

# Securities Litigation – Step-by-Step Evolution in Russia

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Any phenomenon tends to appear at a particular time and place given the appropriate pre-requisites and favourable environment giving rise to it. This is truly applicable to **Securities Litigation**. The phenomenon sprouted in Russia at the turn of 2008/2009, and is expected to boom within the several years to come.

At first sight, the reasons that trigger Securities Litigation are clear to both lawyers and professional players in the financial markets and are attributed to the global financial turmoil reverberating across Russian economy at its strongest as early as September 2008. We believe, however, that it is not exactly correct to see this factor as *the only* one contributing to the birth of Securities Litigation in Russia; the phenomenon budded as far back as mid-2006 when Article 84.2 of the Federal Law “On Joint-Stock Companies” (the “Joint-Stock Companies Law”) was enacted. This is exactly when the failure by majority shareholders to make to the shareholders a mandatory share purchase offer became relevant.

It would be inappropriate to consider Securities Litigation exclusively as court disputes over securities (i.e., in essence, only as a new litigation trend). This is a more global phenomenon that may be split into the following (considerably large-size) components:

- Securities Litigation as a new trend in Russian judicial practice;
- Securities Litigation as a new trend in Russian legislation;
- Securities Litigation as a new practice area in Russian law firms.

Each component will be meticulously considered in more detail below with a reasoning of why specifically these, and not any other components, were distinguished.



## Securities Litigation: a new trend in Russian judicial practice

As a stand-alone phenomenon, Securities Litigation should be considered primarily as a new trend in the practice of Russian arbitration courts and, unfortunately, courts of general jurisdiction, too<sup>1</sup>. In other words, this is a new judicial trend that requires developing certain approaches to resolving securities disputes. These approaches should be developed, first, by legislators and, second, by arbitration courts (represented by the RF Supreme Arbitration Court). Said approaches might include, for example, the following:

- formalizing in legislation of the arbitration courts' exclusive jurisdiction over securities disputes;
- introduction of the mechanisms employed by investor class actions into the law enforcement practices;
- clarifications on admissible protection against the claims arising from securities litigation.

It should be noted that securities disputes are not entirely new to the Russian law enforcement practice. Prior to September 2008, such disputes, however, were not involved extensively; only scarce disputes between minority and majority shareholders used to occur due to failure by the latter to buy out shares as prescribed in Article 84.2 of the Joint-Stock Companies Law.

<sup>1</sup> As of April 2009, this is exactly how the bond disputes developed: where a bondholder was an individual person, the claims against bond issuers were submitted with a court of general jurisdiction (see further in the article).

This kind of disputes that have already gained some considerable publicity includes, first of all, the conflict between the shareholders in OJSC TGK-2 and OJSC TGK-4. In this dispute, by filing various lawsuits and using some evidently ostensible criteria, majority shareholders tried to reduce to zero the efforts the minority shareholders made to force them to buy out shares under Article 84.2 of the Joint-Stock Companies Law.

**Bond disputes** appear to be a new development in the judicial practice: a wave of such litigation caused by massive defaults on the part of obligors trading bonds on the MICEX has swamped Russian arbitration courts. It was felt most strongly by the Moscow Arbitration Court: most of the issuers are either registered in Moscow or have included contractual jurisdiction clauses in the issue documents providing for the disputes arising from improper performance by the issuer (and/or bond security party) of its bond obligations to be referred to exactly this arbitration court.

It will be noted that these disputes can hardly be seen as complex. The *bondholder/obligor relationships* are essentially arising from a loan agreement, which should not cause any particular difficulties to the courts. At first sight, the claims bondholders make in these disputes are obvious and incontestable and the in-court recovery procedure is rather formal, since other ways of having the loan repaid are not always available or realizable (especially, in the context of the macroeconomic crisis affecting Russian economy).

Nonetheless, prompt and effective in-court resolution of such disputes is complicated as the issuers and/or security parties file claims with the sole purpose of dragging out trials initiated by investors. For example, they would lodge interrelated claims challenging the bond sale agreements, guarantees, etc.

This is not to say that courts did not face such situations before: in previous years they considered lawsuits for debt recovery under loan agreements. Dragged-out trials are well known to judges, too. Yet, no massive claims from investors against issuers charged with defaults on, specifically, bonded loans have been seen in courts. Besides, in this kind of relationship the parties are governed not only by the civil laws, but by special legislation on the securities market, including a like-named Federal Law No. 39-FZ of 22 April 1996 and orders of the Federal Financial Markets Service of Russia. Numerous nuances should not be disregarded, either, in the relationships between investors and issuers of bonds in a specific dispute that may arise from issue documents, for example, from a resolution to issue bonds and bond issue prospectuses, as well as from an investment memorandum, which, although not part of the issue documents, is published by most issuers in open sources together with the prospectus and issue resolution, and is circulated among potential investors (as describing a certain global “outside perspective” of the issuer’s business and its most optimistic development scenarios).

The aggregate of these circumstances charges courts with a kind of increased responsibility. Nonetheless, our analysis of enacted court rulings over bond disputes demonstrates that the formal approach to resolving such disputes still persists – obviously, due to inadequate solution of the tasks set before the courts. These tasks emerge not from the statements

of claim or arguments presented in the proceedings; these tasks are global and are set by the market itself. Their essential purpose is to stabilize interaction between investors and issuers, to ensure competent comprehensive conflict resolution and to generate consistent securities litigation case law.

Today, we are witnessing development of case law in disputes between bondholders, on the one hand, and issuers and security parties (mostly, guarantors), on the other hand. Such disputes are due exclusively to the issuers’ default on coupon yield, repurchase offer or bond redemption.

A number of court rulings have been already issued in cases on terminating bonded loan agreements due to a significant deterioration in loan security. In one of these cases, a bonded loan agreement was terminated because of the bankruptcy of the issuer’s guarantor. The conclusion offered by the court in this case may be considered correct, yet, no clear-cut criteria of “significant deterioration in loan security conditions”, subject to which a loan agreement may be terminated, have been provided on either legislative level or at the level of clarifications by the highest courts.

Following the case law stemming from bondholders’ claims against issuers and security parties, the practice is being developed of invalidating bond sale agreements and guarantees designed to secure bonded loans. This case law is generated exclusively “thanks to” the active countermeasures taken by a number of issuers defaulting on their bonds who have been charged with claims to recover nominal value of the bonds and/or to enforce repurchase offers. As a rule, these claims serve the sole purpose of dragging out bondholder proceedings; whereat the scheme is used grounded in Clause 1, Article 143 of the RF Arbitration Procedure Code (regarding

mandatory stay of proceedings until a related case is considered). In practice, the scheme involves use of a number of interrelated claims aimed at challenging (invalidating) the grounds giving rise to legal relationships between investors, issuers and guarantors with respect to a bonded loan and its security.

Most of the times, such claims may be qualified as an abuse of one's right to court access, but the RF Supreme Arbitration Court has not yet developed a single position on Article 143 of the RF Arbitration Procedure Code when interrelated claims are lodged. The reason is probably that there is a very fine line between the real protection and abuse of rights, and the courts are merely unwilling to assume responsibility, in each specific case, for distinguishing between the abuse and actual protection of its rights by a party when the latter does not claim "ostensible" grounds for submitting an "interrelated" (parallel) action seeking to stay the proceedings in an interrelated case.

One way or another, this scheme is applied quite often by issuers in their disputes with investors. What are the possible implications?

In practice, the following usually occurs. Satisfying the issuer's (or guarantor's) petition to stay the proceedings over the investor's claim for recovery of nominal value of the bonds prior to enacting the judgment in a case, for example, for invalidation of a bond sale or guarantee agreement, would mean "blocking" the investor's claim for at least 7 to 9 months. Is it good or bad? No doubts, the issuer and, sometimes the guarantor, will benefit from this: they will have their obligations deferred tangibly, possibly up to 1.5 to 2 years. While the investor will have to either wait passively or appeal against the court's ruling to stay its proceedings.

It is hardly possible to have a direct statutory ban imposed on said scheme used in securities disputes. De facto, this would mean an unjustified restriction, if not deprivation of issuers (guarantors), of their right of court access, which contradicts Russian Constitution providing for equal rights of court access.

This is not the entire list of securities disputes with respect to bonds. Once the situation in the corporate bond market stabilizes (i.e. the defaults are over), the bond disputes will not end. On the contrary, arbitration courts should be getting ready since, once the notions of the general meeting of bondholders and their representative are incorporated into the securities market legislation, some conceptually new categories of bond disputes will arise.

Analysis of the draft law on general meetings of bondholders prompts a conclusion that a positive trend is in the making to streamline the issuer/bondholder relationships. It is fair to say that introduction of the general meeting of bondholders and a bondholder representative will give rise to a kind of disputes previously unknown to the Russian arbitration practices and associated with rights to securities. Such disputes may include the following:

- bondholders vs general meeting of bondholders;
- bondholders vs bondholders' representative;
- bondholders' representative vs issuer.

The "**bondholders vs general meeting of bondholders**" disputes might appear due to the above draft law stipulating that a "*bondholder may appeal to court against a resolution passed by the general meeting of bondholders, <...> such application may be submitted with a court within three months of the day a bondholder became or should have become aware of the resolution so passed*".

The contents and meaning of this rule is substantially similar to Part 7, Article 49 of the Joint-Stock Companies Law dictating that: *“a shareholder may appeal to court against a resolution passed by the general meeting of shareholders, <...> such application may be submitted with a court within six months of the day a bondholder became or should have become aware of the resolution so passed”*. At the same time, while it is positively clear that, in the event of a shareholder appealing against the general meeting’s resolution it is the joint-stock company (general meeting of shareholders is one of its management bodies and, as per Article 53 of the Russian Civil Code, it is specifically through its management bodies that a legal entity acquires civil rights and assumes civil obligations) that will be defending in the case, the reviewed draft law does not make it possible to establish who will be acting as a defendant in court in a case where a bondholder files a claim to invalidate a resolution passed by the general meeting of bondholders. This meeting is not a body within a legal entity, therefore, the issuer may not be a defendant in such disputes. Neither does the general meeting of bondholders have a legal entity status and, hence, may not be a defendant in court. As a result, because of a legislative gap, a bondholder who disagrees with the resolution of the general meeting of bondholders will be de facto deprived of the opportunity to exercise its right to appeal against the resolution violating, in its opinion, its statutory rights.

It may be assumed that all the bondholders voting for the resolution appealed against by a dissenting bondholder will act as defendants (specifically as defendants, not a defendant) in this kind of disputes. Another scenario is hardly possible given the structure of legal relationships between bondholders within their general meeting.

In this context, it is absolutely indispensable that the RF Supreme Arbitration Court should issue clarifications for the courts on how to apply provisions under which a bondholder may appeal against resolutions of the general meeting of bondholders by analogy with Resolution No. 19 of the Plenum of the RF Supreme Arbitration Court of 18 November 2003 “On Certain Aspects of Applying the Federal Law “On Joint-Stock Companies” that proved effective for the courts resolving corporate disputes.

The second category of disputes (**bondholders vs bondholders’ representative**) may result from the direct reference in the draft law on general meetings of bondholders to the bondholders’ representative liability towards the bondholders for the *“losses caused by its wrongful acts (omission)”*. In the context of the crisis affecting the stock market, it is likely expected that certain bondholders will take advantage of this rule (if adopted) in case the issuer defaults on bonds: the bondholders’ representative will be charged with failure to take steps to protect the rights and statutory interests of the bondholders or failure to reveal the circumstances causing violation of right and statutory interests of the bondholders.

Therefore, much care should be taken in applying the rule (if passed), which is true for both bondholders and courts to consider the disputes. It is important that this rule does not become an obvious and simplest way for the bondholders and issuers failing to assess their own investment risks to shift all their losses to the bondholders’ representative, whereat many market players may be tempted by this in the current environment. Furthermore, given the legislative rule in its current form and the negative case law (*negative for the bondholders’ representatives – Author*), it is highly

likely that difficulties will arise in finding volunteers for the position of a bondholders' representative: the liability imposed on these representatives is very significant. No liability insurance is contemplated in the draft law with respect to such persons.

Finally, the third category (**bondholders' representative vs issuer**) will include, first, the disputes emerging from the claims filed by the bondholders' representative seeking performance of bonded obligations (enforcement of a repurchase offer and coupon yield) analogous to the ones already considered by the courts at the suits of bondholders, and, second, potential disputes rooted in the claims filed by the bondholders' representatives against the issuer arising from the list of rights granted to the bondholders' representative for it to perform its obligations.

These claims from the bondholders' representatives may include:

- claims to force the issuer to comply with the resolutions passed by the general meeting of bondholders;
- claims for the issuer to eliminate the circumstances that might entail violation of rights or statutory interests of bondholders;
- claims for the issuer to restore the security for bonds to the condition prescribed in the loan agreement (in the resolution to issue bonds and bond issue prospectus);
- claims against the issuer, its auditor or appraiser requesting necessary information;
- claims for the issuer to remove obstacles for the right to attend, without voting, the meetings of its management bodies.

This is, undoubtedly, only a sample list of claims that bondholders' representatives will be entitled to file against the issuer following the list of rights

and obligations attached to the issuer in accordance with the current version of the draft law on general meetings of bondholders.

**Compensation claims from investors** purchasing the securities against **managers and underwriters in issues of securities** (both bonds and shares) should become shortly an integral part of Securities Litigation requiring an absolutely new approach to protecting investor rights. Let us consider the reasons bringing such claims to the Russian judicial practice.

Firstly, even now the corporate bond market faces the situation where defaulting issuers become apparently insolvent. Either creditors or shareholders (participants) initiate bankruptcy proceedings against such issuers, so it becomes very difficult for the investor to have the bonded loan repaid to the least extent: under the bankruptcy legislation, such debts refer to the third priority debt, which means the probability of it being repaid is rather low. The situation aggravates further where the issue is secured by a guarantee and the guarantor, alike the issuer, becomes actually bankrupt and has no sufficient property to satisfy the bondholders' demands.

Secondly, the issuer and guarantor play a nominal role in the bond placing process; de facto the securities are sold by a bonded loan manager under a relevant contract with the issuer. Analysis of most of the contracts for arranging bonded loans suggests that the role of the manager is to select from the issuer all the required "filling" for the end financial product.

The liability of the securities issue manager in this case may be built upon the general liability rules found in the civil legislation. It should be noted, however, that default and bankruptcy of the issuer as such does not mean that the manager may be

held liable and charged with the nominal value of securities and the income payable on it to investors. To hold the issue manager liable, it is prerequisite that a fact is established and proved that a purposely “substandard” financial (investment) product was placed on the securities market.

Of course, such compensation claims will be difficult to materialize in the Russian environment given the absence of case law on analogous cases and any direct indication in the laws on the managers’ liability, as well as a very specific fact in proof. This is, however, what makes Securities Litigation distinguished from other disputes: extraordinary complexity of cases, economic significance and

specific legal relationships of an “investor – issuer – issue manager” – these are the qualities typical exclusively of securities disputes.

All of the above suggests a disappointing conclusion that it won’t be at once that compensation claims are established (introduced) in the Russian judicial practice. The participants of the Russian securities market have been enjoying continuous plentiful growth for a very long time and nobody was thinking it necessary to have a stricter liability formalized in legislation for the professional securities market players. It will be quite difficult to break in a moment some decade-long stereotypes as the resistance will be quite high.

## Securities Litigation: a new trend in Russian legislation

It will be noted that now already, in the depths of the RF Federal Financial Markets Service and legislative authorities, a mechanism of the “quasi-class” investor action is being developed designed specifically to consolidate bondholder opinions by introducing the institutions of a general meeting of bondholders and their representatives.

Why are these institutions seen as a prerequisite for a “quasi-class” action? First of all, it should be emphasized that this is not a classical class action as used, for example, in the USA, when investors act as co-plaintiffs in bringing action against a company whose securities they acquired. In the USA, a class action implies that each plaintiff may join in the

case with a separate claim towards the issuers, i.e. to claim any damages (compensation). The critical criterion here is the cause of action: all the investors hold the same category of securities of one offering and claim that the issuer should, for example, pay damages resulting from “false or misleading statements” made by the issuer when selling the securities they acquired.

It does not appear possible to implement this mechanism (namely, to bring action against the issuer where co-plaintiffs include all holders of the bonds it issued claiming, for example, damages caused by its failure to perform securities obligations) in Russia. And there are several reasons for this.

The first reason (or rather, obstacle) is that effective Russian procedural laws, including the RF Arbitration Procedure Code and the RF Civil Procedure Code, provide for a particularly clear distribution of jurisdiction over disputes. One of the distribution criteria is the status of a person filing a claim (i.e. whether the claimant is a private individual or a legal entity). Given the statutory distribution criteria, a bondholder who is a private individual may not refer to an arbitration court with a claim against the issuer failing to discharge its obligations with respect to securities. A claim from an individual is to be filed with a general jurisdiction court. The same applies to corporate bondholders: such investors must refer exclusively to arbitration courts.

It is easy to see that said distribution is a very serious obstacle to implementing the quasi-class action; it may be eliminated only at a legislative level by appropriate amendments made to the RF Arbitration Procedure Code. Yet, even if this obstacle is removed, it will not be possible to instrument the class action in its classic way (as implemented in the West), as the second obstacle appears. Effective procedural laws prohibit lawsuits that consolidate independent pecuniary claims of several entities (even where arising from possession of securities of one issue/issued within one offering).

Meanwhile, according to the Federal Law “On Amendments to the Federal Law “On the Securities Market” (in terms of creating mechanisms aimed at protecting bondholder rights) (hereinafter the “Draft Law”), in particular its Article 27<sup>1-2</sup>, “an obligor or a general meeting of bondholders may appoint (elect) a bondholders’ representative”. Furthermore, it follows from Article 9 of the same Draft Law that *“a bondholders’ representative represents the bondholders before third parties, including the issuer and a party providing security for the bonds,*

*and before judicial authorities. A bondholders’ representative exercises its powers, including with respect to signing statements of claim, statements of defense and applications for interim relief, referring the case to an arbitration tribunal, full or partial withdrawal of claims and their admission, change of cause or subject matter of action, concluding settlement agreements and agreements on matters of fact, signing applications for revision in light of newly discovered facts, appealing against the rulings issued by the arbitration court, receiving monetary or other awards on the basis of a resolution to issue bonds (resolution of a general meeting of bondholders) without a power-of-attorney”.* Finally, clause 10 of the same article states that *a bondholders’ representative must refer its claims to a court if a relevant resolution is passed by the general meeting of bondholders and in other statutory contexts, as well as perform any other procedural actions, unless the general meeting of shareholders provides otherwise.*

It may be assumed, therefore, that soon there will be a mechanism put into effect in Russia whose essence bears vague resemblance to a class action filed by investors in the USA. This is precisely why such action should be called “*quasi-class*”: unlike the arrangement applied in the West where each plaintiff (investor) acts independently in its own name and forms a certain *tangible group* of independent plaintiffs (although consolidated by a single cause of action) holding securities of one offering and from one issuer, in case of a bondholders’ representative, there is a sole plaintiff engaged in the action, who is a kind of a legal representative of all bondholders who may not bring class action against the issuer due to the statutory restrictions effective in Russia. Furthermore, unlike the plaintiffs bringing “Western” class action, where each investor expresses its own will, a bondholders’

representative under the Russian laws will be expressing not its own will, but the *will of investors* manifested in the resolution to be passed by the general meeting of bondholders.

It will be noted that, along with introducing the institutions of a bondholders' representative and a general meeting of bondholders, the Draft Law has settled to establish arbitration courts' jurisdiction over disputes arising from improper performance. It follows from clause 9, article 27<sup>1-1</sup> "Specifics of Issue and Sale of Bonds" of the Draft Law that "disputes related to performance of bond obligations are considered by arbitration courts".

Meanwhile, it is already possible to implement and use the "quasi-class" action of investors today; there is a way to bring such action without the need to wait till the law on the general meeting of bondholders and their representatives is passed. Russian civil laws provide for a trust management mechanism applicable, without limitation, to securities (including bonds). A management company with a relevant status (permit) confirmed by a license issued by the RF Federal Financial Markets Service may pool investors in one issuer and file a joint claim against the issuer as a "single"

plaintiff. Under this scenario, the "quasi-class" action is effected as follows:

- bondholders transfer their bonds to a management company on the basis of individual trust management agreements;
- the management company credits these bonds to a custody account opened, for example, with the National Depository Center (NDC);
- in its own name, the management company files a "single" "quasi-class" action associated with protecting rights of bondholders entrusting it with their bonds (seeking, for example, to have bonds redeemed or repurchase offers effected).

It is fair to say that a "quasi-class" action (whatever shape it takes) will enable investors to accomplish their goal with the highest chance of success. For example, provisional remedies are more likely to be granted by court where a "quasi-class" action by pooled investors is filed rather than in case of a single investor (no matter how big). Therefore, a "quasi-class" action and Securities Litigation are two inseparable notions (or even phenomena) in the Russian judicial practice that will shortly be implemented and employed by investors universally.

## Securities Litigation as a new practice area in the Russian law firms

While analyzing the legal and enforcement aspects of the Securities Litigation alone, it is impossible not to consider this phenomenon as a professional service area, as well as an exclusive practice area of some lawyers and law firms.

It is no secret that many law firms in developed Western countries (particularly, the USA) have been operating the whole **Securities Litigation** departments for ages. Associates in these departments are engaged exclusively in projects involving conflicts between investors and companies whose shares, bonds, depository receipts and other financial and investment instruments were placed and purchased at foreign trading sites. For a number of American law firms, this practice area is essentially their major; these firms have built teams of the strongest experts in the area of legal support for litigation and SEC investigations relating to misrepresentations made to investors by security issuers and other violations on the issuers' part.

It is clear there are no such practice groups, in their pure form, in Russian law firms. There are practice groups providing litigation support without any clear-cut specialization; there are practice groups majoring in legal support of security issues and their subsequent placement on the market. None of the Russian law firms, however, can boast a practice group today to be called a classic Securities

Litigation practice. Accordingly, no Securities Litigation as such has been spread in this country, either.

This is a natural state of things since it was not until relatively recently that market relations have set in Russia, while securities market started operating in the proper sense of the word only in early 2000. Besides, thanks to the stable economic climate in the country, up until mid-2008, none of the investors or issuers saw capital market distress similar to the one shaking it up during the current crisis. Only today, after a spate of defaults, bankruptcies and other crisis events, public discussions began in Russia on possible misrepresentations made to investors, on concealed or corrupted information provided by issuers and on the need of investigations with respect to certain issuers and managers to be undertaken by the RF Federal Financial Markets Service, etc.

Presently, practicing lawyers and separate law firms in Russia can (and should) absorb all the market trends. All the experience (both positive and negative) gained by Western colleagues in the areas of securities litigation and SEC investigations should be analyzed, and Russian business should be offered new legal products and new practice areas, where lawyers will render analogous top quality services under Russian laws.

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To sum up the above, it will be noted that positive perception and development of Securities Litigation as a new trend in legislation, judicial practice and services of Russian law firms by lawyers, judges, investors and issuers in the aggregate will have an exceptionally beneficial impact on the Russian investment climate. There is a trend taking shape in our country intrinsic exclusively to highly-developed economies, which may appear to be one of the prerequisites for Russia to become and be perceived as one of the leading international financial centers.

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