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Going Beyond: The Ultra Vires Problem in Russian Corporate Law

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LEGISLATIVE OVERVIEW

GOING BEYOND: THE ULTRA VIRES
PROBLEM IN RUSSIAN CORPORATE LAW

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I. INTRODUCTION

One of the important issues in corporate law is the ultra vires problem. If a corporation taking a certain action exceeds its legal capacity, can such an action be binding? Another but related question: If a corporate governing body or agent exceeds its authority, can its action be binding for the corporation? The common-law and civil-law systems provide somewhat different answers to these questions. In this article, I discuss the ultra vires problem as it stands in Russian corporate law, and, to a certain extent, compare the Russian understanding of the issue with those of the United States and Europe.

As a civil-law country, Russia does not maintain the legal concept of ultra vires in the sense of British or American law. That is, a commercial organization normally has unlimited capacity to enter into any kind of transactions (with certain reservations discussed below). On the other hand, transactions entered into by the company’s CEO beyond his or her management powers (as de-

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fined in the company’s founding documents) may often be held invalid. This limitation makes the rights of bona fide third persons doing business with the company vulnerable, particularly, relative to similar transacting parties in Europe or the United States.

During Russia’s communist era, the state limited the capacity of legal organizations to restricted purposes. However, the situation changed in 1995 with the enactment of the first part of the Civil Code of the Russian Federation (“GK RF”). While the status and activities of legal persons are now subject to various specific statutes (such as the Law on Joint-Stock Companies and the Law on Limited Liability Companies), basic provisions controlling the validity of transactions of legal persons are stipulated by the Civil Code. The judiciary, also, while not formally a source of law in Russia, often establishes legal norms almost as important as statutory ones, as we will see below.

II. CAPACITY OF A LEGAL PERSON

Article 49 of the Civil Code (Art. 49 GK RF) (“Capacity of a Legal Person”) stipulates the following:

1. A legal person may have civil rights conforming to the purposes of its activity, as provided for in its founding documents, and may undertake obligations connected with this activity. Commercial organizations, with the exception of unitary enterprises and other types of organizations specified by law, may have civil rights and undertake civil obligations required for the exercise of any type of activity not prohibited by law. With regards to certain types of activity, the list of which is determined by law, a legal person may engage in such activities only under special permit (license).

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2. Grazhdanski Kodeks RF [GK] [Civil Code] part 1 (Russ.) (last amended 2007).
5. An organization is a legal person, and it may be either commercial or non-commercial; commercial organizations may further be divided into companies, partnerships, manufacturing cooperatives, and unitary enterprises. Companies, the most fre-
Thus, the capacity of most commercial organizations is unlimited by default but should “conform” to the purposes of the respective organizations. This requirement, however, leaves one question open: Does “conforming to the purposes” mean that a company may do anything not explicitly prohibited by its “founding documents” (i.e. the articles of incorporation or the corporate charter, to use the American terminology), or, on the contrary, that its activity is limited by what is explicitly allowed by the founding documents? This is exactly the question encountered by the House of Lords in England, in 1862, in the famous Ashbury case\textsuperscript{6} which introduced the ultra vires doctrine into British corporate law.\textsuperscript{7} Because of ambiguous language in the relevant statutes, the issue had to be resolved by the judiciary in both Russia and the United Kingdom, respectively. However, the answer given by the Russian judiciary appears to be the opposite of that given by the House of Lords in 1862.

A joint plenary session of the Supreme Court and the Supreme Arbitration Court\textsuperscript{8} - the highest judiciary authorities in Russia’s...
parallel worlds of general justice and commercial disputes, respectively - resolved the issue as follows:

18. In resolving disputes, it is necessary to consider that commercial organizations, with the exception of unitary enterprises and other organizations envisaged by law, are vested with general capacity (Article 49 [GK RF]) and may carry on any kind of business activity not prohibited by the law, unless in the founding documents of such commercial organizations there is an exhaustive (closed) list of the kinds of activity in which the corresponding organization has the right to engage. . . .

Unitary enterprises, as well as other commercial organizations for which law stipulates special capacity (banks, insurance companies, and certain other kinds of institutions), shall have no right to make transactions contradicting to the purposes and objects of their activity, defined by the law or by other legal acts. Such transactions shall be void on the ground of Article 168 [GK RF].

Transactions made by other commercial organizations in contradiction with the purposes of their activity definitely restricted in their founding documents, may be held invalid by the courts in the cases envisaged in Article 173 [GK RF].9

From the language of both the Civil Code and the discussed decision we can conclude that the capacity of non-commercial organizations in Russia is limited. For example, in one of its decisions,10 the Federal Arbitration Court for the Moscow Circuit tested the limits of the corporate capacity of a non-commercial organization, the Bolshoy Theater of Russia ("Theater"). The Theater entered into a surety contract with a bank, having assumed joint and several responsibility for repayment of a bank loan by an indi-

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vidual. Since the individual had not repaid the loan, the bank sued the Theater. The Theater counterclaimed, alleging the surety contract to be invalid. The court, in three instances, held the contract void. The court reasoned that the Theater, as a non-commercial organization specializing in dramatic and musical arts, enjoyed only special capacity. The surety contract went beyond the stated purposes and had been entered into without an agreement of the owner of the Theater’s assets (namely, the Russian Federation); hence, the contract was void (Art. 168 GK RF).

As for commercial organizations, Art. 173 GK RF ("Invalidity of a Transaction of a Legal Person beyond Its Capacity") establishes the following rule in respect to the invalidity of their ultra vires transactions:

A transaction performed by a legal person in contradiction with the purposes of activity expressly restricted in the person’s founding documents or by a legal person not having a license to engage in the respective activity may be held invalid by court in an action by this legal person, its founder (member) or a state agency exercising control or supervision of the legal person’s activity, where it is proved that the other party to the transaction knew or certainly should have known of the illegality thereof.

A U.S. reader may notice how both Art. 173 GK RF and § 3.04 ("Ultra Vires") of the Model Business Corporations Act 11 ("MBCA") contain a similar list of possible claimants. Note, however, that the GK RF, unlike the MBCA, does not impose any restrictions on the circle of persons against whom an action may be brought. In particular, a company is able to challenge its own transaction against the other party to the transaction if the other

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11. Model Business Corporation Act § 3.04 provides in part:

(a) Except as provided in subsection (b), the validity of corporate action may not be challenged on the ground that the corporation lacks or lacked power to act.

(b) A corporation’s power to act may be challenged:

1) in a proceeding by a shareholder against the corporation to enjoin the act;
2) in a proceeding by the corporation, directly, derivatively, or through a receiver, trustee, or other legal representative, against an incumbent or former director, officer, employee, or agent of the corporation; or
3) in a proceeding by the Attorney General under section 14.30.
party "knew or certainly should have known" that the transaction was *ultra vires*.

A European reader, in turn, may appreciate the similarity that the "knew or … should have known" clause has to the provision of Art. 9(1) of the European Communities’ First Directive [on corporate law matters] ("Directive"). Note, however, that the Directive further explains that the mere presentation of corporate documents to a third party does not prove the third party’s knowledge of the limitations contained therein; the Russian Civil Code does not say so, nor do Russian courts construe the Code so broadly (see below).

While the problem of corporate transactions occurring beyond a corporation’s founding documents is somewhat theoretical (Russian companies’ founding documents almost never restrict the types of their activities to a closed list), the other problem addressed by the same article, namely the problem of carrying out certain transactions without a proper license, is rather relevant. As we see, to challenge such a transaction, one should prove that the other party in the transaction knew or should have known that the organization did not have the license to engage in such a transaction. Note that the right to challenge the transaction belongs only to the organization itself, its members and state organs. Thus, for example, if an organization insured somebody without a relevant license, the organization can, in principle, challenge the transaction, but the insured person cannot.

As an example where a court applies Art. 173 GK RF, consider a case of the Moscow Circuit Federal Arbitration Court. An airline company entered into a contract with a helicopter plant ("MIL"). The contract provided for safe custody, parking and servicing a helicopter belonging to the company. After the plant failed to perform the contract for more than a year, the company terminated the contract. The plant sued the company to recover the amount stipulated by the contract plus interest accrued. The company counter-claimed for a breach of contract, seeking damages relating to im-

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12. "Member States may provide that the company shall not be bound where such acts are outside the objects of the company, if it proves that the third party knew that the act was outside those objects or could not in view of the circumstances have been unaware of it; disclosure of the statutes shall not of itself be sufficient proof thereof." Council Directive 68/151, art. 9(1), 1968 O.J. Spec. Ed. 41 (EEC).

pairment of the helicopter because of improper servicing and parking. The court, in two instances, awarded the plant with the value of parking services (RUR 3 million), though not the value of the work; but it also awarded the company damages for repairing the helicopter (RUR 200 million). The plant appealed to the Moscow Circuit arguing, in particular, that the original contract was void in relation to technical servicing because the plant did not have the relevant license. The FAC held that the contract was not void but rather voidable in accordance with Art. 173 GK RF. The plant, however, did not submit any proof that a court had ever invalidated the contract. Accordingly, the judgment was affirmed and the appeal was dismissed.¹⁴

To summarize, commercial organizations, generally speaking, have general (unlimited) capacity, but their founding documents may explicitly limit the list of their activities. In this case, any transaction beyond the limit would be voidable (i.e., may be held invalid by a court decision). Non-commercial organizations, as well as certain types of commercial ones, have special (limited) capacity, that is, have a right to do only what they are directly permitted to do by law. Their transactions beyond the capacity are void (i.e., invalid without any court decision).

A. Powers of a Legal Person’s Governing Body

A completely different story is the ultra vires actions of the legal persons’ governing bodies, including actions of the general director of a company (i.e., actions beyond the powers of a governing body).¹⁵ While the capacity of a company as a whole is normally

¹⁴. To understand what happened, it is important to know that the statute of limitations for challenging void transactions - Grazhdanskii Kodeks RF [GK] [Civil Code] part 1, art. 181 (1995) (Russ.), which was ten years at the time of the suit, and is now three years - is longer than the similar limitation for voidable transactions (one year). Id. Since the contract had been formed more than a year ago, the plant would be unable to have held the voidable contract invalid, so it tried to argue that the contract was in fact void. The court disagreed.

¹⁵. To expand more on terminology: governing bodies (or “organs”) of a Russian company are its general meeting, its board of directors (also known as supervisory board) if any, and its executive board, very often reduced to an “individual executive body” (also variously known as the [sole] director, general director, or president). See Grazhdanskii Kodeks RF [GK] [Civil Code] part 1, art. 91, art. 103 (1995) (Russ.). See also specific statutes cited in supra notes 3-4. Of all corporate governing bodies, only the “individual executive body” (general director) is able to represent the company without a power of attorney in transactions with third parties. However, it is important to distinguish be-
unlimited, the powers of any of its governing bodies are limited by law and may be additionally restricted (or rather redistributed) by corporate documents. Exceeding a governing body's powers results in the invalidity of the action. These issues are controlled by the next article of the Code: Art. 174 GK RF ("Consequences of Restricting Powers to Perform Transaction"), which states the following:

Where a person’s powers to perform a transaction are restricted by agreement or where the powers of a legal person’s governing body are restricted by its founding documents . . . , and where in its performance such a person or governing body go beyond these restrictions, the transaction may be held invalid by a court upon a challenge of the person in whose interests the restrictions are established, only in cases where it is proved that the other party to the transaction knew or certainly should have known of the aforesaid restrictions.

Several questions immediately arise with respect to the above-quoted provision. First, who is the enigmatic person “in whose interests the restrictions are established”? Second, what does the phrase “certainly should have known” mean in this context? The answers (to a certain extent surprising) are again available in judicial acts. The problem of exceeding the authority by a company’s governing body can by no means be called a purely theoretical issue for Russia. A SAC Plenary Session adopted a special decision devoted to the application of Art. 174 GK RF.16 According to the SAC, the restrictions placed on the powers of a legal person’s governing body, stipulated by the founding documents, are established in the interests of (guess who?) this very same legal person.17 Accordingly, only the organization itself is able to challenge the transaction. Other persons, including the company’s shareholders, can make a claim only in cases explicitly stipulated by law.


17. Id. at para. 4.
As for the second question, the SAC provides a somewhat vague explanation: "this circumstance is a part of the subject of proof in such cases", and "the burden of proof is on the claimant."\textsuperscript{18} In practice, courts often follow a very simple (and very questionable) rule: any commercial partner of a legal person "certainly should have known" the contents of the legal person's founding documents (supposedly having requested them before entering into any contract).\textsuperscript{19} This unwritten rule (in some jurisdictions known as the "constructive notice" doctrine) is, as we see, in striking contradiction with the above-mentioned European rule, which assumes that even actual possession of such papers does not necessarily impute knowledge of the restrictions contained therein. One practical conclusion is that you always must examine the founding documents of a Russian company before entering into any contract with it; otherwise you may find yourself a party to an invalid contract.

Finally, the SAC emphasized that Art. 174 GK RF is relevant only to the power restrictions that the founding documents place upon legal persons; if a governing body exceeds its powers stipulated by law (e.g., a company's supervisory board member signs a contract on behalf of the company), then the transaction is void under Art. 168 GK RF (unless other consequences are stated by that specific law).\textsuperscript{20}

As an example, consider a case decided by the Moscow Circuit FAC.\textsuperscript{21} The founding documents of a limited liability company stipulated that only the general meeting of its members is competent to dispose of the company's property. In contradiction to this provision, the same documents also empowered the general director of the company to perform transactions "without a power of attorney". The general director, without asking the members, sold certain real property belonging to the company to another organization, and, in the opinion of the members, did it at an understated price. The other organization sold the property to a third party and was soon liquidated. Members of the company sued both the liquidated organization and the third party. The first instance court (1) dismissed the case against the first organization because of its

\begin{footnotesize}
\textsuperscript{18} Id. at para. 5.

\textsuperscript{19} See, e.g., infra, note 21 (a first-instance court ruled that the buyer should have familiarized oneself with the founding documents of the seller).

\textsuperscript{20} Supra note 16 at para. 1.

\end{footnotesize}
liquidation, but (2) held the contract for the sale of the property was invalid on the ground of Art. 174 GK RF because the general director exceeded his powers. However, an appeals court in the second instance reversed the second part of the judgment indicating that, in accordance with Art. 174, only the company itself, and not its members, may challenge the transaction. The third-instance court (the Moscow Circuit) agreed with this conclusion, but nevertheless vacated and remanded the judgment indicating that the transaction might well be invalid because of its being “major,” as the claimants indicated. Russian corporate law requires a special approval procedure for transactions involving more than 25% of a company’s assets; unless the procedure is observed, the transaction is voidable.\footnote{22}

To summarize, transactions exceeding the powers of governing bodies, stipulated by the founding documents, are voidable at the challenge of the organization itself; transactions exceeding the powers of governing bodies stipulated by law are void unless other consequences are envisaged by that law.

B. Powers of a Legal Person’s Representative

Unlike common-law legal systems, Russian law draws a bright line between (1) a legal person’s governing body, including the company’s general director, who exceeds the authority of the governing body (stipulated in the founding documents), and (2) a legal person’s representative who exceeds his authority (normally stipulated in a written power of attorney). The latter case is governed by Art. 183 GK RF “Conclusion of a Transaction by an Unauthorized Person,” which states the following:

In the absence of authority to act in the name of another person or where such authority is exceeded, a transaction shall be deemed concluded in the name and in the interests of the person performing it, unless the other person (principal) subsequently gives direct approval to this transaction.

Subsequent approval of a transaction by the principal shall create, alter or terminate for him civil rights and obligations under the transaction from the time of performance thereof.

In particular, acceptance of performance (including acceptance of payment) from the other party constitutes an approval of a contract. This is again a judiciary-created provision.\(^{23}\)

In one case, the Moscow Circuit FAC examined a claim of a mobile phone operator against an organization to recover a debt and a penalty charge under a contract for providing communication services.\(^{24}\) The claim was dismissed and the judgment affirmed up to the third instance. The court based its reasoning on the fact that the contract was signed on behalf of the organization by the abonent (phone user) herself, and the claimant did not produce any proof that the abonent actually had concluded the contract on behalf and in the interests of the organization in question. A guarantee letter of the organization was presented, but the authority of the persons having signed the letter was also not proven. Accordingly, the organization was held to be an "improper defendant." The court proposed that the mobile company substitute the improper defendant for the abonent herself, but the company declined (apparently doubting the likelihood to recover from a private individual).

To summarize, a transaction concluded by an unauthorized representative of an organization is valid (unlike a transaction of an unauthorized governing body). However, not the organization, but rather the unauthorized representative himself, is a party to the transaction. The organization is able to ratify the transaction, thereby becoming a party to the transaction instead of the representative.

C. Are \textit{Ultra Vires} Transactions of a Governing Body Approvable?

The Civil Code does not envision (at least explicitly) a possibility for a legal person to ratify the \textit{ultra vires} actions of its governing body such as the actions of its general director (as opposed to the actions of its representative). This differentiation was probably intentional. As discussed, the transactions in question are invalid

\(^{23}\) Information Letter of the Presidium of the Supreme Arbitration Court of the Russian Federation on Some Issues of the Practice of Application of Article 183 of the Civil Code of the Russian Federation, No. 57 of 23, Oct. 2000, \(\text{, Vestn. VAS RF, 2000, No. 12, translated in LEXIS GARANT 12021112.}\)

(voidable), and the Code consistently avoids situations in which an
originally voidable transaction turns into a valid one at a later
time.25 The position of the Code drafters is understandable: since
the ratified transaction would become valid from the moment of
entering into the transaction rather than from the moment of its
ratification, the situation is fraught with paradoxes (whether or not
the parties are bound by the terms of a contract depends upon the
act of ratification, which may or may not occur in future).

However, courts, driven by practical needs rather than by con-
siderations of theoretical purity, consistently allow post factum
ratification of transactions entered by the corporate governing bod-
ies beyond their powers, where such extensions of the power of the
governing bodies were not specifically prohibited by the relevant
law. One example is the possibility to ratify “major” transaction.26
With respect to corporate governing bodies exceeding the authority
stipulated by the founding documents (rather than by law), the
SAC articulated this position in its above-discussed decision on
Art. 174 GK RF:

The person in whose interests the restrictions are estab-
lished [i.e., the company] has a right to approve at a later
time the transaction performed with defects mentioned in
Art. 174 GK RF [i.e., beyond the powers of a governing
body]. Since the article does not contain provisions on rati-
fication of transactions, by virtue of Art. 6 GK RF [“anal-
ogy of law”] such relations are governed by Art. 183(2) GK
RF [ratification of unauthorized representative’s transac-
tions] regulating similar relations. . . .27

Finding a right of ratification by analogy may seem questionable
here; however, we should keep in mind that SAC decisions on is-
SAC decisions on issues of court practice are binding on the commercial courts. Ac-
cordingly, as a result, the SAC introduced an imperative norm of
which is not less effective (in the system of state commercial
courts) than the Civil Code itself. As we see, the “bright line”

25. The only exception is ratification of transactions concluded by minors under Art.
26 GK RF. In addition, there are several cases where an originally void transaction may
be turned into a valid one by a later court decision: transactions without necessary notar-
ial certification (Art. 165 GK RF), transactions of mentally disturbed persons (Art. 171
GK RF), and of infants below the age of 14 (Art. 172 GK RF). See Sergey Budylin, A
Comparative Study in the Law of the Non-Existent: Contract Invalidity in the U.S. and
26. See generally Budylin, supra note 22.
27. Supra note 16, para. 7.
drawn by the Code between corporate governing bodies and corporate representatives is somewhat blurred by judiciary practice.

To summarize, the organization may later ratify voidable transactions beyond the powers of corporate governing bodies.

III. CLASSIFICATION PROBLEM

As a practical matter, it is not always easy to distinguish three different situations: (1) a governing body exceeds its authority under law; (2) a governing body exceeds its authority under the founding documents; and (3) a representative exceeds its authority (normally, under a power of attorney).

In one case, a selling organization sued a buyer requesting the court to invalidate a transaction. The transaction in question was a contract for sale of an apartment. The seller claimed replevin of the apartment because the signatures of the seller’s director on both the contract and the transfer deed had been forged by the seller’s chief accountant. The question was whether the contract was void under Art. 168, voidable under Art. 174, or else “not entered into” by the company under Art. 183. The legal consequences are somewhat different, in particular with respect to the applicable statutes of limitation (respectively, ten years, one year, and three years).28

After a series of contradictory decisions, the case reached the last-instance court. The SAC Presidium resolved the issue as follows: a chief accountant is not allowed under law to enter into transactions on behalf of a company, hence, Art. 168, rather than Art. 174 or Art. 183, is applicable.29 The court upheld the claim, finding the transaction void. To summarize, special attention to the issue of ultra vires action classification is advisable.

IV. CONCLUSION

The capacity of a Russian commercial organization is unlimited by default, but the capacity of a non-commercial organization is always limited. Ultra vires transactions of a non-commercial or-
organization are void. Transactions of a commercial organization that violate explicit restrictions contained in its founding documents or concluded without a proper license (if needed) are voidable.

Transactions by a corporate governing body (in particular, the general director of a company) beyond its powers, as prescribed under the founding documents, are voidable. An organization can later ratify such transactions, making them valid. Transactions by a corporate governing body beyond its powers under law are void, unless other consequences are stated by that specific law.

Transactions by a corporate representative beyond that representative’s powers are valid, but bind only the representative, and not the organization. However, the organization can later ratify such transactions, after which they become binding.

The potential for the future invalidation of the actions of corporate governing bodies makes the interests of third persons doing business with the organization relatively vulnerable.