noted that in such a sale the shares are typically appraised below their actual value and the amounts paid for the shares are often frozen in an account at a bank controlled by the attacker (a court order or judgment in respect of an absurd claim being referred to as the basis for such freezing).

The purpose of such transaction is to preserve the attacker's right to challenge any actions of the controlling shareholder, and to have a governmental office or third party between the attacker and the existing controlling shareholders in the chain of title to the shares. Thus, Russian government agencies are directly enlisted to facilitate the hostile takeover. This involvement of a government agency is intended to make it possible for the attacker to claim that it is a *bona fide* purchaser of the controlling interest in the shares of the target company. The attacker will subsequently allege that it had no knowledge of the circumstances related to how the shares came to be offered for sale by the R.F. Property Fund. The attacker will cynically claim the protection granted to a *bona fide* purchaser of shares under the Civil Code of the Russian Federation.

The controlling shareholder would first learn about the underlying judgment brought by the unknown minority shareholder, who has now disappeared, only after the expiration of the deadline for appeal of the court order obtained in the distant court. The controlling shareholder loses the right to appeal the underlying judgment, and is left only with the possibility of discretionary review of the underlying court decision at the request of supervisory authorities in the local judiciary or the local prosecutor's offices. The controlling shareholder, ostensibly deprived of ownership of its subsidiary, is thus left at the mercy of individuals who, it is frequently shown, are unduly friendly to the attacking side. The shares of stock in question are likely to have been sold to the attacker or legal entities controlled directly or indirectly by the attacker by the time that the existing controlling shareholder first learns that it has a problem to deal with. The foregoing scenario appears to involve the closely coordinated, pre-arranged cooperation of a dozen or more individuals in distant locations, and in key positions in the local courts there, and in several government agencies, giving the entire undertaking its hallmarks as "organized" activity to deprive a controlling shareholder of ownership of its subsidiary.

The attacker would then revert to the steps described in other hostile takeover scenarios, such as Scenario 1 above, and conduct an ESM. The ESM would elect a new board of directors. The new board would appoint a new General Director. The purchaser would attempt to implement the scheme described under Scenario 1 to acquire actual physical control over the target company. The attacker's strategy would also rely on "administrative resources" to delay the review by supervisory authorities of the original court judgment in the case filed on behalf of the unknown minority shareholder.

Such an abusive takeover scheme would also include an attempt by the acquirer to obtain control over the target company's share register and, if possible, to get rid of its existing registrar. In one case, a company's shareholder registry documents were physically seized and taken by a bailiff, pursuant to an order issued by a court of general jurisdiction (which had no authority to consider the case), as a provisional remedy in favor of the unknown minority shareholder who had purchased just a couple of shares of stock in the company. That individual requested that the register be moved to his domicile (in another distant region of the Russian Federation) as seizure and removal of the share registry would facilitate the registration of his acquisition of a few shares of stock. The registry was seized from the company's legitimate registrar by the bailiff, escorted by armed representatives of the attacker that launched the takeover attack against the first company, and was transferred to another registrar friendly to the attacker. On the next day, an offer for the sale of the controlling stake owned by the company's management was posted on an Internet website. The controlling stake was alleged not to belong to the management anymore. Should this approach have succeeded, its further implementation would have followed the scenarios described above.

It should be noted that an example of a civilized acquisition abiding by the letter and the intent of law is difficult to find in modern Russia, except in the case of corporate acquisitions accomplished by foreign companies and certain Russian publicly-held companies who have committed themselves to high degrees of transparency and compliance as a condition to accessing global capital markets. Most acquisitions of control of Russian corporations today involve the use of "administrative resources", i.e., improper intervention by judicial and government agencies. Foreign investors holding significant stakes in various industries have also been attacked in the manner described here.

The impunity of the numerous attackers who employ these methods, in conjunction with the typically passive or compromised attitude of the government authorities involved in a particular hostile takeover, corrupts the business community by suggesting such means of corporate takeovers are legitimate, rational and acceptable, and that it would be foolish not to employ such tactics while other business groups are employing such methods and getting away with it. Russia is, accordingly, witnessing the inception of a

new phase in the market for the acquisition of control, and transfer of ownership and control, over business enterprises in Russia. This new phase features the use of extraordinary court orders to eliminate competitors in a privatization tender or auction[8], the formation of profit sharing alliances between business groups inexperienced in abusive takeover practices and the "pioneers" that have become skilled attackers. This new phase includes attempts to apply the foregoing and other hostile takeover methods to seize stakes in companies owned by the federal government or a political subdivision of the Russian Federation.

These evolving techniques for hostile takeovers involving administrative resources are referred to as "the new know-how" in corporate mergers and acquisitions. A number of firms have emerged which specialize in developing a customized approach to acquiring control over just about any company in Russia that a well-financed attacker may desire to control. Any Russian business that expands operations, earns profit, improves corporate governance, seeks to attract investors and aspire to access the capital markets is subject to becoming the target of an unscrupulous attacker at any time. Indeed, the timing of certain hostile takeover attempts appears to have been directly related to the announcement by existing controlling shareholders of plans to reorganize their companies and raise new capital, suggesting, apparently, to potential attackers that the time to strike was immediately prior to the implementation of such plans. Unless an end is put to the vicious practices frequently involved in abusive hostile takeovers, bailiffs escorted by masked guards will continue to rush through the front doors of many more Russian companies during 2003 and beyond, announcing the commencement or completion of yet more unscrupulous takeovers.

Experience shows that an attacker is generally not a manager more successful than the owner of the target company concerned. A successful hostile takeover is often followed by asset stripping to remove the most attractive financial or other assets, or to create a monopoly resulting in the restriction or complete suppression of competition in some sectors of the economy. Combinations created by attackers generally feature low transparency and poor corporate governance, even by Russian standards.[9]

The publicity released by an attacker and its nominated new management during a hostile takeover is typically to the effect that they pursue a "noble goal" (though they have not yet formulated it publicly). Their apparent goal is to squeeze the controlling shareholders (including the state and its political subdivisions, where possible) into acceding to a loss of control over successful companies in strategic industries by applying the above methods so as to acquire full control over such industries. When an attacker gains financial control in a Russian region in which its own principal subsidiaries are located, the attacker and its management will seek to influence the local regional government, then to seek greater influence on decision making at federal level.

At this critical stage of the development of Russia, the Russian President and his Administration, government, parliament, the Supreme Court, the Supreme Arbitration Court and the business community should consider tough measures to amend existing laws and regulations to combat the widespread use today of "administrative resources" in abusive hostile takeovers. Existing Russian laws and regulations concerning mergers and acquisitions ought to be enforced fairly. The new "know-how" about how to appropriate controlling interests Russian corporations should be shunned by the business community and appropriate and effective legal reforms ought to be enacted. Otherwise, the rule of law in Russia will have become an exception to the rule. These are fundamental concerns for the market economy in Russia: to reduce organized crime, to reduce corruption, and to create circumstances in which large-scale foreign investment will return to Russia.

3. Proposals for Legal Reform

3.1. Measures against Judicial Corruption

Russia's judicial system is very ill. This has been recognized by President Putin. On April 3, 2001 he said in his message to the Federal Assembly that "the domestic system of courts does little in practice to help introduce changes in the economy ... justice has not become speedy, proper or fair, not only for businessmen but also for many people seeking to legally restore their rights." Mr. Putin noted that "a war between claimants to property would not stop even after a judgment is rendered by a court and such judgment is not infrequently influenced by interested parties rather than relying on law." We agree with the President that "shadow justice is developing

[8] The mass media widely covered the story of a leading Russian company that was disqualified as a bidder in a privatization auction using a court order issued in connection with an absurd claim filed by an individual. Same leading Russian company was prepared to offer much more than the winner of the auction for the stake offered for sale. As one might expect, the plaintiff withdrew his claim after the completion of the auction. We are concerned that such a technique will be applied at many privatization auctions in the future; the outcome of such auctions is easy to predict: the treasury will lose many millions of dollars in revenues. Russia effectively goes back to "Wild West-style privatization" where property is given to one's own people.

[9] There were several publications in the press about a company taken over for several months and then returned to its legal owners by the attacker. During those months more than US$20 million credited to the company's bank accounts disappeared, no wages were paid to its employees and the company executed onerous contracts for the delivery of its products.

alongside the shadow economy" in Russia. Moreover, shadow justice has become fully entrenched in some regions. Almost all corporate takeovers today involve local judicial decisions influenced by corporate raiders. In regions in which corporate raiders have their core operations, key government and judicial offices are frequently reported to be nominees of the leading local business figures. Such small states within the state protect their local business "heroes". We are not aware of an instance in which a judge who rendered illegal judgments and issued unjustified orders in support of an abusive hostile takeover has been removed from his or her office by local judicial oversight boards. We are not aware of an instance in which a judge has been held criminally liable for bribery for decisions rendered to facilitate a hostile takeover. One of the most active judges issuing decisions that paved the way for two ongoing attempted hostile takeovers continues to administer justice in the name of the Russian Federation and recently moved to an eight-room apartment in the center of the Siberian city where he lives.

Tough measures against corruption among the judiciary must become a priority for Russia's leadership.

We believe that judicial corruption stems in part from laws on the liability of judges. In practice, a regional qualification board must take action by a two-thirds majority vote to take disciplinary action against a judge or to remove a judge. When a qualification board receives a complaint from a person who suffered as a result of the actions of a judge, the board may elect to authorize the chairman of the court at which such judge works to review the complaint.

In practice, such a case often "dies" at the level of the chairman of the court concerned. It is not typical for a qualification board to agree to remove a judge, following the principle of protecting one's own). In addition to the action taken by a supermajority vote of the regional qualification board, approval by Russia's Prosecutor General is also required to instigate criminal proceedings against a judge. Such approval is very uncommon.

Impunity corrupts, twists thinking and involves more and more people in corruption. Respect for government and judiciary reduces with each obviously illegal judgment and order for extraordinary and improper relief that is rendered in the name of the Russian Federation.

Many judges would likely discontinue such improper practices and corruption in the judiciary would likely decline if the threat of punishment and removal from office were to become a reality. Accordingly, the procedures for instigating disciplinary action against judges, and for holding judges criminally liable for their actions, should be changed and strengthened.

It would likely be advisable that decisions concerning the removal of judges and approval of criminal prosecution against judges should be put in the hands of seven independent special commissions (with judges accounting for part of their membership). One commission may be formed in each Federal District for which a *permanent representative of the Russian President* is appointed. A case involving a judge could be considered without bias or improper intervention by regional leaders if the authority to make such determinations were transferred from the regional level where a governor or an oligarch may try to influence the local qualification board, to Federal Districts. Today's requirement in applicable law for approval by the local Prosecutor General to hold a judge criminally liable likely unnecessarily complicates and impedes disciplinary proceedings. A representative of the Office of the Prosecutor General may be included as a voting member in each independent special commission. It would likely be an effective measure to require Judges and members of their immediate families to file tax returns. A bribe is often given by an attacker to a judge through his or her relative by executing a contract providing for consulting services to be rendered by relative to the attacker, or to its related entities. If information on income and sources of income is acquired in respect of judges and their relatives, the government should be able to identify suspicious enrichment of judges, which would facilitate criminal prosecution against corrupt judges and their expulsion from the judiciary. The above recommendation equally applies to bailiffs, staff of a prosecutor's office, employees of the office of internal affairs, and Russian officials generally.

3.2. Establishment of a Specialized Corporate Governance Court

Abusive hostile takeovers Are still Possible under New Procedural Law: 2003 Forecast.

Under the new procedural law (Article 33 of Russia's Code of Arbitration Procedure) a commercial ("arbitration") court shall have jurisdiction over any dispute between a joint stock company and its shareholder. Therefore, any claim of a minority shareholder will now be reviewed by a business court. In light of such legal development it is very likely that attackers will "recruit" judges of business courts for certain regions to support abusive hostile takeovers.

It is possible that a court of general jurisdiction may still be used in connection with an abusive hostile takeover. Under Article 22.4 of Russia's Code of Civil Procedure a complaint including several related claims that cannot be separated should be reviewed and resolved by a court of general jurisdiction even if some of the claims come within the jurisdiction of a business court. We expect that attackers and their consultants will use such wording in the claims filed by them, or a fictitious plaintiff purporting to have no relation to them, to make it impossible to separate the claims that come within the jurisdiction of a court of general jurisdiction from the claims that a commercial court has the authority to handle. The outcome is easy to predict: a case will be reviewed

and resolved by the court of general jurisdiction provided the judge concerned has been influenced accordingly. Claims of minority shareholders will give way to claims of individuals for the protection of *violated or challenged rights* based on civil or *other* legal relationships (under Article 22.1 of Russia's Code of Civil Procedure). Such proceedings are likely to be used to obtain court orders for extraordinary provisional remedies following which such plaintiffs would withdraw his or her claims and disappear, as described below.

Establishment of a Special Corporate Governance Court to Review Corporate Conflicts

The Russian Union of Industrialists and Entrepreneurs (the "RSPP") has recently established a "Court of Honor" in which leading Russian businessmen, commonly referred to as "oligarchs", themselves serve as arbitrators. It is interesting to note that various attackers who use the most unscrupulous methods in hostile takeovers are well represented in the new arbitration venue. Accordingly, it seems likely that the new court of the RSPP will not be an effective tool in preventing abusive hostile takeover practices. There is also a proposal to establish a similar, though less biased, arbitral tribunal at the Chamber of Commerce and Industry of the Russian Federation. We believe that such proposals will not bring the desired results since an attacker is unlikely to agree to refer its case to such tribunal or will unduly influence such venues. Unscrupulous corporate raiders would be afraid their methods would be exposed by an unbiased tribunal.

We would recommend, instead, that a specialized corporate governance court be established as part of the Russian judicial system. The proposed new court of law would have discretionary jurisdiction over litigation in any court in Russia that is involved in corporate takeovers. The court would consist of independent professional judges specializing in corporate law and the other Russian laws that are involved in legitimate corporate takeovers. It would likely be advisable for the envisioned new court to be located in Moscow or Saint Petersburg. A special constitutional law may be enacted to establish such a court. The law would define the types of cases that may be referred to the court and address certain procedural aspects. It would be important that such a specialized corporate governance court administer justice publicly, and that all its orders and judgments be posted on a Website for convenient review by any interested party and the public at large.

We note that specialized military courts exist in Russia at the present time. Russian laws governing the judicial system, and procedural law permit the establishment of additional specialized courts such as the proposed corporate governance court. Specialized courts (such as tax courts, bankruptcy courts, etc.) have been successfully established in many countries.

3.3. A Clear Definition of Provisional Remedies that Russian Courts May Issue

In practice, the main tool employed by corporate raiders in Russia today is a court order issued as a provisional remedy in connection with the claim of a third party (whose services are arranged by the attacker). Such claims may be filed with many courts as a matter of routine and are often submitted by the same individuals (some of them have served several sentences or who are refugees from former USSR republics who hold Russian passports, roam around Russia and file claims in various cities). It was not a surprise for us to learn that a judge in a regional court "stamped" almost identical orders permitting attackers to take over companies that belong to different owners.

Typical court orders in hostile takeovers appear to be absurd, but are all too real. Preliminary relief granted by sufficiently motivated judges prohibit the target company from completing undertaking any transactions involving its property, attach the shares held by the existing controlling shareholder, attach all movable and immovable property of the company affected, prohibit the relevant company's governing bodies, officers and general director from exercising their powers or affixing the corporate seal to any documents. Court orders would prevent a lawfully appointed registrar from maintaining the target company's share register, or would require that "attackers" be allowed to enter the company's premises. We have seen orders issued by invented or nonexistent courts, orders which the judges who signed them pretend to be unaware of, and orders that have not been recorded by the court's clerk, etc. The attackers (and their consultants) employ the method whereby the plaintiff (effectively hired by the attacker) withdraws his claim before its trial on the merits as soon as the relevant preliminary relief order is executed. There are also repeated examples of judge canceling their own order after they have been executed. These practices blatantly bring the Russian legal system into disrepute.

We recommend that Russian procedural laws be amended to prevent such abuses of process. Under Russia's existing Code of Arbitration Procedure and Code of Civil Procedure a plaintiff who withdraws his claim may incur no liability for the losses incurred by the defendant or other parties as a result of provisional remedies. Under Article 98 of Russia's Code of Arbitration Procedure such liability shall only be incurred after the business court's decision dismissing the claim takes effect. Under Article 146 of Russia's Code of Civil Procedure the plaintiff may be held liable only after the court's judgment dismissing the claim takes effect; the Code of Civil Procedure does not provide for the plaintiff's liability to "other parties" who may incur losses due to provisional remedies in connection with his claim. We think that the law should provide for a plaintiff's liability to the defendant and other parties who may incur loss due to provisional remedies in connection

with the plaintiff's claim even if the plaintiff withdraws the claim.

Procedural law requires that provisional remedies must be *commensurate* with the claim submitted. The judge is expected to determine what is commensurate. We recommend that clear criteria to determine what forms of preliminary relief are commensurate be added to Russia's Code of Arbitration Procedure and Code of Civil Procedure. These codes should include a comprehensive provision allowing one to determine whether a given provisional remedy is necessary and reasonable and what its consequences are realistically intended to be, in monetary terms.

To discontinue existing bad practice we recommend that the procedural law require a plaintiff to provide an injunction bond (or similar judicial bond) in the amount *equal* to the relief granted by court as a provisional remedy, which will prevent abuse of process by the plaintiff. (Such requirement may be limited to a certain class of cases such as claims of shareholders against their companies and individuals' claims against legal entities in connection with the operations of such entities, etc.) If a court issues an order as a provisional remedy providing for the attachment of property, real or personal, prohibiting the delivery of products, etc., we believe that such order should *always* be accompanied by the provision of a bank guarantee, the deposit of cash in the court's deposit account, etc., by the plaintiff as a judicial bond in case the defendant claims damages due to such remedy. The procedural law should clearly describe how the court should determine the amount of the injunction bond and whether it is commensurate with the provisional remedy concerned. For example, if the plaintiff requests that a company's oil exports be stopped he should provide security in the amount of tens or even hundreds of millions of rubles before the judge issues an order granting his request. In one case a court issued an order in connection with the claim of a woman (who presumably was hired by a third party for such purpose) requesting the court to ban the export of products of a company pending the disposition of her action; the company incurred more than two billion rubles in losses as a result of such ban. Another order issued in connection with an absurd claim of a minority shareholder blocked all export deliveries of a company and thus resulted in its default under export contracts and substantial losses. We recommend that the procedural law provide that *the chairman of the court* before which a case is pending shall be *required to approve in writing on any order* issued in a case to attach property or forbid a defendant in the case or others to carry on conducting the ordinary courses of their businesses while litigation is pending. The written approval requirement may be limited to orders issued in connection with the claim of a minority shareholder (e.g., the holder of less than a 5% interest; such a shareholder involved in an abusive hostile takeover typically owns just a few shares in the company concerned) or of an individual against a company. Such internal procedures within a court providing for additional supervision would facilitate the limitation and control of corrupt orders and decisions control and prevent inappropriate provisional remedies from being issued by many courts.

Existing procedural law permits a court of general jurisdiction or a business court to grant "*other provisional remedies*", i.e., other remedies in addition to those contemplated by Russia's Code of Civil Procedure or Code of Arbitration Procedure, as the case may be. In other words, a judge may grant *any* relief he or she may think necessary as a provisional remedy. Such provision, which is not backed by any comments, often leads in practice to abusive orders being issued by judges in cases that instrumental to hostile takeover attempts. We recommend that the procedural law define the term "provisional remedy" and describe the objectives that may be accomplished by means of provisional remedies and the matters that require a judgment (i.e., a prior resolution of a dispute on the merits). We recommend that the procedural law specify the types of orders that grant relief as a provisional remedy and may be issued in connection with specific types of claims.

In practice, "other provisional remedies" accompanying an abusive hostile takeover may be an order to stop operations, an order prohibiting the legally elected governing bodies of a company from performing their duties, from affixing the company's corporate seal on any documents, from executing transactions on behalf of the company, or restrain the export or domestic sales of products. There also frequently are orders directing a registrar to transfer a company's share registry to a third party (related to the company that has launched an attack on such company), or prohibiting the registrar from making any entry in the registry to record any transactions with shares. There is frequent order permitting the attacker's representatives to enter the premises of the target company, etc. When a court grants such "relief" as a provisional remedy in a case it does not first examine the facts or evidence in the case or determine whether the governing bodies or registrar were appointed legally, etc. We think that such orders abuse the very concept of provisional remedies as being ancillary measures to aid enforcement of a future judgment.[10] Instead, the preliminary relief is

[10] Let us consider the following example. As a provisional remedy in connection with the claim of a minority shareholder, a court orders that the registrar legally appointed by an issuer transfer the issuer's share register to a third party (which is either the registrar of the attacker in question or the attacker's representative). A court's decision invalidating the relevant agreement between the registrar and the issuer is necessary under law to take the register. In addition, any transfer of a register to a new registrar must always be made in accordance with the rules established by Russia's Federal Commission for the Securities Market. The issuer must be involved in any proceedings in which the legality of

the whole point of the instigation of litigation which, as described above, is subsequently frequently withdrawn before any trial on the merits. Here the court's role, in fulfillment from its de facto client, the corporate raider, is to authorize the disruption of the target company's operations in the ordinary course of its business as conducted by its rightful owners. This disruption causes immediate losses and damage to the company's shareholders, and violates the letter and the spirit and intent of laws which the court is supposed to observe and protect. All of the above proposals should fully apply to provisional remedies available before the filing of a claim, and to measures taken in aid of execution after a judicial decision (Articles 99 and 100 of Russia's Code of Arbitration Procedure).

3.4. Amendments to the JSC Law

A Special General Meeting of Shareholders Conducted by an Attacker

All abusive hostile takeovers involve an extraordinary general meeting of shareholders conducted on the attacker's initiative, and the election of its own board of directors that in turn elects a new General Director. Under the JSC Law, shareholders owning at least ten percent of all voting shares in the company concerned must submit a request to the existing board of directors to hold a meeting of shareholders. The board of directors shall have five days to check the proposed agenda (as set forth in the shareholders' request) for compliance with law and to schedule the general meeting. The board of directors may deny the request if the agenda is not in compliance with law or the request has been submitted by less than ten percent of the shareholders. The requesting shareholders may appeal in court the refusal of the board to call the meeting or to include a specific item in the agenda. In reality, the board of directors of the target company would not receive any request or participate in the meeting of shareholders. The attacker would hold the meeting for the purposes determined by the attacker itself and engage an outside registrar (which is typically controlled by the attacker) to count votes. The attacker then obtains orders or judgments that allegedly confirm the legality of the meeting and of which the target company and its legitimate management are not aware. Such illegal meetings held in violation of the applicable procedures results in dual management structures allegedly being created for the target company.

It may be advisable to amend Article 55.6 of the JSC Law to provide that no general meeting of shareholders held without the consent of the board of directors and in violation of the applicable convocation procedures shall have any legal effect, i.e., all resolutions approved by the shareholders at the meeting shall be void *ab initio* and any body elected at the meeting shall have no authority. Such provision will significantly weaken the position of the attacker at the initial stage of its illegal attack. The JSC Law may also be amended to specify the actions sufficient to constitute the "submission" of a request for a special meeting of shareholders to a board of directors. We believe that a receipt evidencing the dispatch of a registered mail letter (which receipt can be acquired by the attacker's representatives from postal personnel) is clearly insufficient as proof of "submission" of a request for a meeting to the board of directors.

3.5. Amendments to Law on Enforcement Proceedings

No shares should be sold in the course of enforcement proceedings against a debtor unless no cash stands to the credit of the debtor's bank accounts; and the debtor should have the right to voluntarily comply with a judgment.

In an abusive hostile takeover, the main goal pursued by the attacker is to quickly get hold of a controlling stake in the target company before the original judgments are challenged by the existing controlling shareholder. The hearing of appeals of the original judgments will intentionally be delayed for months to bring additional pressure to bear on the target company and its key managers and shareholders. Under Article 59 of Russia's Federal Law No. 119-FZ "On Enforcement Proceedings," dated July 21, 1997, a bailiff has a choice prior to ordering the sale of a judgment debtor's shares of stock to seize cash on deposit in the debtor's bank accounts. IN an abusive hostile takeover, the bailiff would always immediately sell such shares to the attacker or its related entity. The bailiff takes the trouble of going to the target company's registrar's office in another area of Russia and makes arrangements to hold an auction, even though monies in the debtor's account may be more than sufficient to satisfy the claim against the debtor. The bailiff does not give the debtor an opportunity to voluntarily comply with the judgment even though he is required by law to do so.

To address this widespread abuse, Article 59 of the law "On Enforcement Proceedings" may be amended to provide that the sale of shares may only be a bailiff's second choice, which shall not prevent a bailiff from attaching the shares in case funds are insufficient to execute the judgment. The law should may provide that the bailiff may not take a formal approach to the above requirement but shall be obligated to check all bank accounts of the debtor in an attempt to identify sufficient funds to pay the amounts awarded by the court, and allow the judgment creditor to post a bond or deposit additional funds to satisfy the judgment against it, if that judgment is not overturned on appeal.

its registrar is challenged and should have the right to submit evidence in such proceedings.

The Russian Federal Property Fund should not have the right to sell shares as an agent for the target company by means of a direct and immediate sale of shares pursuant to a judgment.

In light of the existing abusive practice at the Russian Federal Property Fund, and in its territorial offices in particular, it may be advisable to prohibit the Fund from acting as an agent on behalf of a defendant in conducting a sale of shares of stock belonging to the defendant. Such a sale of shares, if it is an appropriate remedy, should only occur after a final judgment in the courts and then only through a public auction only. The law should set forth rules for public auctions that provide for their transparency and the accurate appraisal of the fair market value of the shares.

The Fund may also be prohibited from selling shares of stock at public auction to an intermediary that is a nominee. The purchaser of such shares should always be their new actual owner. The sale of shares should be deemed to occur as soon as the amount paid for the shares is credited to the debtor's bank account, rather than upon the transfer of the shares.[11]

3.6. *Bona Fide* Purchaser of Shares and Uncertificated Securities

Russia must revisit the concept of who is a bona fide purchaser of shares and impose restrictions to prevent abuse of this doctrine as an additional protection for unscrupulous attackers. Special provisions should be added to the law to ensure that the legal owner of uncertificated shares is able to enforce his ownership rights, and to recover the shares improperly acquired by a corporate raider.

Appendix. ABUSIVE HOSTILE TAKEOVERS" IN RUSSIA IN 2001 AND 2002

A major regional machine-building plant

An abusive takeover attempted by creating dual management and using orders issued by courts of general jurisdiction in connection with shareholders' claims.

One of the largest Russian refineries

Creation of a second register, two lists of shareholders and dual management.

Leading pulp and paper and forest products companies

Attempts to create dual management and two boards of directors and to take the premises of the companies by force relying on orders issued by various courts in connection with the claims of minority shareholders. Attempts to create a second register and to transfer shares from the accounts of their legal owners and then sell the shares to allegedly *bona fide* purchasers.

A leading aluminum company

Multiple arrests of shares and manipulations with the company's register relying on questionable court orders issued as a provisional remedy in connection with the claims of minority shareholders. Force was used to obtain control over the company.

A major Moscow food company

Creation of dual management and long confrontation of the confronting parties, which involved the use of force and court orders issued as a provisional remedy in connection with shareholders' claims.

A subsidiary of a major oil company

Creation of dual management and two boards of directors and an attempt by the new managers to take the company by force relying on courts orders issued in connection with the claims of minority shareholders.

Several leading breweries and producers of soft drinks

The companies' operations were nearly paralyzed by multiple court orders issued as provisional remedies in connection with shareholders' claims. The orders prohibited the companies' management to take any action, ordered the attachment of the companies' assets, etc.

A leading Russian distillery

Creation of dual management and long confrontation of the confronting parties, which involved the use of force and court orders issued as a provisional remedy in connection with shareholders' claims.

A major regional producer of fat and oil products

Taking of the company's share register from its registrar, which involved the use of force and relied on orders issued by courts of general jurisdiction in connection with shareholders' claims. An attempt to create a second register and two lists of shareholders. Who is the next?

[11] There was a case in which, according to the press, controlling stakes in one of the largest industrial holdings in Russia were sold by bailiffs through a regional office of the Russian Federal Property Fund pursuant to an absurd judgment, which was subsequently cancelled. The Fund, acting as an agent, sold the stakes directly to the relevant attacker. It took less than two days to sell the stakes. A notice of sale was placed on the Internet. The court subsequently determined that the direct sale through an agent was invalid as the Fund was required to sell the shares at public auction. By then, however, the shares were already well down the chain of allegedly *bona fide* purchasers.