Protecting Beneficiaries in Corporate Control Allegations

Kraujalis Denis

Lawyer, junior partner of the Law Firm "Yakovlev and Partners"

Boldyreva Anna

Senior Lawyer
YUG "Yakovlev and partners"

This article examines issues related to beneficial ownership: who is at risk; grounds for accusations of control; procedural features of the courts' assessment of a person's behavior; key features when developing a legal defense strategy.

VARIOUS LEGAL APPROACH TO BUSINESS ABOUT BANKRUPTCY AND FOR CORPORATE DISPUTES

As a rule, issues related to the protection of beneficiaries in accusations of corporate control arise precisely in the context of bankruptcy cases, when the bankruptcy trustee and/or the creditor(s), in order to satisfy claims, make claims against persons who controlled the debtor and are responsible for the actions that, in the opinion of the claimants, led to the bankruptcy. This is especially acute the question may arise in light of transactions involving the sale by foreign companies of part of the business to the management of Russian companies. At the same time, if the beneficiary controls the company not through ownership of its shares/interests, then there are not many mechanisms for determining it, and this is facilitated by the fact that there are no uniform criteria for identifying such persons.

However, it seems necessary to start with the fact that, despite the constant improvement of Russian legislation and a number of changes, we will not find a single definition of the term “beneficiary”, namely as a person who owns shares/interests in a company and/or participates in/controls the company’s activities and/or receives income from the company’s activities. “Anti-money laundering” legislation contains a definition of the term “beneficial owner”, but the criteria for determining a beneficiary[1]you can also find in the practice of applying corporate law and bankruptcy legislation.

1 For convenience, here and further in the article, the term “beneficiary” includes such definitions as “beneficial owner”, “ultimate beneficiary”, “person controlling the debtor” and others.

At the same time, if we consider the practices of applying corporate law and bankruptcy legislation, the positions developed are diametrically opposed: If in bankruptcy cases the establishment of the status of a beneficiary can be based on indirect evidence, as a rule, with an active negative position of the person, then in cases of corporate disputes it requires careful and complete confirmation of control even in the presence of a direct statement from the person.

One thing remains constant: it is the individual who is recognized as the beneficiary.

In general, most definitions of beneficial ownership are based on ownership thresholds or voting rights thresholds (in Russian law, the threshold for determining who is a beneficial owner is "more than 25 percent in the capital" of the ownership interest). But it is also possible for a person to recognize control over a company without actually owning shares or interests (through the ability to control the actions of both the company and its founder, director, member of the founder's collegial executive body, chief accountant).

That is, as can be seen, beneficial ownership consists not only in the simple level of ownership to be considered controlling or predominantly owned, but also in having control or benefit without actual ownership. If we refer to the glossary of the Financial Action Task Force (FATF) recommendations concerning combating money laundering and terrorist financing, then "beneficial owners" are defined as individuals who:

- ultimately own, control or benefit from legal an entity such as a company, partnership, trust, foundation, etc., or
- have effective control over them.

Thus, it becomes clear that anyone who owns, for example, even 1% of shares/interests or does not own at all, can be identified as a beneficial owner even in the absence of formal control. In general, based on the analysis of the provisions of the laws, it follows that the legislator has left wide opportunities for determining and recognizing a beneficial owner, especially in terms of indirect control.

Moreover, if, within the framework of bankruptcy cases, recognition of a beneficial owner is aimed at "finding" and holding accountable persons who controlled a legal entity, then within the framework of corporate cases the goals may be different, for example, to return assets or challenge a transaction of a legal entity, in the event of a corporate conflict, as well as, for example, within the framework of tax legislation - to determine whether this person can explain how it acquired assets and whether it paid the appropriate property tax, if required.

TRANSFORMATION OF THE CONCEPT "BENEFICIAL OWNERS" IN LAW ENFORCEMENT PRACTICE

In recent years, the topic of subsidiary liability of the ultimate beneficiary has become extremely relevant. Changes in legislation and emerging law enforcement practice are moving towards transforming the position of beneficial owners of businesses into full-fledged subjects of legal liability. The very trend of changes in legislation is largely aimed at creating

greater transparency in terms of disclosing the persons who control the company. At the same time, taking into account the reform of the institution of subsidiary liability, the risk group includes shareholders, affiliated persons, ultimate beneficiaries, persons whose control is established during the analysis of international financial reporting standards (IFRS).

As a general rule, a business owner is not liable for the obligations of a legal entity (clause 2, Article 56 of the Civil Code of the Russian Federation). However, there are exceptions to this rule - a compensation mechanism in the form of subsidiary liability of persons controlling the debtor, which is an extraordinary legal instrument and consists in the fact that the person controlling the debtor is held liable in the event that it is impossible to satisfy the claims of creditors at the expense of the original debtor.

In fact, it can be said that the beneficiary's benefit exists in the economic plane through the extraction of profit from business ownership. But the complete lifting of the corporate veil occurs only after the bankruptcy of the company, when it becomes necessary to apply such a mechanism to disclose the entire complex structure of business ownership through a chain of controlled companies and to attribute the risks of such ownership to the ultimate owner and beneficiary of the business. In this case, the problem is also visible in the gap between the obligations of the beneficiaries and the rights corresponding to them, the relationship between the concept and status of the beneficiary in various branches of law.

It should be noted that in bankruptcy cases, based on applications from bankruptcy trustees and/or creditors to bring the persons controlling the debtor to subsidiary liability, applicants, as a rule, consider it necessary and important to identify the entire chain ownership and to disclose each person who had control over the debtor by other means. In principle, it is difficult to deny that holding the main beneficiary liable is of the greatest interest to the bankruptcy trustee and creditors, since the hope of finding hidden property somewhere, including in another jurisdiction, and foreclosing on it in order to obtain repayment of the debt is attractive, especially given the media coverage of various successful cases for claimants.

On the one hand, such an approach can also be considered fair, since it is the beneficiary who is interested in the economically successful operation of the company, and, accordingly, it is difficult to imagine making important decisions that affect the operating activities of the company without his participation, that is, the beneficial owner cannot be released from liability. In addition, the very fact that the beneficiary must be identified indicates their desire to remain in the shadows with minimal liability. However, on the other hand, one cannot help but take into account that when a holding company is created with a large number of independent business entities and management, which usually implies a complex multi-level ownership and management structure, the issue of the beneficiary's participation in making certain decisions should be studied in detail.

In general, disputes on bringing persons controlling the debtor to subsidiary liability in bankruptcy cases are among the most difficult for both applicants and defendants. In particular, the process of proving this category of disputes is often accompanied by objective difficulties: applicants do not have direct written evidence, beneficiaries do not want to disclose

documents and circumstances that in some way reflect their status.

In any case, the question of the validity of the application and the sufficiency of the grounds and evidence is subject to examination by the court. Nevertheless, the law enforcement practice in disputes on bringing the KDL to subsidiary liability is currently developing in such a way that, along with other factors, the courts evaluate indirect evidence (for example, correspondence; synchronicity of the actions of subjects in the absence of objective economic reasons for this; the contradiction of these actions to the economic interests of the debtor with a simultaneous significant increase in the property of the persons brought to liability; the fact that these actions could not have taken place under any other circumstances, except in the presence of subordination of one to the other) in order to establish, in particular, to what extent the person was involved in the management, whether there was an actual opportunity to make economic decisions.

So, according to the position of the Supreme Court[2], indirect evidence can and should be used to prove control, and under certain circumstances (for example, limited access of the creditor to direct evidence of the beneficiary giving instructions regarding the execution of transactions[3]) courts may shift the burden of proof to the person who is named as the beneficiary and is held subsidiarily liable.

However, as a rule, circumstantial evidence is used in such a way as to generate some “suspicion” regarding the actions of the ultimate beneficiary, to “hint” at the presence of control in order to shift the burden of proof. However, it is worth noting that it is quite difficult to collect such a volume of circumstantial evidence that would directly indicate the presence of control by one or another person (with the exception of obvious things, for example, when funds from the debtor were transferred directly to the person).

JUDICIAL APPROACH TO THE DEFINITION "BENEFICIARY OWNER”, RISKS IN CASE OF ALLEGATIONS OF CORPORATE CONTROL

Returning to the question of how a beneficiary can be determined in the context of bankruptcy legislation, the court may recognize a person’s control over the debtor if there is evidence (both direct and indirect) confirming the actual participation of such a person in the management of business processes, for example:

- visa of contracts concerning business social activities of the company;
- the presence of a "working" space in the office companies;
- workers' testimonies;
- testimony of authorized persons of the counterparty the company's members who conducted the negotiations;
- electronic correspondence confirming coordination of business decisions and/or processes, including from identical IP addresses;
- any other circumstantial evidence, which can show actual control/management of business processes.

2 For example, the Ruling of the Supreme Court of the Russian Federation dated September 3, 2020 No. 304-ES19-25557 (3) in case No. A46-10739/2017.

3 Determination of the Judicial Collegium for Economic Disputes of the Supreme Court of the Russian Federation dated 15.02.2018 No. 302-ES14-1472 (4, 5, 7) in case No. A33-1677/2013.

Moreover, in the well-known "Ladoga" case[4]
The court actually formulated a position regarding the establishment of control and prosecution even in the absence of evidence that a person gave instructions to perform specific actions that led to the bankruptcy of the company.

The current legislation does not exclude the possibility of bringing to subsidiary liability a person who actually controls the debtor, who carries out his will through other individuals and legal entities controlled by the actual manager, who in fact did not act as independent subjects of civil relations.

However, in practice there are virtually no disputes in which control would be established and a person would be held subsidiarily liable based only on a combination of circumstantial evidence. The presence of formal legal ties still plays a significant role.

In general, at the moment, the following difficulties can be identified associated with developing a strategy for the legal protection of a beneficiary in the presence of accusations of corporate control:

1 **Simplified procedure for proof in the presence of a presumption of guilt in bankruptcy.**

The same indirect evidence - the applicants question the legality and appropriateness of the actions and transactions committed by the debtor, show facts that in some way indicate the participation of the person. This may be the same correspondence in which the beneficiary's email was simply copied on the emails, in which case the burden of proof would shift to the defendant to prove that the content of the emails was not material and that they did not demonstrate control.

In addition, it is worth considering the position of the Supreme Court of the Russian Federation, according to which the ultimate beneficiary, who does not have the appropriate formal powers, is not interested in disclosing his status as a controlling person and tries to disguise the possibility of influencing the debtor. With a different approach, the beneficiaries of the debtor, due to their control over the organization's document flow, would have the opportunity to unilaterally determine the subject of subsidiary liability by drawing up internal organizational documents in a manner favorable to them.[5].

2 **Retrospective assessment by the court of the circumstances of the dispute and the lack of additional evidence due to the time that has passed since the events took place.**

In this case, it is necessary to understand that the bankruptcy trustee and creditors use and will use any opportunity to present evidence in a favorable light (in principle, this is the usual behavior of any party). From the point of view of protection, the difficulty may lie in the fact that the transaction may be much broader and it is necessary to search for and analyze a large array of documents in order to prove, for example, the expediency of the transaction, for a period that goes beyond the three-year period established by law, and the absence of participation of the person in decision-making.

At the same time, it is impossible to rule out situations where the company's management made transactions without

4 Case of insolvency (bankruptcy) of OJSC Industrial Group Ladoga No. A56-83793/2014.

5 Ruling of the Supreme Court of the Russian Federation dated September 3, 2020 No. 304-ES19-25557 (3) in case No. A46-10739/2017.

agreement with the beneficiary. In this case, it is also necessary to present a convincing position in the absence of evidence.

3 **High risk of personal bankruptcy and loss of personal assets.**

4 **If the offshore company refuses to disclose the identity of the beneficiary, the fact is considered proven.**

In Russia, a practice has been established with respect to offshore companies, according to which the obligation to disclose the identity of the beneficiaries is imposed on offshore companies, and if the relevant person does not provide it, it is assumed that the fact is proven. This practice began to develop after the well-known case "Skakova 5", in which the Presidium of the Supreme Arbitration Court of the Russian Federation noted:

> **"Due to the non-public structure of ownership of shares (interests) in an offshore company <...> the burden of proof of the presence or absence of circumstances protecting the offshore company as an independent entity in its relations with third parties should be placed on the offshore company. Such proof is carried out primarily by disclosing information about who is actually behind the company, that is, by disclosing disclosure of information about its ultimate beneficiary"[6].**

This practice was subsequently developed in other decisions of Russian courts, which used similar arguments, and failure to provide information entailed unfavorable procedural consequences for the relevant party.[7]. Courts also agreed to accept evidence presented by offshore companies only if information about the beneficiaries of the companies was disclosed, that is, their good faith was proven.[8]Thus, in one of the cases, the arbitration court noted:

> **"In connection with the refusal of offshore companies to provide the court with information about the ultimate beneficiary, the court of first instance rightly proceeded from the fact that these persons are interconnected"[9].**

DEFENSE STRATEGY BENEFICIARIES

The development of a strategy for the legal protection of a beneficiary when accused of corporate control can be divided into two stages:

1 procedural, which includes determining the circle of persons, the period and the amount of liability;

6 Resolution of the Supreme Arbitration Court of the Russian Federation dated March 26, 2013 No. 14828/12 in case No. A40-82045/11-64-444.

7 Resolutions of the Arbitration Court of the Eastern Military District dated 21.05.2018 No. F01-1545/2018 in case No. A43-30569/2015, the Arbitration Court of the Moscow Region dated 29.03.2018 No. F05-7221/2017 in case No. A40-96862/2016, dated 20.01.2016 No. F05-12062/2014 in case No. A40-26432/12, the Fourteenth AAS dated 22.06.2018 No. 14AP-2998/2018 in case No. A13-10654/2016, the Eighteenth AAS dated 10.05.2017 No. 18AP-4133/2017 in case No. A07-17994/2015.

8 Resolution of the Seventeenth AAS dated September 19, 2017 No. 17AP-1083/2017-GK in case No. A60-27089/2016.

9 Resolutions of the Seventh AAS dated 26.02.2018 No. 07AP-1669/2014 (29), 07AP-1669/2014 (30) in case No. A27-18417/2013, the Ninth AAS dated 07.08.2018 No. 09AP-23046/2018 in case No. A40-158290/16.

2 material, which includes an analysis of the specific circumstances of the dispute and the evidence of the applicants.

But, we believe, an integral part at any stage is active participation in the process - refutation of the existence of the status of the KDL, proving the absence of a causal relationship between the actions of the KDL and the debtor. At the same time, based on the position of the courts, it is not enough to simply declare the absence of a connection and deny the circumstances that the applicants insist on, but the defendant must present his own version of events.

It is important to understand that, as a rule, the position of applicants in the absence of the possibility of obtaining a full volume of evidence is based on the principle of "we bring everyone to justice for everything." That is, as a rule, the application is structured as follows:

- general list of persons suspected of are involved in corporate control;
- a general list of actions (usually transactions) that resulted in the debtor's bankruptcy;
- Normative justification in support statements.

In this case, at the first stage, the positive aspects will be obtaining clarifications to the application indicating specific actions, transactions, decisions in relation to each person, as well as building a chronology of events and imputed actions on the subject of the applicable version of the Bankruptcy Law.

At the second stage, it is necessary to understand and analyze the facts and the impact of certain actions and decisions of the beneficiaries on the bankruptcy of the debtor. It is necessary to find out whether and how the transaction on the reasons for bankruptcy, that is, whether or not the actions and transactions of the beneficiary passed the "materiality test" in relation to the scale of the debtor's activities for the purpose of applying the presumption of bankruptcy.

The cornerstone in disputes about bringing beneficiaries to subsidiary liability is proving the absence of a causal relationship between the actions of the credit institution and the debtor. In particular, in paragraph16 Resolution of the Plenum of the Supreme Court of the Russian Federation of 21.12.2017 No. 53[10]It is indicated that the actions of the KDL must be a necessary cause of the debtor's bankruptcy, without which objective bankruptcy would not have occurred. Moreover, in the Ruling of the Supreme Court of the Russian Federation dated September 30, 2019 No. 305-ES19-10079 in case No. A41-8704/2015, the panel of judges indicated that the court must exclude other (objective, market, etc.) options for worsening the financial situation of the debtor.

That is, bankruptcy must be in direct connection with the actions of the debtor and the beneficiary. For example, the main problem is when there is a consistent chain of transactions, from which it is clear that there was a creation of "loss-making" and "profitable" centers within a group of companies, when liabilities are concentrated on the debtor, and profits and assets are distributed among other companies. Let's say a loan was opened for the debtor, which was then distributed among intra-group loans to the companies of the group - in this case, with a high degree of probability, we can say that the actions of the beneficiaries were aimed precisely at creating such centers.

However, it is important to note here the so-called business decision protection rule (paragraph 18

10 Resolution of the Plenum of the Supreme Court of the Russian Federation of 21.12.2017 No. 53 "On certain issues related to bringing persons controlling the debtor to liability in bankruptcy."

Resolution of the Plenum of the Supreme Court of the Russian Federation dated 21.12.2017 No. 53), when the creditor is not subject to subsidiary liability if his actions: did not go beyond the limits of ordinary business risk; were not aimed at violating the rights and interests of the company and its creditors. The essence of this rule is that a person whose actions were not aimed at violating the rights of the company or creditors, but circumstances developed in such a way that, despite all the actions taken, it was not possible to bring the debtor out of the crisis, is not subject to liability.

The problem of proof in this case is that it is often quite difficult to determine whether the beneficiary's decision was simply unfortunate or whether it will be considered as bad faith behavior. In fact, the court must give some economic assessment of the imputed actions. One option in support of the position may be the opinion of specialists from the point of view of economic analysis of the actions taken or the findings of a forensic examination, the resolution of which may involve a wide range of questions.

For example, a debtor was refinanced in a bank on not very favorable terms, after which the company was declared bankrupt. When considering the issue of the advisability and grounds for making a decision to conclude a loan agreement, previously obtained expert opinions may be presented, which showed that the company can carry out sales volumes at a certain level, that is, when deciding to agree on such a step, the beneficiary conscientiously relied and counted on sales in a certain volume, respectively, on the fact that the received funds would be sufficient to service the loan. At the same time, in the process of considering the dispute by the court on attracting additional financial analysis may be carried out to establish subsidiary liability, which, for example, will show that the reason why the original financial plan was not implemented was that prices for this type of product fell on the world market.

However, at the present time, the rule of protecting a business decision when assessing the actions (inactions) of a KDL is rarely encountered in practice.

CONCLUSION

In conclusion, I would also like to note that in disputes on bringing beneficiaries to subsidiary liability in bankruptcy cases, it seems important to monitor and work in the information field. Since often, especially if the dispute concerns a large company, one of the parties or parties seeks to make the situation public in order to exert certain pressure on the person accused of corporate control, to form a specific opinion among certain groups. In this regard, it is necessary to consider and prepare options for conducting complex negotiations with procedural opponents, as well as public support of the conflict to form public opinion.

Although there are no prerequisites for significant changes in the legislation regarding subsidiary liability in bankruptcy cases in the foreseeable future, in practice the courts are quite strict and critical of persons who have influenced the company in one way or another. Nevertheless, at the present time the courts are trying to more scrupulously and carefully examine the circumstances of the dispute regarding subsidiary liability, individually in relation to each defendant.