

Client Alert

Latham & Watkins
Corporate Department

***Farimex vs. Telenor:* Russian Court Ruling May Lower the Bar for Piercing the Corporate Veil**

On March 12, 2009, a Russian court bailiff seized Telenor's multi-billion dollar 29.9 percent stake in OAO Vimpelcom, Russia's second-largest mobile communications operator, following a Siberian court decision that found Telenor liable to Vimpelcom for US\$1.7 billion in damages.

The plaintiff in the case is Farimex Products Ltd., a little-known British Virgin Islands company owning 0.002 percent of Vimpelcom. In its complaint, Farimex alleged that Telenor intentionally blocked Vimpelcom's expansion into Ukraine in 2005 to protect Telenor's stake in Kyivstar, Ukraine's largest mobile services provider, effectively delaying Vimpelcom's entry into the Ukrainian market for one year and causing significant losses to Vimpelcom.

In ruling for Farimex, the court made the unprecedented decision to "pierce the corporate veil" with respect to a minority shareholder and hold Telenor responsible for the actions of Vimpelcom. The case is currently on appeal and is likely to make its way up to Russia's highest court, the Supreme Arbitrazh Court. If the ruling is upheld on appeal, it may have significant implications for all shareholders capable of exercising *de facto* veto power over the actions of Russian companies, particularly through voting or abstention by their nominees to boards of directors.

Factual Background

The Parties and Their Interests

Vimpelcom is a Russian open joint stock company and the second-largest mobile services provider in Russia. Its ADRs have been listed on the New York Stock Exchange since 1996. Vimpelcom's two largest shareholders are Alfa Group, one of Russia's largest privately owned conglomerates, and Telenor, a Norwegian telecommunications company majority owned by the Norwegian government. Telenor, which owns 29.9 percent of the voting shares of Vimpelcom, and Alfa Group, which owns 44 percent of the voting shares of Vimpelcom, have a long a history of corporate disputes relating to their interests in Vimpelcom. Telenor has asserted, and Alfa Group has denied, that Farimex is a related party of Alfa Group.

Vimpelcom's Board of Directors (the Board) is comprised of nine directors, four of whom are nominees of Telenor, four of whom are nominees of Alfa Group and one of whom is independent.¹ Vimpelcom's charter² provides that resolutions on acquisitions or disposals of interests in other companies must be approved by at least 80 percent of the Board — *i.e.*, eight of the nine Board members.

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The Transaction

According to Farimex's complaint, in November 2004, Vimpelcom's management presented the company's Board with an opportunity to expand into the Ukrainian mobile communication services market through the acquisition of a company called ZAO Ukrainian Radiosystems (URS). The Board decided to engage independent advisors in connection with this potential acquisition and, on February 18, 2005, Vimpelcom entered into an option agreement giving it the right to acquire 100 percent of the shares of URS.

In April 2005, with the company's exclusive rights under the option agreement about to expire, Vimpelcom's management asked the Board to approve the acquisition of URS. However, the Board failed to do so, as three Telenor-nominated Board members³ voted against the transaction.

In June 2005, Vimpelcom's management submitted a new proposal to the Board to acquire URS. The Board again rejected the transaction, with two of Telenor's four Board nominees voting against it.

In August 2005, Vimpelcom's management requested that the Board approve a resolution generally affirming its support for the company's strategy to expand into Ukraine. The resolution was rejected, with one Telenor-nominated director voting against it and two other Telenor-nominated directors abstaining.

In September 2005, Vimpelcom's extraordinary general shareholders' meeting approved the acquisition of 100 percent of URS. Vimpelcom subsequently signed an agreement to acquire URS in November 2005.

The Litigation

Procedural Posture

On April 14, 2008, Farimex⁴ filed a claim with the Yugra Arbitrazh Court (the Trial Court) against a number of Vimpelcom's shareholders, including Telenor and Alfa Group⁵, seeking approximately US\$3.8 billion in damages on behalf of Vimpelcom.

In its claim, Farimex alleged that the damages represented losses incurred by Vimpelcom as a result of the shareholders intentionally impeding Vimpelcom's expansion into the Ukrainian market. In this connection, the court ordered independent expert testimony regarding (i) the amount by which Vimpelcom's market capitalization would have increased had it entered the Ukrainian market in November 2004 instead of a year later, (ii) the profits generated by URS from November 1, 2004–April 14, 2008 and (iii) as of April 14, 2008, the overall loss to Vimpelcom resulting from the delay in the URS acquisition. The experts valued the overall loss at US\$2.8 billion.

On August 16, 2008, the Trial Court ruled in favor of Farimex. However, among all of the defendants, only Telenor was found by the Trial Court to be liable, and was ordered to pay damages of US\$2.8 billion to Vimpelcom. Telenor appealed this decision to the Eighth Arbitrazh Appellate Court based in the Russian city of Omsk (the Regional Appeals Court).

On December 19, 2008, the Regional Appeals Court set aside the Trial Court's ruling and initiated a *de novo* review of the case. On February 20, 2009, the Regional Appeals Court ruled for the plaintiff, and ordered Telenor to pay US\$1.73 billion to Vimpelcom.

The Holding and the Rationales

In its decision, the Regional Appeals Court held that Telenor, by virtue of the veto power exercisable by its nominees to the Board on the issue of acquisitions and disposals, was the "effective parent" of Vimpelcom, and that Telenor was liable to Vimpelcom for the knowing exercise by its nominees of such veto power to Vimpelcom's detriment.

Article 6(2) of the Federal Law "On Joint Stock Companies,"⁶ or the Joint Stock Companies Law, sets forth certain criteria for recognizing a person as an "effective parent" of another company, including the person's (i) predominant participation in the charter capital of the company; (ii) ability to determine the

decisions adopted by the company by virtue of an agreement between them; or (iii) ability to determine the decisions of the company by other means. In addition, a relationship between two companies may be viewed as that of an effective parent and an effective subsidiary with respect to specific individual transactions.⁷ Article 6(3) of the of the Joint Stock Companies Law allows a shareholder of a company to seek damages from the effective parent on behalf of such company, if the shareholder can prove that the damages occurred due to the fault of the effective parent through knowing exercise of control over the company. Applying the law to the facts of the case, the Regional Appeals Court found that because Vimpelcom's charter requires 80 percent of the Board to approve acquisitions or disposals, Telenor's ability to appoint at least two of the nine directors to the Board effectively enables Telenor to determine Board resolutions with respect to these issues, thereby satisfying one of the criteria for deeming Telenor an "effective parent."

The Regional Appeals Court further held that Telenor's actions to block the URS acquisition resulted in losses for Vimpelcom, and found that Telenor was actually aware that its actions would be detrimental to Vimpelcom due to (i) its extensive knowledge of the Ukrainian telecommunication market; (ii) the lack of any alternatives for Vimpelcom to penetrate the Ukrainian market other than through the acquisition of URS; and (iii) Telenor's involvement with/commitment to another Ukrainian cellular operator, Kyivstar.

In its defense, Telenor asserted that it cannot be viewed as Vimpelcom's effective parent because the exercise of voting powers by its nominees to the Board expresses such nominees' independent judgment, and not Telenor's will. Telenor further argued that its nominees to the Board voted against the transaction due to their belief that URS was overvalued and had no credible business plan, as well as their concern as to the lack of transparency in the transaction, including a lack of information

concerning the identity URS's beneficial owners (*i.e.*, the sellers). Accordingly, Telenor asserted that its nominees had acted in Vimplecom's best interests, and not intentionally to Vimpelcom's detriment.

Nevertheless, the Regional Appeals Court held that Telenor acted as the "effective parent" and, in this capacity, caused a loss to Vimpelcom. The Regional Appeals Court largely relied on the experts' assessment of the damages in the Trial Court proceeding, but adjusted it downward to US\$1.73 billion due to changes in the assumed market share of URS and the earliest date that the acquisition could have been consummated.

On March 4, 2009, Telenor appealed the decision of the Regional Appeals Court, and the case is currently pending in the North-Western District Federal Arbitrazh Court (the Federal Appeals Court) with a hearing scheduled for May 26, 2009. The Federal Appeals Court denied Telenor's petition to stay the enforcement of the Regional Appeals Court's judgment, and Telenor's entire shareholding in Vimpelcom was seized by a bailiff on March 12, 2009. The seizure of Telenor's shares prevents Telenor from transacting in the shares or using them as collateral, and could ultimately result in their sale through a public tender. On April 3, 2009, Telenor was served with a notice ordering it to pay the \$1.73 billion claim within five days. Telenor's failure to do so will allow the bailiff to sell Telenor's stake in Vimpelcom to satisfy the judgment.

Implications

The holding in the *Telenor* case is potentially breathtaking in scope. The court's rationale does not even depend on Telenor having a blocking stake (25 percent) of shares, and could conceivably support veil piercing in many cases where a shareholder has the right to nominate a director who finds himself or herself in the uncomfortable position of having the swing vote on any issue put to a vote of the board.

If the decision is upheld on appeal and followed, it would tend to undermine

fundamental principles of limited shareholder liability under Russian corporate law. It is at best a leap of logic to impute (without further analysis) a director's *de facto* ability to veto a board resolution to the shareholder that nominated him, and a stretch of the plain language of Article 6(2) to interpret that imputed veto as giving the shareholder the ability to determine the actions of the company. More fundamentally, however, the rationale behind the holding strays far off the well-trodden path of the alter ego theory of veil piercing, which generally requires some combination of a unity of interest between the shareholder and the company, failure to observe corporate formalities, and the use of the company to commit a wrongful act to the detriment of a third-party plaintiff.

That said, since Russian law does not operate under a precedent system, other courts would not be bound to follow this decision even if affirmed on appeal. In that regard, it is interesting to note that Farimex did not bring the more obvious claim for breach of the directors' duties to act reasonably and in good faith for the benefit of the company under Article 71(2) of the Joint Stock Companies Law. Quite simply, it could not — as a 0.002 percent shareholder of Vimpelcom, it did not have the requisite 1 percent needed for standing to sue. Moreover, the directors would have been unable to satisfy a multi-billion dollar claim, and Telenor's shares therefore presented an obvious and tempting target to the plaintiff. While the Regional Appellate Court was willing to stretch Article 6 beyond the breaking point in an effort to provide a remedy to Farimex, other courts faced with similar facts may well be reluctant to make the same stretch.

In the meantime, even if ultimately reversed on appeal or distinguished by other courts on its facts, the Regional Appellate Court's ruling throws a previously well-settled area of law into question, and both new investors and existing shareholders in Russian joint stock companies will need to reevaluate their relationships with the directors they nominate and the companies those directors serve.

Endnotes

- ¹ According to Vimpelcom's Form 20-Fs for the years ended December 31, 2004, 2005 and 2006, Vimpelcom directors were nominated by the following shareholders for the relevant periods: April 30, 2004: Telenor: 4, Alfa Group: 4, nominated by Telenor and approved by Alfa Group: 1. April 30, 2005: Telenor: 4, Alfa Group: 4, nominated by Telenor and approved by Alfa Group: 1. March 31, 2006: Telenor: 4, Alfa Group: 5.
In addition, under the terms of a shareholders agreement dated as of May 30, 2001 between Telenor and Alfa Group, Telenor and Alfa Group each have the right to nominate up to four candidates for election to Vimpelcom's board of directors.
- ² Vimpelcom's charter, Articles 10.5, 10.5.11 and 10.6: http://about.beeline.ru/media/Documents_for_download/Documents%20Vimpelcom/VimpelCom-Charter_2007.pdf
- ³ Vimpelcom Form 20-F for the year ended December 31, 2005, filed with the U.S. Securities and Exchange Commission, page 112.
- ⁴ Farimex owns 25,000 Vimpelcom ADRs, amounting to approximately 0.002 percent of Vimpelcom's share capital. In its ruling, the Trial Court specifically held that ADR holders of a Russian company had standing to bring a lawsuit in the Russian courts based on positions expressed in publications by the Russian Federal Service for Financial Markets (Federal Service for Financial Markets' letter No. 05-VG-03/13719 dated August 29, 2005) and the Russian Ministry of Finance (Ministry of Finance's Letter No. 03-03-05/272 dated December 12, 2007 and Ministry of Finance's Tax, Customs and Tariffs Department's Letter No. 03-08-05 dated March 2, 2005), as well as Vimpelcom's charter (Article 3.1). The Regional Appeals Court further supported this view by expressly stating that an ADR holder's claim against a Russian issuer of the underlying shares does not contradict Russian public policy.
- ⁵ Some of the defendants were affiliates of Telenor and Alfa Group. The case was initiated in Yurga based on the registered address of one of the defendants, CT-Mobile, an Alfa Group affiliate.
- ⁶ Federal Law No. 208-FZ "On Joint Stock Companies" dated December 26, 1995, as amended.
- ⁷ Clause 31 of the Decree of the Supreme Court Plenum and the Supreme Arbitrazh Court Plenum No. 6/8 "On Certain Issues of the Russian Civil Code Application" dated July 1, 1996.

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