

**APPLICATION OF SHAREHOLDERS' AGREEMENTS: WHAT LESSONS CAN BE
LEARNED BY KAZAKHSTAN FROM THE US**

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Abstract

Shareholders' agreement¹ is a document, which is widely used in the common law countries (the United States of America, the United Kingdom, Canada, Australia etc.). Many experts tend to think that SHAs help to combine corporations², prevent hostile takeovers and provide mechanisms to plan a long-term business strategy of the corporation. SHAs also deserve special attention as a mechanism for minority shareholders' protection and inter-generational transfer of wealth in the US family close corporations.

Current Kazakhstani legislation does not regulate SHAs, however it also does not offer any restrictions on their conclusion. Due to the lack of legislative regulation, conclusion of SHAs is not a common practice in Kazakhstan. Recognition and enforcement of such agreements is also questionable.

The aim of this thesis is to analyze to what extent the use of SHAs would be reasonable in different Kazakhstani legal entities and find possible variants and mechanisms of SHAs' application in practice. In order to achieve this purpose the author examines the definition of the SHA, its types, peculiarities and matters, which can be regulated by the SHAs according to U.S. statutory and case law.

In Kazakhstan the theme of SHAs' applicability is new and topical. The thesis is one of the first attempts to examine what kind of American business practices and contractual solutions related to SHAs may be applicable in Kazakhstan context.

Particular attention is paid to the analysis of the SHA's and articles of association's³ comparative characteristics and correlation, validity of the SHAs in close corporations under U.S. statutory and case law. Practical advice on drafting of the SHAs and recommendations for

¹ Full definition or abbreviation "**SHA**" sometimes will be used for readability purpose.

² For the purpose of this paper the definitions of legal entity "**corporation**" and "**company**" are used interchangeably. "Corporation" is used in the U.S. and "company" in Kazakhstan.

³ Definitions of "articles of association" and "charter" are the same and used interchangeably. "Articles of association" is used in the U.S. and "charter" in Kazakhstan.

the strengthening of the regulatory framework in Kazakhstan are provided in the end of the thesis.

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Table

COMPARATIVE CHARACTERISTICS OF THE CHARTER (ARTICLES OF ASSOCIATION) AND SHAREHOLDERS' AGREEMENT

Characteristics	Charter (Articles of association)	Shareholders' agreement
Regulatory basis	Creation of the statutory law (primarily regulated by the statute)	Governed by the ordinary rules of the contract law
Binding effect	Bind all shareholders (stockholders) ⁴	Bind only shareholders signed shareholders' agreement
Mandatory / Voluntarily	Mandatory	Voluntarily
Number	One	Unlimited
Formalization	Mandatory, formal, written	Voluntary, less formal, written (should be set forth in the articles of association and approved by all shareholders participating in it)
Transparency	Available for public inspection (according to the legislative requirements)	Usually confidential
Duration	A company (corporation) should always has an articles of association as long as it remains in existence	Can be concluded by the shareholders and then terminated by the agreement of the parties
Scope	The whole complex of relationships between shareholders without details	In most cases conclusion of the agreement on a specific issue with all details
Time of primary development and adoption	On the stage of the company's establishment	At any stage of the establishment and functioning of the company
Modifications	More complex (through the registration process)	Consent of all shareholders participating in the agreement is necessary, unless agreement provides otherwise
Jurisdiction	In accordance with the legislation of the country	In some cases choice of jurisdiction is possible

⁴ Definitions “shareholder” and “stockholder” are the same in the US. The author use in the thesis definition “shareholder” for uniformity and consistency.

	where the company is registered	
Connection to new shareholders	Fulfillment of requirements is obligatory	Voluntarily (in practice new shareholders conclude the same agreement with the remaining shareholders or more commonly they enter into deed of adherence to be bound by the terms and conditions of the existing SHA)

List of abbreviations

ABA	American Bar Association
CBCA	Canada Business Corporation Act
DGCL	Delaware General Corporation Law
IBA	International Bar Association
IPO	Initial Public Offering
JSC	Joint Stock Company
LLP	Limited Liability Partnership
MBCA	Model Business Corporation Act
RK	Republic of Kazakhstan
RMBCA	Revised Model Business Corporation Act
SEC	United States Securities and Exchange Commission
SHA	Shareholders' agreement
U.C.C.	Uniform Commercial Code
U.S.	United States of America
USHA	Unanimous Shareholders' Agreement

Introduction

A shareholders' agreement is a popular instrument of corporate management in developed countries. However, it is largely unknown to Kazakhstani businessmen and counsels participating in global business transactions. Recently some foreign investors offered Kazakhstani companies to conclude a SHA for the settlement of specific issues. However, Kazakhstani legislation does not regulate SHAs. Therefore, there are only few articles devoted to this theme.

Kazakhstani legislation does not offer any restrictions on conclusion of the SHAs. However, the question of their recognition is controversial, since judges are not inclined to validate documents, which are not provided by the legislation. Moreover, they can recognize certain provisions of these documents as contradictory to current legislation.

The subject matter of this thesis is extremely topical today, since associates of law firms⁵ increasingly face the dilemma whether to advice their international clients to conclude SHAs in Kazakhstan or not. The problem is aggravated by the fact that due to the lack of legislative regulation, the use of the SHAs is not a common practice in Kazakhstan according to the case law⁶. However, one SHA was concluded recently by the Kazakhstani joint venture of two big international companies, but the fate of this agreement and possibility of it's enforcement in the future is questionable⁷.

Taking all the foregoing into account, the main goal of the thesis is to analyze to what extent the use of the SHAs would be reasonable in Kazakhstan: specifically, find out what is the main function of the SHAs, what types of the SHAs would make sense to introduce in Kazakhstan and what kinds of problems can be solved by SHAs' application.

⁵ The author works as an associate with one of the Kazakhstani law firm.

⁶ The author reviewed Kazakhstani case law from January 2005 till February 2016 in the Bank of judicial acts on the official web site of the Supreme Court of the Republic of Kazakhstan. The acts are available in Russian and Kazakh at <http://sud.gov.kz/eng> (last access 13-03-2016).

⁷ According to the confidentiality agreement concluded by the author, the names of the clients (international companies and joint venture) cannot be disclosed.

To achieve this purpose the following objectives will be undertaken. Firstly, to review U.S. statutory and case law with respect to the SHAs' application in close corporations and find out in which situations courts can invalidate SHAs and what kind of matters can be subject of the SHAs. Secondly, to review the main problems of the SHAs' application in Kazakhstan and determine relationships between SHAs and constitutive documents of the company. Thirdly, to consider definition of SHA and find out whether these documents can be confidential. Fourthly, the most important objective is to offer recommendations for the strengthening of the SHAs' legislative framework and prepare practical recommendations for the counsels drafting SHAs.

Selection of the United States as an analog jurisdiction for the research is not coincidental and based on the fact that the U.S. as one of the biggest worldwide business "sharks" has a solid experience of SHAs' application in close corporations. Moreover, there are some historically famous landmark decisions considering the issue of SHAs' recognition.

Timeliness of the research theme is confirmed by the fact that the problem of SHAs' implementation is one of the least studied themes in Kazakhstan. For realization of the goal and objectives of the research, historical and comparative legal research methods, as well as method of expert assessments, were used.

The author studied relevant material in such legal databases, as LexisNexis, JSTOR, HeinOnline, WestLaw and other e-sources. Books and articles, located through the CEU Library were analyzed to study opinions of different researchers in the field of corporate law and official comments to the relevant legislative acts. The Kazakhstani legal databases like PARAGRAF and ADILET were also used for the analysis of the Kazakhstani legislation and articles.

CHAPTER 1. OVERVIEW OF SHAREHOLDERS' AGREEMENTS IN THE U.S.

1.1. Statutory regulation of shareholders' agreements

Today SHA as a specific contractual mechanism for regulation of shareholders' internal relationships is quite common especially in the U.S. and other developed countries. However, even a cursory analysis of U.S. case law would show that the development of SHAs' practice has come a long way from invalidation of the SHAs by courts one century ago to their legislative recognition at the state level.

The emergence of corporate agreements in the US has occurred due to the deficit of flexible legal mechanisms to regulate the relationships between shareholders in order to plan for a long-term development of corporations and ensure inter-generational transfer of wealth.

Corporate agreements in the American legal system received the following modern regulatory distinction: "voting agreement" ("pooling agreement"⁸), "voting trust"⁹ and "shareholders' agreement". However, two centuries ago these definitions did not exist and sometimes case law referred to the so called "partnership agreements"¹⁰ or just "contracts" or "agreements between shareholders"¹¹.

The legal system of the United States does not doubt the right of shareholders to enter into agreements. The main problem of such agreements is rather the determination of the boundaries of the possible content.

We will focus on two major documents, which are the Model Business Corporation Act (hereinafter referred to as "**MBCA**"¹²) and the Delaware General Corporation Law (hereinafter

⁸ Voting agreement is "a contractual arrangement by which corporate shareholders agree that their shares will be voted as a unit. Also termed as a *voting agreement* or *shareholder control agreement*" (Black's Law Dictionary 789 (10th ed. 2014)).

⁹ Voting trust is "a trust used to hold shares of voting stock in a close corporation, usually transferred from a parent to a child, and empowering the trustee to exercise the right to vote. The trust acts as a custodian of the shares but is not a shareholder" (Black's Law Dictionary (10th ed. 2014)).

¹⁰ *Faulds v. Yates*, Illinois Supreme Court, 57 Ill. 416, 418 (1870) [hereinafter *Faulds v. Yates*].

¹¹ MODEL BUSINESS CORPORATION ACT WITH OFFICIAL COMMENTS AND REPORTER'S ANNOTATIONS / ADOPTED BY THE COMMITTEE ON CORPORATE LAWS OF THE SECTION OF BUSINESS LAW, §§ 7.30-7.32 (4th ed. 2008) [hereinafter *MBCA*].

¹² RMBCA was introduced in 1984, it is a revised version of the MBCA.

referred to as “**DGCL**”). They cover the main aspects of the SHAs’ statutory regulation and the majority of the states follow these two approaches. The MBCA is not a legal act, but a model statute, which is widely spread. Corporations’ laws in twenty-four states were made on the pattern of the MBCA with minor variations. However, the DGCL is the most influential act, governing corporations’ law in the state of Delaware, where the majority of all U.S. corporations are registered.

Validity of the shareholders’ voting agreements’ and articles’ of association restrictions on board discretion was established under the MBCA by 1969. Many states followed the same approach in substance and adopted provisions which permitted more flexibility and freedom of corporation’s management than was allowed under previous editions of general corporation laws¹³.

The MBCA has sections 7.30-7.32 related to the corporate agreements (SHA, voting trust and voting agreement). Amendments to the MBCA with respect to statutory regulation of the SHAs were drafted by the ABA’s Corporate Laws Committee in 1990¹⁴. The basic meaning of the section 7.32 is to establish the following what kind of legal provisions for corporations may be waived in the SHA. It is defined that such derogation is unacceptable, if the corporation's shares are listed on the stock exchange. The main goal of the section 7.32 is to regulate how SHAs can control a board of directors and limit it’s power in certain cases.

At first sight, voting trust and voting agreement can seem similar, however they are absolutely different. Definition and preconditions of the voting trust are prescribed by the statutory law. According to the official comments to the MBCA, “a voting trust is a device by which one or more shareholders divorce the voting rights of their shares from the ownership,

¹³ Dennis S. Karjala, *An analysis of close corporation legislation in the United States*, Arizona State Law Journal № 2, 663 (1989), available at

<http://homepages.law.asu.edu/~dkarjala/Articles/AzStLJFall1989.html#FN:Fa> (last access 23-03-2016).

¹⁴ *Changes in the Revised Model Business Corporation Act - Amendments Pertaining to Closely Held Corporations*, The Business Lawyer, Volume 46, № 1, 297 (1990), available at <http://www.jstor.org/stable/40687191> (last access 23-03-2016).

retaining the latter but transferring the former to one or more trustees, in whom the voting rights of all the shareholders, who are parties to the trust, are pooled”¹⁵. In return for voting rights shareholders get trust certificates which can be traded on the stock exchange. A trustee exercises the right to vote and performs other corporate acts in accordance with the material and procedural terms of the voting trust. Shareholders get economic benefits, however they do not hold shares and do not exercise the right to vote.

Until 2013 duration of the voting trust was limited to 10 years (with the possibility to extend this period for additional 10 years). In accordance with current statutory provisions, there are not any limitations, if otherwise not specified in the voting trust by the parties¹⁶. The MBCA provides special procedure for the creation of voting trust, according to which thirty-two states imposed an obligation for the trustee(s) to maintain a record of the beneficial shareholders at the registered office of the corporation. Contrary to this, the DGCL only provides opportunity for the shareholders to get a copy of voting trust to become familiar with its provisions¹⁷.

Case law illustrates that early decisions considered voting trusts illegal since they separated voting power from ownership title, which was declared against public policy¹⁸. Other courts enforced voting trusts, which goals were consistent with law, not fraudulent and not harmful to the interests of the shareholders, who did not participate in voting¹⁹. Adoption of the MBCA helped to secure status of voting trusts.

In comparison with voting trust, which is based on statutory law, voting agreement (or pooling agreement) is based on precedents. There is no special definition of voting agreement, as well as duration of this type of agreement is not limited by the MBCA.

¹⁵ *MBCA*, *supra* note 11, § 7.30.

¹⁶ *Id.*

¹⁷ Delaware General Corporation Law, tit 8, §218 (1953), available at <http://delcode.delaware.gov/title8/c001/sc07/> (last access 24-03-2016) [hereinafter *DGCL*].

¹⁸ *Sheppard v. Rockingham Power Co.*, Supreme Court of North Carolina, 64 S.E. 894, 776 (1909).

¹⁹ *MBCA*, *supra* note 11, § 7.30.

Section 7.31 of the MBCA clearly defines that provisions related to the voting agreement are not subject to the rules of voting trust. In case of the voting agreement, a shareholder appoints another person by the power of attorney to vote all shares subject to the agreement. Thus, unlike voting trust, voting agreement does not provide “transfer of the legal title of shares to the trustees and change in the record ownership of the shares”²⁰. Another difference from voting trust is that, filling of voting agreement is not mandatory by statute but shareholders may provide it by the agreement.

Since the validity of the SHA, voting trust and voting agreement is judged as for any other contract, both these documents should be in writing and signed by all parties.

The MBCA has section 7.32, which does not give definition of the SHA, but provides legal provisions, which may be derogated in the SHAs for it to be effective. At the same time, section 7.32(d) provides the requirement that such derogation is unacceptable, “if shares of the corporation are listed on the national securities exchange or regularly traded in the market maintained by one or more members of the national or affiliated securities association”²¹. According to the MBCA, SHA is valid even if it is contrary to the articles of association, but complies with the essential requirements, in particular:

1) SHA must be set forth in the articles of association (or bylaws) and approved by all shareholders, or, alternatively, it should be signed by all shareholders and they must provide written notice to the corporation about SHA;

2) SHA can be amended only by the unanimous consent of all shareholders, unless the SHA provides otherwise²².

The DGCL also does not give definition of the SHA, however in the section 350 it expressly allows agreements, which restrict discretion of directors in close corporation, if the

²⁰ *MBCA, supra* note 11, § 7.31.

²¹ *MBCA, supra* note 11, § 7.32.

²² *MBCA, supra* note 11, § 7.32 (b).

agreement concluded by “shareholders holding a majority of the outstanding stock entitled to vote (solely among shareholders or with a party which is not a shareholder)”²³. Thus, even though some of the shareholders are excluded from the agreement, it is valid. “Liability for managerial acts or omissions in this case will be transferred from directors to shareholders to the extent and for particular period defined in the SHA since power of the board of directors is controlled by the SHA”²⁴. Hence, shareholders may be liable for unlawful acts committed through the power granted by the SHA.

In the absence of section 350, the agreement limiting power of directors, could be declared void, since sections 141(a) and 102(b)(1) of the DGCL specify that management of the corporation organized by that section should be provided by the board of directors, except otherwise provided by the statute or certificate of incorporation²⁵. Indeed, in the past these agreements were claimed void, however in process of time case law became more favorable to the SHAs restricting discretion of the board and relevant provisions were adopted in the section 350.

It is important to emphasize that such agreement only binding among shareholders signed it and the agreement should not negatively affect interests of the creditors, public, third parties and shareholders not participating in the agreement, otherwise it should be set aside.

From the meaning of the section 350, somebody can make wrong conclusion that shareholders can replace board of directors. It is not right, since according to the section 350 direct shareholder management is permitted only to the extent specifically provided by the certificate of incorporation²⁶.

²³ *DGCL*, *supra* note 17, § 350.

²⁴ EDWARD R. WELCH, ANDREW J. TUREZYN, ROBERT S. SAUNDERS, *FOLK ON THE DELAWARE GENERAL CORPORATION LAW: FUNDAMENTALS*, 1040 (Aspen Publishers, 2011).

²⁵ *Id.*, at 99.

²⁶ *DGCL*, *supra* note 17, §351.

The content of section 354 of the DGCL is broader than that of section 350, since it validates agreements among shareholders even if they are “tantamount to the efforts to treat a close corporation as a partnership”²⁷. Such agreements *inter alia* can relate to any corporation’s affairs and management, dividends’ policy, election of directors and officers, employment of shareholders by the corporation or issues of disputes resolution mechanisms²⁸.

As well as the MBCA, the DGCL also recognizes validity of voting agreements under section 218 and reasonable restrictions on transfer of shares are also valid under section 202²⁹. The right of first refusal and first option are the most common forms of restrictions since close corporations usually strive to limit the ability of their shareholders to sell shares to outsiders and impose requirements that shares should be sold back to the corporation after the death of the shareholder³⁰.

To conclude, statutory regulation of the SHAs tend to provide a great degree of flexibility and freedom of contract in the sphere of the SHAs’ regulation and the most important limitation is related to the possibility to restrain the board of directors.

1.2. Legislative recognition of close corporations

Both fixing the status of close corporations in the legislation of several states and major judicial precedents contributed to gradual acceptance and legitimization of the SHAs in close corporations. The first factor will be discussed in this subchapter.

²⁷ E. J. Bradley, *A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes*, Duke Law Journal, Volume № 3, 525–535 (1968) available at <http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2172&context=dlj> (last access 24-03-2016).

²⁸ *DGCL*, *supra* note 17, §354.

²⁹ *DGCL*, *supra* note 17, §§ 202, 218.

³⁰ Ayres Ian and Stephen Choi, *Internalizing Outsider Trading*, Michigan Law Review, Volume 101, №. 2, 382 (2002).

In order to consider statutory regulation of close corporations it is important to emphasize that there is no US federal regulation of corporations. All legal issues related to corporations are regulated on the state level and states' legislations can vary significantly in certain spheres.

In comparison with many countries of continental Europe, initially US law did not provide for a business enterprise form, similar to the limited liability company. The activities of all business corporations, which were provided for limited liability of participants, were regulated by the general law of corporations. Due to the fact that there was a need for a legal structure similar to the limited liability company, separate rules applicable to close corporations were gradually developed in case practice.

Besides case law, the problem of shareholders' agreements' admissibility and recognition was partially resolved by introduction of the MBCA in 1950. However, a major shift occurred when the status of close corporations was fixed in the legislation of several states in the middle of the 20th century³¹. One of the first states which established a statutory definition of "close corporation" were Delaware, North Carolina and New York³². The DGCL devoted special subchapter for the regulation of close corporations.

After Delaware fifteen other states followed the same approach³³. However, statutory provisions related to close corporations varied considerably, courts started to recognize SHAs as valid documents and subject to protection in close corporations. At the same time with the adoption of the MBCA in 1984, Model Statutory Close Corporation Supplement was

³¹ Joseph L. Weiner, *Legislative Recognition of the Close Corporation*, 27 Michigan Law Review, Volume 27, 273 (1928).

³² *DGCL*, *supra* note 17, §341-356.

³³ The fifteen states were California, North Dakota, Maryland, Minnesota, Wisconsin, Texas, Alabama, Arizona, Kansas, Maine, South Carolina, Georgia, Illinois, Pennsylvania and Rhode Island.

introduced by the ABA³⁴. The latter document included Section 22, which established a possibility of complete replacement of close corporation's bylaws by the SHAs³⁵.

As a result of the states' legislative activity, there was a mix of different corporation laws for private corporations. Both general corporation laws and close corporation statutes were available to private corporations, however initially many of new corporations continued to rely on the general corporation statutes. Moreover, because of the well-known policy of "regulatory competition" in the US a corporation can be established under the law of the state other than the state where the corporation is practically situated or where "it has most or all of its contacts"³⁶. Under this policy there is a competition among the states in order to attract more corporations to be established in a certain state and, hence, get more taxes from them.

Almost all acts related to the close corporations offer provisions that the close corporation's certificate of incorporation must contain "a heading stating the name of the corporation and denotation that it is a close corporation"³⁷. The DGCL and the MBCA define an acceptable maximum number of shareholders. For example, the DGCL specifies that this number must not exceed 30 persons.

Status and activity of public corporations in the United States are very strictly regulated not only by the legislation, but, mostly, by the United States Securities and Exchange Commission (hereinafter referred to as "SEC"), while the status and activity of close corporations are subject to much less statutory and regulatory constraints.

One of the main incentives for the introduction of a close corporation type of business were the special management arrangements. Firstly, shareholders in close corporations often

³⁴ *Proposed Statutory Close Corporation Supplement to the Model Business Corporation Act*, The Business Lawyer, Volume 37 № 1, 269–311 (1981).

³⁵ Model Statutory Close Corporation Supplement, available at <http://ebook.%20Administration/ppendix%20H%20-%20Model%20Statutory%20Close%20Corporation%20Supplement.pdf> (last access 21-03-2016).

³⁶ Dennis S. Karjala, *supra* note 13, at 671.

³⁷ *DGCL*, *supra* note 17, §343.

wanted to participate in the management of corporation. Secondly, minority shareholders wanted to be sure that their interests would not be violated. Thirdly, there was a tendency to decrease expenditures for the management of close corporations. Thus, US legislation tried to address these issues.

According to the general corporation statutes majority shareholders could *inter alia* determine who will be an employee, indicate the direction of corporation's activity and decide whether to declare dividends or not. Protection of the minority shareholders' interests can be realized by a cumulative voting, conclusion of the SHAs, adoption of a special decision-making system and enforcement of rights in voting through the issuance of shares of different categories. In the latter case benefits of the owners of the shares of a certain category should be fixed in the articles of association. Mutual obligations of shareholders to vote in a certain way, for example, to choose each other as directors can be provided by the SHAs.

To summarize legislative recognition of the close corporations was explicit in some states (the most prominent is Delaware, which defines special provisions to close corporation) and implicit in others (for example, North Carolina, where close corporations are eligible for special regulation only indirectly, as "corporations which has a few or limited number of shareholders and whose shares are not generally traded in the securities market"³⁸). Implicit recognition envisaged that certain SHAs should be invalidated on the ground that they impede discretion of the board of directors.

³⁸ George J. Siedel, *Close corporation law: Michigan, Delaware and the Model act*, Delaware Journal of Corporation Law, Volume 11, 384-390 (1986), available at <http://www.djcl.org/wp-content/uploads/2014/08/CLOSE-CORPORATION-LAW-MICHIGAN-DELAWARE-AND-THE-MODEL-ACT.pdf> (last access 22-03-2016).

1.3. Validity of shareholders' agreements under US case law

The first references to the corporate agreements between shareholders can be found in U.S. case law of the 19th century. In *Faulds v. Yates* case (1870) the Supreme Court of Illinois recognized the agreement of majority shareholders, determining the order of voting by shares. In this case the aim of the agreement was to establish corporate control. The court emphasized that majority shareholders “have the right to select the agents for an honest management of the corporation”³⁹. In the court’s view, “it was strange that a man cannot, for honest purposes, unite with others for the protection and security of his property and rights, without liability to the charge of fraud and inequity”⁴⁰.

Application of the voting agreement can be illustrated by *Smith v. San Francisco & North Pacific Railway co.* case (1897), where “the votes of two shareholders were rejected on the ground that they were not *bona fide* shareholders and that, by force of a certain agreement, the stock had been pooled for the term of five years and was cast in pursuance of that agreement”. At the preliminary meeting, the shareholders “agreed that for the period of five years they shall vote the said stock in one block at all elections for officers”⁴¹. The Supreme Court of California held that “there was an adequate consideration for the agreement granting the right to vote the stock. The court decided that the shareholders were *bona fide* shareholders of the corporation”⁴².

In the early stages of corporate development court decisions were hostile to recognition of the SHAs. There were many cases when courts invalidated SHAs on the grounds that they were against public policy or violated state law on the control of corporations. In *Harvey v. Linville Improvement Co.* the court decided, that pooling agreement was contrary to public policy. It was emphasized that “agreements by which the shareholders surrendered their voting

³⁹ *Faulds v. Yates*, *supra* note 10, at 416.

⁴⁰ *Id.*

⁴¹ *Smith v. San Francisco & North Pacific Railway co.*, Supreme Court of California, 47 P. 582, 596 (1897) [hereinafter *Smith v. San Francisco*].

⁴² *Id.*, at 588.

powers were invalid. The power to vote was inherently inseparable from the real ownership of each share, and could only be delegated by deputy with power of revocation”⁴³.

In *Hafer v. N.Y.L.E. & W.R.R. Co.* (1885) the court decided that the interests of the shareholders pursued by the corporate agreement could not contradict to the interests and welfare of the corporation⁴⁴. In this case, by interests of the corporation were implied interests of the majority shareholders. The court held that the voting trust agreement was invalid at the suit of minority shareholders. The argument was that when a shareholder voted himself, pecuniary interests impelled him to vote in a manner favorable for the corporation’s welfare. Contrary to this, if somebody else voted for the shareholder, he or she might pursued interests and motives, which would not contribute, to the welfare of the corporation⁴⁵.

In *Boyer v. Nesbitt* (1910) voting agreement between shareholders, which pursued corporation’s “interest of maintaining the sound business policy of the corporation”⁴⁶, was recognized valid and subject to judicial protection.

By the beginning of the 20th century, voting agreements were more often considered valid if they did not involve fraud⁴⁷ and did not infringe US law⁴⁸, corporations’ constituent documents and bylaws. In addition, such agreements should not limit the discretion of the directors or operated in order to oppress shareholders⁴⁹. Sometimes courts also invalidated agreements when a non-shareholder was empowered to vote for shareholders and he voted in

⁴³ *Harvey v. Linville Improvement Co.*, Supreme Court of North Carolina, 24 S.E. 489, 699 (1896).

⁴⁴ *Hafer v. N.Y.L.E. & W. R. R. CO. ET AL.*, State of Ohio, Superior Court, Cincinnati, 13 (1885) [hereinafter *Hafer v. N.Y.L.E.*].

⁴⁵ Louie M. Horne, *Voting Trust Agreements in Indiana*, Indiana Law Journal, Volume 19, 228 (1944), available at <http://www.repository.law.indiana.edu/cgi/viewcontent.cgi?article=3980&context=ilj> (last access 23-03-2016).

⁴⁶ *Boyer v. Nesbitt.*, Supreme Court of Pennsylvania, 76 A. 103, 398 (1910).

⁴⁷ *Randall v. Howard*, Supreme Court of the United States, 17 L. Ed. 269, 588 (1862).

⁴⁸ *Kantzler v. Bensinger*, Supreme Court of Illinois, 73 N.E. 874, 10 (1905).

⁴⁹ LeRoy H., Redfern S., *Corporations – Shareholders’ voting agreement – Drafting precautions*, Michigan law review, Volume 46 № 1, 70-77 (1947).

a way, which was unfavorable to the welfare of the corporation as was decided in *Hafer v. N.Y.L.E. & W.R.R.* case (1885)⁵⁰.

Another example, where voting shareholders' agreement was held valid is *Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling* case⁵¹. The Supreme Court of Delaware held that mutual promises were a sufficient ground for conclusion of the voting shareholders' agreement. This fact helped to exclude the problem of consideration⁵².

In addition, as were pointed out by Ventrizzo, SHA "was not used as a control enhancing device among American listed corporations since unlike close corporations, rights of minority shareholders in listed corporations were adequately protected by the legislation, and this fact excluded the necessity to resort to contractual mechanisms"⁵³.

1.3.1. No damage to the third parties as one of the grounds for recognition of SHA

In this subchapter and two others we will consider several landmark decisions on recognition of the SHAs, among which are *Clark v. Dodge* (1936)⁵⁴, *McQuade v. Stoneham* cases (1934)⁵⁵, *Galler v. Galler* (1964)⁵⁶ and *Zion v. Kurtz* (1980)⁵⁷.

Clark v. Dodge (1936) and *McQuade v. Stoneham* cases (1934) are the most prominent examples of how courts determine validity of the SHAs in two, at first sight, similar cases. In *Clark v. Dodge* case, Mr. Dodge owned 75% shares of Bell & Company, Inc. and Hollings-Smith Company, Inc. The remaining 25% of shares were co-owned by Mr. Clark. Shareholders

⁵⁰ *Hafer v. N.Y.L.E.*, *supra* note 44, at 7.

⁵¹ *Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling*, Supreme Court of Delaware, 53 A.2d 441, 612 (1947).

⁵² Comment, *Corporations: Voting Trusts and Irrevocable Proxies*, California Law Review, Volume 36, 282 (1948), available at http://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?_californialawreview (last access 19-03-2016).

⁵³ Ventrizzo M., *Why Shareholders' Agreements are Not Used in U.S. Listed Corporations: A Conundrum in Search of an Explanation*, Penn State Law Research Paper № 42-2013, 5 (2013).

⁵⁴ *Clark v. Dodge*, Court of Appeals of New York, 199 N.E. 641, 413 (1936) [hereinafter *Clark v. Dodge*].

⁵⁵ *McQuade v. Stoneham*, Court of Appeals of New York, 189 N.E. 234, 331 (1934).

⁵⁶ *Galler v. Galler*, Illinois Supreme Court, 203 N.E. 2d 577, 579-587 (1964) [hereinafter *Galler v. Galler*].

⁵⁷ *Zion v. Kurtz*, Court of Appeals of New York, 428 N.Y.S.2d 199, 683-685 (1980).

entered into agreement under which terms Mr. Clark agreed to disclose to Mr. Dodge's son a secret formulae of certain medicines' manufacturing and Mr. Dodge in return promised that he would keep Mr. Clark as a director and would pay him 25% of all net income provided that Mr. Clark would be betrayed to the interests of the corporation and competent in management issues⁵⁸. Under agreement Mr. Dodge also promised that he would not set salaries to other workers of the corporation, which would adversely affect the amount of income that would be paid to Mr. Clark.

After some time, Mr. Dodge did not vote for Mr. Clark for a director position and stopped to deliver promised percentage from the revenue. Mr. Clark sought enforcement of the SHA, reinstatement and payment of money. Mr. Dodge cited *McQuade v. Stoneham* case, decided two years before, claiming that the SHA was unlawful since it was "an attempt to remove questions bound up with the management of the corporation from the discretion of the directors", prohibited by the New York Corporation law⁵⁹. However, in *Clark v. Dodge* case the court enforced agreement. It highlighted that in *McQuade v. Stoneham* case the similar agreement was invalidated because it negatively affected third parties, who did not participated in the agreement, and therefore it was against public policy. Contrary to this, agreement in *Clark v. Dodge* was concluded between two sole shareholders who jointly had 100 % ownership of the corporations. The court pointed out that the SHA was concluded unanimously. In addition, contrary to *McQuade v. Stoneham* case, there was not general limitation upon the power of the board of directors in *Clark v. Dodge* case. Hence, interests of the state, creditors and possible purchasers of the shares were not affected.

Subsequently court's decision in *Clark v. Dodge* case found support in other states of the country. However, many of the issues arising in association with SHAs, invading the sphere of

⁵⁸ *Clark v. Dodge*, *supra* note 54, at 641,643.

⁵⁹ *Corporations. Validity of contract between shareholders of "close" corporation to control discretion of directors*, *Columbia Law Review*, Volume 36 № 5, 836–838 (1936).

the boards of directors' activity, were still unresolved. Among them was the question how far can go shareholders in respect of exemption the function on corporate governance from the competence of the board.

1.3.2. Inter-generational transfer of wealth in family close corporations

Galler v. Galler is a landmark decision, which opened a new era in the development of the SHAs in close corporations since it reflected a greater willingness to enforce SHAs. The court in this case uphold the agreement despite the fact that it was inconsistent with statutory norms.

In Galler v. Galler case two brothers Benjamin Galler and Isadore Galler established family business corporation, where initially they were equal partners. After 20 years brothers decided to involve in business one of its employee, Mr. Rosenberg. Each of the brothers contracted to sell him six shares payable within 10 years⁶⁰. Then two brothers concluded a shareholders' agreement "for the financial support and maintenance of their immediate families to assure their family members, that after the death of either brother, they will have equal control under the corporation"⁶¹.

After Benjamin Galler's death, his wife, Emma Galler wanted enforce SHA. However, Isadore Galler refused and offered modifications unfavorable to the widow. Hence, Emma Galler brought a proceeding to enforce the SHA⁶².

Let us consider the key provisions of the challenged SHA. Firstly, shareholders agreed that "the bylaws of the corporation would be amended to provide for a board of four directors and that the necessary quorum should be three directors"⁶³. The survived shareholders "would

⁶⁰ LINDA O. SMIDDY AND LAWRENCE A. CUNNINGHAM, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES, MATERIALS, PROBLEMS, 162-163 (Lexis Nexis, ed. 8th, 2014) [hereinafter *Cases, Materials*].

⁶¹ *Galler v. Galler*, *supra* note 56, at 580.

⁶² *Cases, Materials*, *supra* note 60, at 162-163.

⁶³ *Galler v. Galler*, *supra* note 56, at 580.

cast their votes only for Galler brothers and their wives at any meeting held to elect new directors”. Secondly, “in case of the death of either brother his wife should have the right to nominate a new director instead of the decedent”. Thirdly, certain dividends should be declared by the corporation on annual basis. “The dividends calculation should be dependent on accumulated earned surplus in excess of \$ 500,000. If the net profits are less than \$ 50,000, nevertheless the minimum \$ 50,000 annual dividends should be declared”⁶⁴. At the same time, each widow was provided with payment of a sum twice of her husband's salary for 1 (one) year, payable every month during five years⁶⁵.

During the trial, Mr. Rosenberg sold 12 (twelve) shares to Isadore Galler. The defendants claimed that the SHA was invalid and unenforceable since it was in contradiction with the Illinois Business Corporation Act and corporations’ bylaws. The Appellate court invalidated SHA on the grounds that the duration of the SHA was not specified and that the SHA’s purpose violated state law and public policy. However, at that time, state law prohibited such agreements and in the earlier cases similar SHAs were invalidated, the Supreme Court of Illinois reversed the lower court decision, recognized and enforced SHA.

The court pointed out that a duration of the SHA could not be specified since the date of the shareholders’ death could not be predicted in advance at the date of the SHA’s conclusion. The court also quoted from Clark v. Dodge case that “there was no reason why mature men should not be able to adapt the statutory form to the structure they want, so long as they did not endanger other shareholders, creditors or public and did not violate a clearly mandatory provision of the corporation law”⁶⁶. In the close corporations the SHAs were usually the result of careful deliberations of all shareholders⁶⁷.

⁶⁴ *Cases, Materials, supra* note 60, at 162-163.

⁶⁵ Spoerri J.F., *Close corporation shareholder agreement sustained*, *The Business Lawyer*, Volume 20 № 4, 1099-1100 (1965).

⁶⁶ *Id.*

⁶⁷ *Id.*

By its decision, the Supreme Court of Illinois determined the following criteria for the validity of SHAs.

- 1) no fraud or damage to the creditors and third parties;
- 2) absence of claims from minority shareholders; and
- 3) non-violation of public interests.

According to the decision, the court recognized a right of shareholders to change management structure of the close corporation under “own needs” of shareholders.

The author absolutely agrees with the court’s decision and wants to emphasize that the SHA in a family corporation is especially sensitive issue for the family members, since family is *sui generis* a close “organization”. Family members have different set of vulnerabilities and expectations than do shareholders in other types of close corporations, or, moreover, shareholders in public corporations. Shareholders in the family close corporations often expect to run business in the manner of a partnership.

A direct shareholder management is very common in the family corporations. This means that, in comparison with large corporations, the same people in family businesses usually represent the management team and the board of directors. Family members usually want to include in the SHAs specific provisions related to the voting rights, maximum number of persons permissible in the board of directors, composition of the board, dividends distribution, dispute resolution mechanisms and so on.

Transfer of shares is one of the most common issues in family businesses, since members of the family always want to retain control under corporation and prevent hostile takeovers or outsiders from becoming new shareholders, since they could change “family traditions of running business” or do not appreciate family values or simply be incompatible with existing shareholders by their personal qualities. Furthermore, elderly people want to transfer business to their descendants and provide income for other family members. SHA can offer provision

that the shares should be transferred to the shareholder's spouse after special life circumstances (for example, divorce or death of the head of the family).

Conflicts between family members are very common. Hence, dispute resolution mechanisms (for example, arbitration or mediation) provided in the SHA in many cases will contribute to maintain friendly relationships, save time and decrease costs significantly. For all these purposes, SHA can be an effective mechanism, which can secure interests of the whole family on confidential basis.

As was illustrated in the US, the SHAs in family close corporations are very popular. These countries have a solid experience with respect to intergenerational transfer of wealth by means of SHAs. Contrary to this, Kazakhstani business is a business of a first generation. The Kazakhstani entrepreneurs' attitude to the issues of management and long-term planning differs significantly from the Western one. According to different reports, most of Kazakhstani businessmen do not see perspectives to transfer business to descendants. They prefer to sell business in the future or attract investors (through IPO). Some businessmen note descendants' lack of preparation for business management or their unwillingness to continue a family run business in Kazakhstan⁶⁸. Businessmen strive to provide family welfare through the creation of liquid assets funds designed to support the family in the future. In addition businessmen tend to invest money in real estate or education of their children abroad. There are also cases when after the death of the founder his or her family members are put under pressure to sell business at a lower price. Therefore, these factors negatively affect the development of mechanisms

⁶⁸ M. Dzhulaeva, Problemy razvitiya semeynogo biznesa v sovremennoy ekonomike, KazNU byulleten', seriya Ekonomika №3 (103), 44 (2014) [M. Dzhulaeva, *The problems of development of Family business in modern economy*, KazNU Bulletin, Economics series №3 (103), 44 (2014)], available in Russian at www.kaznu.kz/index.php/math/article/download/221/196.

(including SHAs) which help to organize management of family business through generations. The author believes that this situation will change in the future.

1.3.3. Protection of minority shareholders' interests

Another one U.S. precedent, which deserves attention, is *Zion v. Kurtz* case. Court practice has developed specific contractual ways to protect the rights of minority shareholders. One of the most important mechanisms for the protection of the rights of minority shareholders from abuse by majority shareholders are agreements negotiated between all shareholders. These agreements *inter alia* can provide certain guarantees to minority shareholders, for example, shareholders can make decisions on certain issues only by unanimous concern, even if it is not required by the current legislation. Such agreements have priority over the statutes according to the principle of party autonomy.

Example of such agreement can be illustrated by *Zion v. Kurtz* case. According to the facts, Harold W. Kurtz and Abraham Zion were majority and minority shareholders respectively. As the shareholders of public corporation they concluded the SHA that prevented corporation from conducting any business or activities of the corporation without the consent of the minority shareholder. After that, Kurtz breached this agreement by entering into two agreements without Zion's consent. Zion sued for the enforcement of the SHA and invalidation of two agreements concluded without his consent. Court of Appeals of New York decided that the SHA was valid since interests of the third parties were not impaired and it was not against statute or public policy to enter into agreement, which restricted power of the board of directors. The interesting fact of this case is that the court enforced the SHA even the formal requirements tailored by the DGCL to close corporation were not fulfilled. Hence, Judge Gabrielli dissented and stated that noncompliance with the statutory requirements to close corporation was a barrier to the enforcement of the SHA. According to the dissenting opinion, public must be

aware about the status of corporation through the articles of association to understand whether the shareholders are managing the corporation or not since the shareholders have only limited liability in comparison with directors who have fiduciary duties.

The author tend to agree with the court's decision. There is no precise statistics, but according to many reports, SHAs are uncommon in public corporation. However, there is no any restrictions to enter into SHA in public corporation. As is shown by the facts, interests of the third parties were not violated. Zion relied on the SHA perspective before he agreed to buy shares in the corporation. Moreover, it was a willingness of both parties to conclude the SHA since not only the minority, but also the majority shareholder got benefits through loan agreement and nonrecourse guarantee.

1.4. Definition of shareholders' agreement, its application and main characteristics

SHA firstly is a contract between two or more shareholders. However, future shareholders or corporation itself also can be a party to the SHA in certain cases. All rules applicable to any commercial contract also applicable to the SHA. Simple contract tend to allocate the risks and describe the terms and conditions of the transaction, which should be completed at a particular time. Contrary to this, SHA is more a plan for a future, which envisages agreement of shareholders on rules applicable in various circumstances, which should govern shareholders' relationships.

Analysis of US case law allows us to say that historically corporate agreements were concluded based on the principle "freedom of contract", which is a key principle of common contract law and one of the fundamental basics of market economy. It served as a legal justification for the shareholders' agreements.

In order to discuss definition and main characteristics of the SHA, it is important to emphasize that SHA is an important mechanism, which ensures shareholders that application

of the law in a manner that they never intended is avoided. Moreover, in the process of the SHA's negotiation shareholders can discuss the most effective ways to tackle the most difficult problems they may encounter. Hence, it helps shareholders to save time and money by not participating in expensive disputes. The main purpose of the SHA is deriving profit for the corporation and protection interests of shareholders.

The author tend to think that the SHAs can be characterized as mixed, consensual corporate agreement, mutually advantageous for shareholders participating in it. The SHAs have a fiduciary character taking into account liabilities of shareholders participating in the SHA. A shareholder entered into the SHA is obliged to exercise his or her rights certified by the shares, and (or) the rights to the shares and (or) refrain from committing them through concerted actions stipulated by the SHA.

Although SHAs can be concluded by the shareholders' of public corporation, they are more common in close corporations, especially small firms, startups and family businesses. Emergence of the SHAs, in particular, caused by the features of the American financial market, traditionally characterized by spreading of corporate capital among many small shareholders. This fact sometimes makes it possible for a shareholder, having 5 – 6 % or even less number of shares, to have control under the corporation. Hence, minority shareholders, constituting the majority of corporation's members, inevitably excluded from the corporation's management, giving it to the board of directors. Abuse of corporate management *inter alia* led to the gradual transformation of the board of directors from the main executive bodies to corporate control bodies. This tendency has resulted in the appearance and then predominance of independent directors in the board of directors. Thus, shareholders' agreements became one of the most effective mechanisms of control over corporate management, which can limit the competence of managers and directors to some extent.

The need for the shareholders' agreements also arises when some of the shareholders became members of the board of directors as is illustrated by the *Galler v. Galler* case above. This is especially common in small close corporations to regulate relationships of such shareholders with other “ordinary” shareholders. Directors have fiduciary duties, as well as the duties of loyalty and care, which they should keep up in managing the corporation.

As was already mentioned in the beginning there is not unified commonly accepted definition of the SHA. Black’s Law Dictionary also does not offer a specific definition for the SHA. In a broad sense by the SHA can be understood any contract between all or several shareholders indicating *inter alia* shareholders' rights and obligations, protection of the shareholders and rules how the corporation should be managed.

According to the IBA Guidelines on Shareholders’ Agreements, one formality applicable for the SHA is that it should be concluded in written form and must be signed by all the participating shareholders⁶⁹. In the past MBCA envisaged the term of the SHA, which could not exceed 10 years, but could be prolonged for the same period⁷⁰. Currently there is no such requirement, hence shareholders can specify any term. However, in practice some SHAs offer provisions for its termination upon merger, sale or liquidation of the corporation.

One of the main benefits of the SHA are confidentiality and flexibility. Articles of association is publicly assessable and the process for its amendment is time-consuming. Contrary to this, shareholders’ agreement offers more flexible and confidential forum. Furthermore, SHA helps to bridge the gap between issues addressed by the statute and bylaws and those rules that the shareholders want to be in place.

Application of SHAs not only helps to avoid hostile takeovers, but also has a positive effect on the activity of many corporations, especially venture corporations where participants

⁶⁹ IBA Guide on Shareholders' Agreements (2012), available at http://www.ibanet.org/LPD/Corporate_Law_Section/Clsly_Held_Growing_Busi_Entprs/shareholderagreements.aspx (last access 23-03-2016).

⁷⁰ *MBCA*, *supra* note 11, § 7.32.

of venture capital financing want to have additional guarantees not provided by the articles of association. Activity of the majority venture capital corporations is characterized by several rounds of financing and implementation of innovations, which requires confidentiality. SHAs help to regulate issues connected to such features of the corporation's activities as well as serves as a mechanism for reduction of corporation's operational costs in the course of its daily activities. For these purposes SHAs can offer provisions related to dividend policy, guarantees, confidentiality, intermediate goals of the corporation, terms of shares' distribution among the shareholders and so on⁷¹.

1.5. Different classifications of shareholders' agreements

The author made a research on classification of shareholders' agreements and found that there are just a few sources devoted to this issue. Here the author offers classification, which she considers the most appropriate. However, other researchers are welcome to offer their ideas on this issue.

Firstly, shareholders' agreements can be divided into two big groups by subject of their regulation. The first group regulates the procedure for the implementation of voting rights at the general meeting. It includes such agreements, as voting trust agreements, voting agreements, veto agreements and transfer of voting rights agreement. According to Christian H. Quack, veto agreements are concluded "in order to protect interests of minority shareholders through the establishment of higher thresholds for corporate decision-making by the general meeting of shareholders"⁷².

⁷¹ Yael V. Hochberg, *Venture Capital and Corporate Governance in the Newly Public Firm*, Review of Finance, 3-5 (Northwestern University & NBER Working paper, September 6, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=474542 (last access 22-03-2016).

⁷² Christian H. Quack, *Shareholder agreements in Canadian Close Corporations*, L.L.M. thesis, McGill University 46-54 (December, 1982), available at http://digitool.library.mcgill.ca/webclient/StreamGate?folder_id=0&dvs=1458858932956~943 (last access 15-03-2016).

The second group regulates the procedure for the implementation of the rights for alienation of shares. It includes pooling agreements, stock-restriction agreements, buy-sell agreements, shareholders' tender agreements, securities lending agreements and so on.

Those types of corporate agreements which have characteristics of several above-mentioned agreements can be qualified as mixed or hybrid shareholders' agreements, since, as was already mentioned, scope of issues which can be regulated by the SHA is almost unlimited⁷³.

Secondly, scholars tend to differ corporate agreements concluded in public and close corporations. For example, voting agreement can be concluded by the shareholders of both public and close corporations, whereas stock-restriction agreement is common among members of close corporation.

Some scholars also define lockup agreements as the SHAs⁷⁴. According to the SEC definition lockup agreements prohibit shareholders, including their family members, employees, venture capitalists to sell their shares for a certain period of time⁷⁵. In case of IPO lockup agreements are very helpful. Most of the corporations who first go public use these types of agreements concluded between shareholders and underwriter. Process of IPO is connected to significant internal changes in the corporations. Thus, it is necessary to balance situation inside of management staff (to make permanent balance of powers at least for a certain period of time).

Analysis of different sources let us to conclude that researchers and scholars define other types of SHAs. According to Sean FitzGerald and Graham Muth, SHAs also include "joint

⁷³ *MBCA*, *supra* note 11, § 7.32.

⁷⁴ Goergen M., Renneboog L., Khurshed A., *Explaining the Diversity in Shareholder Lockup Agreements*, *Journal of Financial Intermediation* Volume 15, № 2, 265 (2006), available at https://www.researchgate.net/publication/222404031_Explaining_the_Diversity_in_Shareholder_Lockup_Agreements (last access 16-03-2016).

⁷⁵ Official web-site of U.S. Securities and Exchange Commission, *Initial Public Offerings: Lockup Agreements* <https://www.sec.gov/answers/lockup.htm> (last access 17-03-2016).

venture agreements” and “put and call option agreements”⁷⁶. The author believes that even the above listed agreements do not cover a mixed variety of different agreements, which can be concluded in the course of corporation’s activity.

1.6. The most common types of the shareholders’ agreement

Main characteristics of the SHAs and issues, which can be subject of the SHAs’ regulation, help us to identify several most common types of the SHA. However, as was noted in the previous subchapter there are many mixed types of shareholders’ agreements, therefore sometimes it might be difficult to differ one from another.

First of all, let us consider one of the most popular types of the SHA which is a unanimous shareholders’ agreement (hereinafter referred to as “**USHA**”). The USHA is typical for startup and family business corporations. All shareholders of all classes of shares must be parties to this agreement. Through the research the author considered different definitions of the USHA proposed by the American scholars, but she found that the most precise and short definition is offered by the Canada Business Corporation Act (hereinafter referred to as “**CBCA**”)⁷⁷. It defines that USHA is “an agreement concluded by all shareholders of the corporation or all shareholders of the corporation and one or more persons who are not shareholders that restricts the power of the board of directors to manage or supervise the management of the business and affairs of the corporation”⁷⁸.

By the definition provided it is clear that the USHA significantly helps shareholders to control decisions of the board. However, at the same time shareholders have all duties and liabilities of the directors to the extent that the USHA restricts the powers of the board to

⁷⁶ SEAN FITZGERALD AND GRAHAM MUTH, *SHAREHOLDERS' AGREEMENTS*, 303, 323 (Sweet & Maxwell Ltd, 5th ed., 2009) [hereinafter *SHAs' Book*].

⁷⁷ Regulation of SHAs in Canada and the US is quite similar.

⁷⁸ Canada Business Corporations Act, Part XII, s. 146 (1) (1994), available at <http://laws-lois.justice.gc.ca/eng/acts/C-44/FullText.html> (last access 24-03-2016) [hereinafter *CBCA*].

manage corporation. This includes even non-voting shareholders and shareholders who do not involve in the exercise of the powers, restricted by the USHA⁷⁹.

In comparison with section 350 of the DGCL, which does not specify how discretion of directors can be limited, sections 25(1), 103(1), 125, 121(a), 189(1) of CBCA define that discretion of the board can be limited to *inter alia* issue of shares, amendment or repeal of by-laws, fixation of the directors' and management's remuneration, appointment of officers and borrow money (or give guarantees on behalf of the corporation), respectively⁸⁰. The author mentions these provisions to illustrate what kind of issues can be subject of the USHA regulation not only in Canada, but also in the U.S.

In practice, USHA is very attractive for shareholders who want to compel distribution of dividends upon the demand of a certain number of shareholders. Similarly, shareholders can control expenditures of directors if, for example, they exceed certain amount and require additional approval by the shareholders.

One of the significant disadvantages of the USHA relates to the issues of its amendment and termination. In most cases termination and all amendments to the USHA can be made subject to unanimous approval by all parties at the date of the agreement. Moreover, in course of time there is a tendency that number of shareholders will increase, thus, ability to terminate or amend the USHA will consequently decrease. Even if one shareholder disagree to amend the USHA, other shareholders will be unable to do anything⁸¹. However, well-drafted shareholders' agreement can help to override this problem and provide mechanism that amendment of the USHA can be available upon a certain vote being taken or the USHA can be terminated on a specific date or occasion. More recommendations on drafting of the SHAs will be discussed in the third chapter of the thesis.

⁷⁹ RICKY W. EWASIUK, DRAFTING SHAREHOLDERS' AGREEMENTS: A *GUIDE*, 15 (Thompson Canada Limited ed., 1998) [hereinafter *Guide on Drafting SHAs*].

⁸⁰ *CBCA*, *supra* note 78, at sections 25(1), 103(1), 125, 121(a), 189(1).

⁸¹ *Guide on Drafting SHAs*, *supra* note 79, at 17.

According to Stepanov V.V., non-unanimous shareholders' agreements can be divided into two main groups, which are SHAs between minority shareholders and SHAs between co-investors⁸². Minority shareholders can face such hazards as mismanagement, nonpayment of dividends, disclosure of trade secrets, fraudulent conduct, waste or sale of assets without consent of minority shareholders etc.⁸³. Hence, minority shareholders strive to conclude SHAs since they desire to have consolidated influence on the corporation's management and prevent oppressive and fraudulent conduct of majority shareholders. Specific types of SHAs designed to protect interests of minority shareholders are mentioned in the previous subchapter.

The SHAs between co-investors are concluded between several investors (majority shareholders) in order to provide management of joint venture or corporation through the creation of an effective mechanism to harmonize interests of all parties. These agreements *inter alia* offer provisions related to distribution of seats in the board of directors, restrictions on sale and purchase of shares⁸⁴, restrictions on the free vote of shareholders at the general meeting and establishment of specific requirements for the decision-making procedure by the corporation's management bodies⁸⁵. In addition, these agreements are very useful for settlement of pre-incorporation/formation issues and arrangement of situation when each of two shareholders has 50% of shares.

⁸² Stepanov V.V., Soglasheniya aktsionerov: Mezhdunarodnyy opyt i potentsial'nyye problemy primeneniya. Glava 1, Trudy molodykh issledovateley po sravnitel'nomu yuridicheskikh issledovaniy № 1 (6), 17 (2010) [Stepanov V.V., *Shareholders' agreements: International experience and potential problems of application. Chapter 1*, Works of young researchers on comparative legal studies № 1 (6), 17 (2010)], available in Russian at <http://www.nsplaw.com/uploads/media/ANSV> (last access 17-03-2016).

⁸³ A.Elson, *Shareholders' agreements, a shield for minority shareholders of close corporations*, The Business Lawyer, Volume 22, № 2, 450 (1967).

⁸⁴ Stock-restriction agreement will be discussed further separately.

⁸⁵ R. B. Thompson, *The Shareholder's Cause of Action for Oppression*, The Business Lawyer, Volume 48, № 2, 705–708, (1993).

Stock restriction – agreement⁸⁶ is another one type of the SHAs, which prevents shareholders from freely transferring their shares⁸⁷. U.C.C.⁸⁸ provides that restrictions on the transfer of shares must be noted on the security itself, otherwise “they are ineffective against subsequent persons without actual notice”⁸⁹.

Shareholders can agree on different types of restrictions: the right of “first refusal”, buy-sell agreements, consent restrictions, the option to buy at a certain time and so on⁹⁰. Restrictions can be imposed by the articles of association or SHA. Common types of buy-sell agreements include *inter alia*: “put-option”, “call-option”, “mandatory buy-out”, “come along”, drag along”, preemptive right and so on⁹¹.

The right of first refusal (first option) means that the shareholder planning to sell his or her shares “must first offer shares to the party specified by the agreement at a price specified in the agreement”⁹². In case of death of the shareholder, the mechanism should be the same. If optionee refuses to purchase shares, they can be freely transferred to the third parties. The right of first refusal is *sui generis* a pre-emptive right for the other shareholders. Consent restrictions requires approval of stock transfer by other shareholders or certain persons specified by the agreement. Buy-sell agreements are usually applicable to the shares held by employee shareholders who are entitled to require the corporation to repurchase shares under specific circumstances.

⁸⁶ Definitions “stock restriction – agreement” and “restriction on transfer of shares agreement” are the same.

⁸⁷ Michael A. Macchiaroli, *Corporations - Stock Restriction – Agreement among Members of Close Family Corporation to Restrict Sale of Stock Is Not Void Merely because of Divergence between Option Price and Actual Value of Stock*, Villanova Law Review Volume 9 № 2, 335 (1964).

⁸⁸ Uniform Commercial Code § 8-204 (2006), available at http://law.justia.com/codes/ohio/2006/orc/jd_130811-56cf.html (last access 19-03-2016).

⁸⁹ Stephen R. Looney and Ronald A. Levitt, *Drafting Shareholder Agreements for Closely-Held C and S Corporations*, 5 (2002), available at <https://www.lexisnexis.com/practiceareas/tax/pdfs/PDFarticle3.pdf> (last access 24-03-2016).

⁹⁰ Christian H. Quack, *supra* note 72, at 58.

⁹¹ *Guide on Drafting SHAs*, *supra* note 79, at 21.

⁹² Michael A. Macchiaroli, *supra* note 87, at 334.

In general stock is a property of shareholders. As a rule, any restrictions on the alienation of personal property initially were not supported by the courts. However, with time past courts started to uphold and enforce stock restriction – agreements which passed “test of reasonableness”. Nevertheless, absolute restrictions are recognized invalid since they preclude shareholders to exercise their fundamental right to alienate of shares. According to F. Hodge O’Neal, usually courts take into account the following major factors in order to determine whether the restriction was reasonable: the size of the corporation, the purpose of the restriction, the length of time the restriction will take place, the likelihood that the restriction will contribute to the development of the corporation and the price value differential⁹³.

Let us briefly consider several cases illustrated application of the stock restriction – agreements. *Palmer v. Chamberlin* (1951) case⁹⁴ is one of the famous decisions on enforcement of the stock restriction – agreement. In its decision, the court noted that the contract should not be enforced only if the difference between option and sale prices is so great as to lead to the conclusion of mistake or fraud⁹⁵. The court upheld restriction of transfer of shares specified at the by-law (not in the shareholders’ agreement) since it did not find them unconscionable or oppressive.

However, several years later another court in *Mather Estate* case (1963) also enforced stock restriction – agreement where the difference between option and sale prices was significant⁹⁶. According to the terms of the agreement, on the death of the shareholder or in the event when he wanted to sell his shares, he or his descendant should offer other shareholder to buy shares for 1 \$ per share. When the agreement was signed, the book value of the shares was zero, however actual value was about 50 \$ per share. When the petitioner brought a claim for

⁹³ F. Hodge O’Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, Harvard Law Review Volume 65, № 5, 778 (1952).

⁹⁴ *Palmer v. Chamberlin*, United States Court of Appeals for the Fifth Circuit, 191 F.2d 532, 542 (1951).

⁹⁵ *Id.*, at 541.

⁹⁶ *Mather Estate*, the Supreme Court of Pennsylvania, 189 A.2d 586, 587 (1963) [hereinafter *Mather Estate*].

a specific performance of the agreement, the book value of the shares soared to 444 \$ and actual value was approximately 1060 \$ per share⁹⁷.

The Supreme Court of Pennsylvania held that there was not fraud or negative effect to the third parties. The agreement was held reasonable since it was concluded by mature persons with the main purpose to “insure that ownership of the corporation would remain with the family”⁹⁸. Hence, any discrepancies between option price and actual value of the stock at the time of sale cannot be a barrier for the enforcement⁹⁹.

Analysis of other cases¹⁰⁰ let us to conclude that the most important role in the decision of the “reasonableness” of the restriction play the purpose of the restriction. The courts generally enforced agreements where the purpose was convenient, reasonable and necessary for the attainment of the purposes set forth at the articles of association. Restrictions on transfer of shares are enforceable only against persons who are aware about them.

To conclude, there are many different types of the shareholders agreements, which designed to protect shareholders in various situations and contribute to the development of the corporation.

⁹⁷ *Michael A. Macchiaroli, supra* note 87, at 334.

⁹⁸ *Mather Estate, supra* note 96, at 587.

⁹⁹ *Michael A. Macchiaroli, supra* note 87, at 334.

¹⁰⁰ *Id.*

CHAPTER 2. ANALYSIS OF THE POSSIBILITIES TO IMPLEMENT SHAREHOLDERS' AGREEMENTS IN KAZAKHSTAN

2.1. Overview of Kazakhstani legislation and peculiarities of LLPs and JSCs

The Kazakhstani legal system belongs to the continental legal system. According to the Constitution of the Republic of Kazakhstan “provisions of the Constitution, the laws corresponding to it, other regulatory legal acts, international treaties, regulatory resolutions of the Constitutional Council and the Supreme Court of the Republic shall be the positive law in the Republic of Kazakhstan”¹⁰¹. Therefore, judicial precedent is not officially recognized as a source of law in Kazakhstan.

The Kazakhstani legislation is unstable and inclined to constant renewal and amendments. For example, many new codes and laws were adopted in 2015, among them the most prominent was the Entrepreneurial Code which consolidated the following laws: “On farming”, “On investments”, “On competition”, “On state control and supervision in the Republic of Kazakhstan” and “On the state support of industrial and innovative activity”.

Among the many types of legal entities in Kazakhstan provided by the legislation, the most common are limited liability partnership (hereinafter referred to as “**LLP**”) and joint stock company (hereinafter referred to as “**JSC**”). For the purpose of the research, the author focuses on LLPs and JSCs (with more than one participants¹⁰²) not only because of their popularity, but also because they are of the greatest interest for comparison with U.S. close corporations where SHAs were successfully applied.

¹⁰¹ Konstitutsiya Respubliki Kazakhstan, prinyataya 30 avgusta 1995 goda na respublikanskom referendum, statya 4, punkt 1 [Constitution of the Republic of Kazakhstan adopted on August 30, 1995 at the republican referendum, article 4, paragraph 1], available in Russian at <http://adilet.zan.kz/eng/docs/K950001000> (last access 20-03-2016).

¹⁰² Partners of the LLP are referred as “**participants**” under Kazakhstani legislation.

LLPs' and JSCs' activity is regulated by the RK Civil Code¹⁰³, RK Law on Partnerships with Limited and Additional Liability (hereinafter referred to as “**Law on LLP**”)¹⁰⁴, RK Law on Joint Stock Companies¹⁰⁵ (hereinafter referred to as “**Law on JSC**”) and subordinate legislation.

Foundation agreement and charter¹⁰⁶ are the main corporate documents. Foundation agreement is a confidential document and it is applicable if the number of participants is more than one. According to the law, foundation agreement is subject to notarization.

State authority (registrar) maintains the register of the LLP's participants. From the date the register has been formed, the foundation agreement terminates. Validity of the foundation agreement at the JSCs terminates from the date of the state registration of the authorized shares.

Since 2013 a legal entity referred to the private enterprise entities (including LLP) is not obliged to submit charter in case of state registration and/or in case of amendments to the charter of the existing legal entity. This rule does not apply for the JSCs and legal entities, which are not referred to the private enterprise entities, which must provide charter in case of state registration and notify the registering authority within 1 (one) month from the date of adoption of any amendments to the constituent documents of the company¹⁰⁷.

¹⁰³ Grazhdanskiy kodeks Respubliki Kazakhstan prinyat Postanovleniyem Verkhovnogo Soveta Respubliki Kazakhstan ot 27 dekabrya 1994 [Civil Code of the Republic of Kazakhstan enforced by the Decree of the Supreme Council of the Republic of Kazakhstan dated December 27, 1994], available in Russian at http://online.zakon.kz/Document/?doc_id=1006061 (last access 21-03-2016) [hereinafter *Civil Code*].

¹⁰⁴ Zakon Respubliki Kazakhstan № . 220 «O tovarishchestvakh s ogranichennoy i dopolnitel'noy otvetstvennost'yu " ot 22 aprelya 1998 [Law of the Republic of Kazakhstan №. 220 “On Partnerships with Limited and Additional Liability” dated 22 April 1998], available in Russian at <http://adilet.zan.kz/rus/docs/Z980000220> (last access 20-03-2016).

¹⁰⁵ Zakon Respubliki Kazakhstan № . 415 «Ob aktsionernykh obshchestvakh» ot 13 maya 200 [Law of the Republic of Kazakhstan №. 415 “On Joint Stock Companies” dated 13 May 2003], available in Russian at <http://adilet.zan.kz/eng/docs/Z030000415> (last access 20-03-2016) [hereinafter *Law on JSC*].

¹⁰⁶ “Charter” is a Kazakhstani equivalent of U.S. “articles of association”. For the purpose of this paper, these terms are used interchangeably.

¹⁰⁷ Zakon RK «O gosudarstvennoy registratsii yuridicheskikh lits i uchetnoy registratsii filialov i predstavitel'stv», kotoraya byla prinyata 17 aprelya 1995 goda № 2198 , stat'ya 6 [Law of the RK “On State Registration of Legal Entities and Record Registration of Branches and Representative Offices”, adopted on 17 April 1995 № 2198, article 6], available in Russian at http://online.zakon.kz/Document/?doc_id=1003592 (last access 20-03-2016).

2.2. Correlation of shareholders' agreement and charter

The dispositive character of corporate law determines that development of internal corporate relationships cannot be limited by commitment of the actions prescribed by the statute or articles of association as long as these actions are not illegal. Shareholders are entitled to choose the means and methods for regulation of their relationships and implementation of agreed policies on various issues of the company.

The charter (articles of association) is determined by the legislation of many countries as mandatory constitutive documents, which defines the legal status of the company as a legal entity¹⁰⁸. The main function of the charter is to ensure a strong skeleton for the company, thus defining its organizational functional parameters. Charter is a mandatory document both for the company and its shareholders. It sets the foundation of the relationships between company and its shareholders. These relationships have a vertical character. For example, charter regulates relationships related to the provision of information to the company by its shareholders.

The author agrees with the opinion of M.V. Trubina that charter does not and should not cover the relationships of “horizontal” nature (between the shareholders) which can be regulated by the SHA¹⁰⁹. The need for the SHAs is related to the impossibility to settle many relationships arising between the shareholders through the constituent documents. Therefore, the SHA can perform additional compensating function to provide shareholders with a proper freedom in exercising their rights and improve corporate governance¹¹⁰. Conclusion of the SHA is voluntarily, based on the principle “freedom of contract”.

¹⁰⁸ *DGCL*, *supra* note 17, § 723.

¹⁰⁹ Trubina M.V., *Grazhdansko-pravovoe regulirovanie aktsionerov soglasheniy* (2016) (dissertatsiya, Rossiiskii universitet druzhby narodov) [Trubina M.V., *Civil law regulation of shareholders' agreements* (2016) (unpublished abstract of the dissertation, Russian University of Peoples' Friendship)], available in Russian at <http://www.dissercat.com/aktsioner-nye-soglasheniya-kak-sredstvo-regulirovaniya-korporativnykh-otnoshenii> (last access 19-03-2016).

¹¹⁰ *Id.*

Correlation of the charter and SHA appears in the charter's regulation of the ways to enter into SHAs, possible objects regulated by the SHAs, deadlines, disclosure of the existence of one or another SHA and so on. However, relations regulated by the articles of association in most cases have priority, even if the other option for the distribution of the shareholders' interests is provided by the SHA. According to some scholars, the content of the SHA, as well as the purpose of its conclusion must not contradict to the goals of charter¹¹¹.

Analysis of different legal reports and memoranda of law firms in common law countries reveals that the advice is to draft SHAs properly in order to avoid the conflicts between SHA and articles of association. There is also advice to include in the SHA a 'supremacy clause', which means that in case of discrepancies the provisions of the SHA should prevail¹¹². The author believes that this practice should not be introduced in Kazakhstan since it will lead to problems in the regulation of the companies' activities and relationships between shareholders. According to the Kazakhstani law, provisions of the charter are binding for all bodies of the company and its shareholders. Usually these provisions reflect requirements of the Kazakhstani law, thus in practice the agreement, which contradicts the charter is likely to contradict the legislation of the Republic of Kazakhstan. As a result this agreement might be invalidated in general or in a part which is contrary the law.

In the author's opinion, the SHA, which prevails over the charter should be considered as an ordinary constituent document (*de facto* charter) since it has the same features and characteristics. SHAs by definition should regulate relationships between shareholders in order to help them to choose the best way to exercise their rights, improve corporate governance and undertake concerted actions on certain issues. Shareholders' agreements should not replace charter.

¹¹¹ *Id.*

¹¹² Emmet Scully, *Shareholders' Agreements - A Practical Analysis*, July 2014, available at <http://www.lkshields.ie/publications/shareholders-agreements-a-practical-analysis> (last access 18-03-2016).

Analysis of the data on possible use of the SHAs allows us to conclude that there are the following types of correlation of SHA and articles of association, which can be used in Kazakhstan:

- 1) SHAs can be drafted to regulate issues that are not considered in the charter;
- 2) SHAs can clarify the provisions outlined in the charter;
- 3) SHA can be used to manage the contractual relationships for the creation of a joint venture (In the U.S. at the initial stage of the creation of the corporation SHA is used instead of articles of association as a pre-incorporation agreement).

SHAs has the following advantages:

1) They may be concluded between several shareholders and may be optional for other existing shareholders or new shareholders, while all shareholders of the company, including new entrants are obliged to follow charter;

2) Many scholars define confidentiality as one of the main characteristics of the SHA. Indeed, in practice shareholders do not want to disclose information related to remuneration of the directors, trade secrets or other sensitive internal issues. Contrary to this, charter is a document, which is publicly available.

3) In the U.S. all changes to the articles of association should be submitted to the corporation's registry. As was already mentioned above shareholders of the JSCs are also obliged to submit the charter to the state authorities in Kazakhstan. Modification of the charter is more expensive and time-consuming process than modification of the SHA. However, in case of the USHA, modification can be even more difficult to implement since usually the unanimous consent of all parties is required.

4) Another one significant benefit of the SHA is that it can include effective alternative dispute resolution mechanism, which provides confidentiality, saves time and money of the shareholders. Usually it is arbitration or mediation.

The Table in the beginning of the thesis illustrates a summary of the comparative characteristics of the charter and SHA.

2.3. Legal qualification of the shareholders agreements and issues that can be regulated by the shareholders' agreements

In this subchapter we will discuss how SHAs can be qualified under current legislation of the Republic of Kazakhstan and consider issues, which can be regulated by the SHA. As was already mentioned in the beginning, Kazakhstani legislation does not regulate SHAs. However, several articles of the Law on LLP and Law on JSC provide indirect references to the agreements between shareholders in the JSCs or participants in the LLPs, respectively¹¹³. Hence, there are not direct prohibitions for the conclusion of agreements between shareholders. However, legal consequences of the agreements depend on its conditions.

Firstly, according to Hans-Joachim Schramm, SHA can be qualified as a multilateral agreement¹¹⁴. Civil Code provides that “general provisions concerning contracts shall apply to the contracts concluded by more than two parties (multilateral contracts), unless this contradicts the multilateral nature of such contracts”¹¹⁵. According to the principle “freedom of contract”, provided by the Kazakhstani law, “parties may conclude contracts both as provided for and as not provided for by the legislation”¹¹⁶.

Secondly, if SHAs can be qualified as a special type of law of obligations, it would allow application to them provisions related to *inter alia* termination, amendment, compensation of damage and so on.

¹¹³ *Law on JSC*, *supra* note 105, article 1, subparagraph 23.

¹¹⁴ Hans-Joachim Schramm, *Legal review of shareholders' agreements*, Bulletin of Corporate Governance № 7, 26 (2008).

¹¹⁵ *Civil Code*, *supra* note 103, articles 378 and 380 (2).

¹¹⁶ *Id.* article 380(2).

Thirdly, as U.S. case law reveals sometimes in the past courts considered SHAs as an ordinary partnerships¹¹⁷. Current Kazakhstani legislation has provisions related to ordinary partnership. Civil Code provides that “an ordinary partnership can be formed on the basis of a joint operation agreement”¹¹⁸. The main purpose of this agreement should be cooperation of shareholders for income generation or attainment of any other goal, which does not contradict the law. The ordinary partnership is not considered as a legal entity under Kazakhstani law. Participants of the partnership agreement can combine their contributions and work together to set a common position on asset management. There are several mechanisms to coordinate partners’ positions on issues of current activities: involvement of independent experts, consultants, mutual consultations, mediation, mini-arbitration, obtainment of information about company’s activity and so on.

In case of ordinary partnership, participants can transfer shares in joint shared property of all participants of the partnership agreement. The agreement can help to decrease risks related to possible requirements on the allocation of part of the property in kind. Conditions related to entry and exceptions of participants can be provided in a manner to meet commercial arrangements regarding the procedure for alienation of shares (indirectly provide conditions of redemption, pre-emptive rights etc.) The author believes that joint operation (partnership) agreement is quiet similar to the shareholders’ agreement in the US.

The most important conclusion of these qualifications is that the SHA is binding only for the shareholder who are the parties to the agreement¹¹⁹. Qualification of the SHA as a contract gives answer to the question whether obligations from the SHA pass to the acquiring party under the SHA in case of the share transfer. Since the SHA is valid only for the parties, the

¹¹⁷ Vandyke v. Brown, Court of Chancery of New Jersey, 8 N.J. Eq. 657, 669 (1852).

¹¹⁸ *Civil Code*, *supra* note 103, article 228(1).

¹¹⁹ *Id.*, article 380(1).

obligations from the SHA are transferred only in case of agreement with the acquirer (for example, deed of adherence in the U.S.).

There is a range of issues, which can be a subject of the SHA regulation in Kazakhstan. For convenience, they can be divided into three main groups:

1) the order of the company's management bodies' formation and the order of voting on a number of issues;

2) transfer of shares' ownership procedure (including restrictions on transfer);

3) settlement of disputes between shareholders, including the resolution of "deadlocks"¹²⁰.

The first group of issues may include *inter alia*:

1) issues of certain shareholders' empowerment to determine individuals for their elections to the company management bodies, for example, to the board of directors or change the procedure of the board of directors' formation;

2) definition of a circle of issues which can be decided by qualified majority of the shareholders or unanimously by all shareholders;

3) change in the time of the annual and extraordinary general meeting or change of the meeting notice period;

4) changes in the list of issues relating to the exclusive competence of the general meeting;

5) provisions, changing the order of the company's executive bodies formation;

6) provisions fixing the procedure for providing information and/or documents to the shareholders, which the company is not obliged to provide in accordance with the law or the articles of association; and other issues.

The second group of issues may affect the relationships between the shareholders on establishment of the mechanisms for compulsory purchase and/or sale of shares, including pre-

¹²⁰ Deadlock means "blocking of corporate action by one or more factions of shareholders or directors who disagree about a significant aspect of corporate policy" (Black's Law Dictionary (10th ed. 2014)).

emptive rights, mutual option to purchase, tag-along, drag-along, as well as provisions for the protection of minority shareholders' rights¹²¹.

Settlement of disputes and related questions may constitute the third group of issues, which can be regulated by the SHA. One of the main issues of this group are provisions on the resolution of "deadlock" provisions. The provisions of the deadlocks' resolution are the provisions that define the rules, which will address issues not agreed upon by the parties in the constituent documents. Thus, these are the conditions, which the parties have established and are obliged to follow them, when a dispute arises between them, and they cannot settle it through negotiations.

The list of issues that can be regulated by the SHA is not exhaustive. In practice, shareholders can include in the SHA other issues, which are not prohibited by the law and do not contradict the charter.

¹²¹ *SHAs' Book, supra* 76, at ix.

CHAPTER 3. RECOMMENDATIONS ON THE USE OF SHAREHOLDERS' AGREEMENTS IN KAZAKHSTAN

3.1. Problems of shareholders' agreements application in Kazakhstan context

Analysis of the current Kazakhstani legislation shows that there are several disadvantages, which can make difficult the use and enforcement of the SHAs at the JSCs.

Firstly, according to the article 14(3) of the Law on JSC, restrictions of the shareholders' rights are not allowed¹²². The main shareholder's right is a right to participate in the management of the company in the manner provided by the law and the JSC's charter. Thus, formally, only these two documents may provide the procedure for the company's management. The SHAs are not included in this list. For example, the SHA forces the shareholder to support the candidature nominated by the other shareholder for the appointment of a general director position at the meeting of the shareholders. Formally, this is a restriction of the right to manage the JSC in the manner stipulated by the charter. Thus, this provision is contrary to the Kazakhstani law and, therefore, may be invalidated.

Secondly, the order of formation and functioning of the executive bodies and board of directors is imperatively regulated by the Law on JSC¹²³. Hence, other mechanisms of formation and functioning of the executive bodies and board may be invalidated.

Thirdly, Law on LLP and Law on JSC does not provide mechanisms for resolution of "deadlock" situations. Usually SHAs in the U.S. provide procedure for the resolution of "deadlock" situations. For example, in case of "deadlock" situation, shareholders can involve an expert, whose opinion will be binding for shareholders, or they can use (put-option or call-option mechanisms.

¹²² *Law on JSC, supra* note 105, article 14, subparagraph 3.

¹²³ *Id.*, articles 36, 53, 59.

Fourthly, another problem is related to the enforcement of the SHAs. In practice there are many situations when provisions of the contract does not contradict Kazakhstani law, however it is difficult to enforce them. For example, provision for pre-emptive right of purchase of shares in the JSC.

Participants in the LLPs and shareholders in the close joint-stock companies have a pre-emptive right. However, the concept of close joint-stock companies was excluded from the Kazakhstani legislation in 2003. Currently there is no direct prohibition in the Law on JSC to oblige shareholders to offer their shares to other shareholders before the sale to the third parties. This is not the right of the shareholder, which can be restricted. However, if the SHA does not provide a penalty clause for violation of this provision, it might be difficult to force shareholder to fulfill his obligations in the case of failure to perform them. In addition, the courts in Kazakhstan often refuse enforcement of the obligation in kind and only impose penalties for the breach of the obligation.

Another one significant problem is the applicable law of the SHA. Article 1114 of the Civil Code regulates the applicable law to the creation of a legal entity and transfer of shares in legal entities with foreign capital participation. Under its provisions “the law of the country where a legal entity is to be founded or has been founded shall apply to the contracts on formation of a legal entity with foreign participation”¹²⁴. This provision also applies to the relationships for creation and termination of a company, transfer of shares and other relationships between the company and its shareholders.

The Civil Code states “provisions of civil legislation must be interpreted literally”¹²⁵. Article 1114 does not provide that it is also applicable for legal entities *without* (emphasis added by the author) foreign capital participation. Thus, if there is no foreign participation,

¹²⁴ *Civil Code*, *supra* note 103, article 1114.

¹²⁵ *Id.*

formally, parties may choose another applicable law, but in this case, attitude of the court or arbitral tribunal to such choice of law is extremely uncertain.

Finally, it is worth to note that in the U.S. close corporation the SHA is a confidential document. In the Kazakhstani LLP, similar document can be confidential. However, any information with respect to the SHA should be disclose by the Kazakhstani JSCs (analogue of U.S. public corporation) which are obliged to follow the Listing rules of the Kazakhstani stock exchange¹²⁶ and Law on JSC on the disclosure of information about any agreements which affect interests of shareholders, investors and creditors¹²⁷.

To conclude, formally shareholders of the JSCs are not deprived of the possibility to conclude SHAs on the implementation of their rights, however the level of principle “freedom of contract” implementation in these agreements is very low because of the large number of mandatory rules regulating the activities of the JSCs. Shareholders in the JSCs will have to disclose all information related to the SHAs to the investors and creditors (information should be publicly available at the official web-site of the JSC) and SHAs should not contradict constituent documents of the JSC and laws of the Republic of Kazakhstan.

3.2. Recommendations for the strengthening of the legislative framework

Studying of U.S. statutory and case law illustrates that application of the SHAs has been successful in close corporations. Analysis of the Kazakhstani legislation reveals that activity of legal entities, especially JSCs, is highly regulated in detail. This fact negatively affect investment climate and realization of the principle of “freedom of contract”. Excessive

¹²⁶ Listingovyye pravila Kazakhstanskoy fondovoy birzhi, utverzhdenie resheniem Sovetom direktorov fondovoy birzhi Kazakhstana (protokol № 29 (z), ot 5 noyabrya 2009 [Listing Rules of the Kazakhstan Stock Exchange approved by the Kazakhstan Stock Exchange Board of Directors decision (protocol № 29 (z), November 5, 2009), article 29(1)], available at http://www.kase.kz/listing_rules.pdf (last access 23-03-2016).

¹²⁷ *Law on JSC*, *supra* note 105, article 79, subparagraph 1, 2-2, 3.

regulation also interferes to the development of business activities and Kazakhstani business integration in the world economy. Therefore, Kazakhstani legislation needs liberalization.

As was already mentioned above, the author admits that SHAs might be applicable in the Kazakhstani JSCs, however they will not be as flexible and useful as in the American close corporations. Contrary to this, Kazakhstani LLPs might be benefited by the possibility to use *agreements of the participants of the LLP* for the regulation of issues not stipulated by the law and/or LLP's charter. For example, resolution of deadlock situations or liability (pecuniary compensation) for failure to fulfil obligations under the agreement can be provided by the agreement. In comparison with this, failure to comply with the terms of the charter only allows to request the transfer of the rights and obligations of the buyer on the remaining participants or the LLP itself.

According to the author's opinion, there is no need to precisely define the SHA or provide description of particular types of such agreements in the Kazakhstani legislation, since it is a complicated concept and a precise definition of what can be the agreement will be a barrier for a large range of different issues, which can be regulated by this document. However, some basics of regulation are necessarily in order to ensure recognition and enforcement of agreements in the courts and provide protection of the rights of LLP' participants, state and third parties whose interests should not be violated. In addition, these agreements should be concluded in good faith and do not have fraudulent objectives.

For the strengthening of the legislative framework, the author recommends introduction of the following amendments to the Law on LLP:

1) Articles 11 and 12 of the Law on LLP regulated participants' rights and responsibilities, respectively, should include provisions that participants can have other rights and responsibilities provided by the Law of the Republic of Kazakhstan, constituent documents of the LLPs *and agreements between participants of the LLP* (emphasis added by the author).

2) The author recommends introduction of the Article 17-1 to the Law on LLP as follows:

Article 17-1. Agreement of the participants of the limited liability partnership

1. Participants of the limited liability partnership have a right to enter into agreements between them or with future participants of the limited liability partnership. According to the agreement, they undertake to exercise their rights certified by their shares in a way stipulated by the agreement or refrain (refuse) to exercise these rights.
2. An agreement shall be binding only to its parties. The agreement may be concluded either by all participants of the limited liability partnership, as well as by several participants. The transfer of rights and obligations under the agreement to new owners of the shares must be fixed by the adhesion contract.
3. An agreement is a document, which constitutes a commercial secret if otherwise not provided by the agreement. An agreement can be provided to the state or other official bodies only by the decision of the limited liability partnership' bodies or in the cases stipulated by the laws of the Republic of Kazakhstan. Submission of the agreement to the state authorities is not required.
4. Issues regulated by the agreement shall not contradict the laws of the Republic of Kazakhstan and/or the charter of the limited liability partnership. The agreement should be concluded in good faith and should not violate rights and interests of other participants of the LLP, third parties and state. The agreement concluded with fraudulent objectives as well as agreement that violate the laws of the Republic of Kazakhstan and/or the charter of the limited liability partnership shall be declared null and void.
5. An agreement shall be concluded in a written form and signed by all parties to the agreement who must notify the limited liability partnership' bodies and other participants (not parties to the agreement) about the fact of the agreement's conclusion

no later than 10 (ten) days from the date of the agreement's conclusion. In case of nonperformance of the rule of notification, participants of the limited liability partnership, who are not parties to the agreement, are entitled to claim damages.

6. If otherwise not provided by the agreement, any modifications to the agreement can be approved only by the unanimous consent of all persons who are parties at the time of the agreement.
7. Methods for ensuring performance of obligations arising out of the agreement and measures of civil liabilities for non-performance or improper performance of the obligations can be provided by the agreement.

Analysis of U.S. case law illustrates that the courts enforced shareholders' agreement in close corporation, which contradicted the articles of association. The author believes that the Kazakhstani courts will not enforce agreements contradicted LLP's charter. Hence, she does not recommend reliance on U.S. approach.

In case of SHAs' introduction at the JSCs, the relevant amendments to the Law on JSC, similar to the amendments illustrated above, should be adopted. In addition, shareholders will have to disclose all information about the SHA to the public and notify state authorities about any SHA. The Listing Rules of the Kazakhstan Stock Exchange should be also amended to oblige JSCs to provide information about the SHAs concluded.

3.3. Practical recommendations on drafting of the agreements

As was discussed in the thesis there are many different types of the shareholders' agreements and each of them has its own peculiarities, which should be taken into account by legal advisors drafting them. The main questions, which should be asked by the counsels before drafting of any agreement are what should be the main purposes of the agreement and what kind of problems parties want to solve by this agreement? Answers to these questions and

recognizing the purpose of the agreement will help to understand what kind of mechanisms and aspects should be included in each situation. In this section the author will provide recommendations for drafting of the agreements using several mechanisms from the international practice, which are mostly unfamiliar to the Kazakhstani businessmen and counsels.

The first of these mechanisms is the resolution of “deadlock” provisions, which was mentioned in the 2.3 section above. There are many LLPs in Kazakhstan with two participants, where each of them holds 50% of shares. In case of discrepancies between participants, which are common in day-to-day business matters, business may suffer since neither of participants has absolute control. An agreement between them, which includes “deadlock” provisions, helps to resolve the disputes. In western practice there are “classical” methods of resolving deadlocks, which are “Russian roulette” and “Texas method” or “Dutch auction”¹²⁸.

In case of “Russian roulette” one of the conflicting parties notifies the other party and indicates the price, by which it estimates the 50% share in the company. The other party that has received the notice has a right either to buy a share from the other party, or to sell its share at a specified price¹²⁹.

In case of “Texas method” each party sends to the intermediary sealed envelope with the price. Parties should specify the maximum price at which each of the parties agrees to buy out a share of the other party¹³⁰. On the contrary, in the case of “Dutch auction” parties indicates the minimum price at which each party agrees to sell its share. Envelopes are opened and according to “Texas method” winning party is one, which offered the highest price, and the

¹²⁸ Materials of the seminar on shareholders' agreements, prepared by Dechert LLP in Kazakhstan, available at https://www.dechert.com/files/Uploads/Documents/Events/Shareholder_Agreements_Seminar_English.pdf (last access 24-03-2016).

¹²⁹ Delaney v. Georgia-Pacific Corp., Court of Appeals of Oregon, 601 P.2d 475, 441-477 (1979).

¹³⁰ Richard R. W. Brooks, Claudia M. Landeo and Kathryn E. Spier, *Trigger happy or gun shy? Dissolving common-value partnerships with Texas shootouts*, The RAND Journal of Economics, Volume 41, № 4, 651-652 (2010).

losing party is obliged to sell its share at that price. At the “Dutch auction”, the highest price wins, but in this case, the winning party buys a share of the other party according to the price specified in the envelope of the losing party¹³¹.

The author also advises call/put option or tag/drag along provisions to be included in the agreements, since they provide additional rights and responsibilities for the alienation of shares in comparison with the standard set rights provided by the Kazakhstani legislation. Call/put option or tag/drag along provisions can be used in the agreements and may be performed subject to compliance with the pre-emption rights and other requirements of the Kazakhstani legislation¹³².

The “tag-along” right (sometimes referred as “piggyback right”) means the right of participants to require the buyer to purchase their shares together with the shares of selling participants on the same terms. Tag-along right is one of the contractual obligations to protect rights of the minority participants¹³³. For example, tag-along right might be a right of a minority participant to sell his shares to the purchaser at the same price at which the participant-seller is selling his shares. In other words, if a participant wishes to sell his shares, he can sell them, only if the buyer agreed to purchase the shares of other participants at the same price, thus, the participant joins the transaction¹³⁴.

The “Drag-along” right is a right of a participant to force other participants (in most cases minority participants) to accept the same offer of shares’ sale on the same conditions¹³⁵. Major participant or several participants may demand other participants to sell their shares to the buyer

¹³¹ Materials of the seminar on shareholders' agreements, prepared by Dechert LLP in Kazakhstan, available at https://www.dechert.com/files/Uploads/Documents/Events/Shareholder_Agreements_Seminar_Russian.pdf (last access 25-03-2016).

¹³² Law of the Republic of Kazakhstan № 220 “On Partnerships with Limited and Additional Liability” dated 22 April 1998, article 31, available in Russian and Kazakh at <http://adilet.zan.kz/rus/docs/Z980000220> (last access 20-03-2016).

¹³³ *SHAs' Book*, *supra* 76, at xi.

¹³⁴ *Id.*

¹³⁵ *Id.*, at ix.

under the same conditions, when the buyer wants to purchase 100% or the majority of the company's shares.

The “call-option” means that a company or participant has a right at any time or after the occurrence of specific triggering event, to purchase the shares of the other participant. For example, the triggering event might be disability of the participant¹³⁶. The “put-option” gives the participant possibility to force company to buy his shares. Usually it happens when a participant does not play an active role at the company or when he or she wants to have an ability to cash out.

These mechanisms included in the contract are subject to the principle of *pacta sunt servanda*, recognized by the Kazakhstani law. Parties may enter into a contract as provided, as well as not provided by the legislation¹³⁷. Terms of any agreement can be determined by the discretion of the parties, except cases when the conditions of the agreements are imperatively regulated by the law¹³⁸.

In addition, the author wants to provide recommendations for dispute resolution procedure and law applicable for the agreement. Participants of the LLP can provide which court (arbitration court or court of general jurisdiction) should decide the dispute in case of discrepancies. Dispute resolution at the Kazakhstani arbitration courts has the following advantages: confidentiality, limited interference of the state in the activity of the arbitration courts, flexibility of the proceedings etc. In addition, participants can choose arbitrators with the desired level of qualification and professionalism. If the parties want to refer to the Kazakhstani arbitration courts, the author recommends such most reputed arbitration courts, as The Arbitration Court of the Eurasian Center for Mediation and Arbitration, International Arbitration Court «IUS» and the Kazakhstani International Arbitrage.

¹³⁶ *Guide on Drafting SHAs*, *supra* note 79, at 21.

¹³⁷ *Civil Code*, *supra* note 103, article 380.

¹³⁸ *Id.* article 382.

There are also some disadvantages of dispute resolution at the Kazakhstani arbitration courts, among them are the costs of the arbitrators' fee, which is higher than the state duty, and more complicated procedure of injunctive relief than realized through the courts of general jurisdiction. At the same time, enforcement of the arbitral awards can be difficult because it is carried out through the courts of general jurisdiction.

Promptness is the main advantage of the dispute resolution at the Kazakhstani courts of general jurisdiction. However, the author recommends to choose the arbitration court since there is a high level of corruption in the Kazakhstani courts of general jurisdiction and judges' level of professionalism is not always appropriate for resolution of complicated disputes. In order to choose arbitration court participants should include properly drafted arbitration agreement: provide precise name of the court, chose the location and language of the proceedings, determine the number of arbitrators and other details, which will reflect preferences of the parties with respect to dispute resolution. The parties can also refer to the "ad hoc" arbitration or they can choose other methods of alternative dispute resolution, such as mediation or conciliation etc.

Some international firms analyzed the possibility to choose foreign (not Kazakhstani) law as an applicable law for the agreements between participants of the LLP. According to the Astapov Lawyers International Law Group's opinion, foreign law cannot be applicable in this case¹³⁹. The author accepts that English law is internationally recognized and widely used. It is undoubtedly more flexible and give more opportunities to the parties to negotiate the terms of the agreements more freely in comparison with the Kazakhstani law. However, the author

¹³⁹ Soglasheniye aktsionerov / Korporativnoye soglasheniye: Ukraina, Rossiya i Kazakhstan , materialy IX yezhegodnogo Foruma po korporativnomu pravu , ot 30 oktyabrya 2015 [Shareholders' agreement / Corporate agreement: Ukraine, Russia and Kazakhstan, materials of the IX Annual Forum on Corporate Law, dated 30 October 2015], available in Russian at <http://uba.ua/documents/brochure/AstapovLawyers.pdf> (last access 20-03-2016).

inclined to agree with Astapov Lawyers International Law Group since there is a high risk of invalidation of agreement between participants of LLP with foreign applicable law.

The Civil Code provides that “law which is subject to application to civil and legal relations with the participation of foreign citizens of foreign legal entities or complicated by any other foreign element shall be determined on the basis of the Civil Code, other legislative acts, international treaties ratified by the Republic of Kazakhstan and international customs being recognized”¹⁴⁰. Therefore, the SHA is not mentioned as one of the sources.

In addition, Article 1088 defines the consequences of evading the law, specifying that agreements “evading rules of this section concerning law which is subject to application should be invalid and the law which is subject to application in accordance with this section should be applied”. Thus, it is highly controversial issue that foreign law can be applied to the agreement in a company without foreign capital participation.

The agreement should also contain termination provisions. Usually parties of U.S. SHA include provisions that the SHA shall terminate upon the written agreement of all parties. The agreement shall also terminates in case of bankruptcy or dissolution of the company or when one participant becomes the beneficial owner of all shares of the company.

Drafting agreement between participants of the LLP, the counsels should always take into account the fact that certain issues or the powers laid down in the agreement should not contradict provisions of the law and the charter, otherwise they may be invalidated.

Law on LLP is generally dispositive. Therefore, where there is no direct or another clearly implied prohibition, participant of the LLP are entitled to broadly interpret the law. In this case, the rights and interests of third parties (including the state) should not be violated.

¹⁴⁰ *Civil Code*, *supra* note 103, article 1084.

Conclusion

The main goal of this paper was to examine the possibilities to implement SHAs in Kazakhstan. To achieve this purpose the author considered U.S. case law on application of the SHAs in close corporations and identified the following criteria for the validity of SHAs: no fraud or damage to the creditors and third parties, non-violation of public interests and absence of claims from minority shareholders. Statutory regulation of the SHAs presented by the example of the MBCA and DGCL also tends to provide a great degree of flexibility in the sphere of the SHAs' regulation.

In the beginning of the research, the author noted that SHAs at U.S. family close corporations deserve special consideration. Analysis of several major precedents revealed that SHAs help to resolve the problem of intergenerational transfer of wealth in the U.S., where traditions of family run business are strong. Contrary to the U.S., Kazakhstani business is a business of first generation, therefore businessmen are less concerned about this issue. Due to unstable political and economic situation in Kazakhstan, as well as reluctance of the younger generation to engage in family business, businessmen are inclined not to plan a long-term business development and prefer to invest money in liquid assets. Therefore, special regulation of agreements at Kazakhstani family companies is unnecessarily at least in the short term.

In addition, the author discussed different classifications and types of the SHAs and determined specific characteristics and advantages of the SHAs over charter. The most significant among them are confidentiality, less formalization, faster and less costly procedure of modifications and possibility to use flexible mechanisms to resolve "deadlock" situations and protect right and interest of the parties more effectively.

As was demonstrated by the thesis, application of the SHAs at Kazakhstani legal entities is formally possible. However, it is practically less advantageous to use these agreements at the JSCs than at the LLPs. The Kazakhstani law imperatively regulates the activity of the JSCs,

which have to disclose all information regarding SHAs and notify state authorities in case of charter's amendment and so on.

Unlike JSCs, LLPs are quite similar to American close corporations. LLP is the most popular form of business in Kazakhstan, which provides participants with more freedom to enter into different types of agreements. The author came to the conclusion that application of the agreements between participants of LLP will be reasonable and contribute to the development of business activities in Kazakhstan. Therefore, recommendations for the strengthening of the legislative framework to ensure the possibility to enter into agreements between participants of LLP are provided.

Kazakhstani legislation is characterized by detailed regulation of business, which in most cases interferes normal business development. The author does not recommend to provide specific types of agreements, which can be concluded in order not to limit the right to enter into any contract not prohibited by the law. Some basic requirements to formalization of the agreements are recommended to ensure recognition and enforcement of such agreements by the courts

The author tried to take into account U.S. experience in statutory regulation of SHAs. However, many provisions of U.S. law cannot be applicable in Kazakhstani context. For example, unlike U.S., in Kazakhstan agreements between participants of LLP cannot prevail or contradict charter since in most cases it will lead to the violation of the Kazakhstani law.

Special attention was devoted to the law, which can be applicable to the agreements. There is a high risk that Kazakhstani courts will invalidate agreements with foreign applicable law. The author holds the view that foreign law cannot be applicable in view of imperative provisions of Civil Code regulated activity of companies incorporated in Kazakhstan.

To summarize all the findings of the research, the author believes that this thesis will help in further studying of problems and possible ways of application of the agreements between

participants of legal entities in Kazakhstan and other post-Soviet Union countries and recommendations for the strengthening of the legislative framework will be implemented.

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