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Use of a Trust Construction for the Purpose to Control Affiliate and Inter-Group Connections Under the Laws of the Republic of Kazakhstan

Abstract. This Article includes a short analysis of a legal notion of trust and possibilities for practical use of various trust constructions known to English law or other legal system developed based on the Common law. General outcomes of such analysis are compared to notions of an affiliate person and controlling shareholder under the laws of Kazakhstan with the intention to find a solution for a major shareholder to retain his/her possession over a company's shares but to avoid his/her qualification as a person exercising control over the company. The authors consider Kazakhstani judicial practice in the issue of determination of existence of a controlling power over a legal entity. It is argued that regulation of a trust management agreement by the Civil Code of Kazakhstan is not sufficient to provide a real independence of a trust manager from the founder and/or beneficiary. It is also noted that in such circumstances Kazakhstani court will unlikely find any ground for acknowledgement of a fact a founder of the trust management under Kazakhstan's law does not have any controlling authorities over the company that shared belong to the founder. Futher research on reception of the trust concept has been recommended.
Keywords: affiliated person, trust, blind trust, trustee, beneficiary, trust founder, control, shareholder.

Introduction

In 2015 there significantly new and essentially different legislative development took place in Kazakhstan following the announcement by the President of Kazakhstan of the National Plan called '100 specific steps for implementation of five institutional reforms of the Head of State Nursultan Hazarbayev' [1]. Particularly, it was declared that this Plan should serve as a response to global and internal challenges and as the Kazakhstan's National Plan to be recognized among 30 developed countries in new historical circumstances [2]. As one of the steps (70th out of entire 100) it was proposed to establish an International Finance Center Astana (IFCA) with its special status. The IFCA will be located in our capital city. Among the features of the special status of the AIFC there 'a creation of an independent judicial system with its own jurisdiction which will be functioning on principles of English law; its corpus of judges will be formed out of foreign specialists' have been announced.

This idea has been implemented in the form of adoption of the Constitutional Law dated 7 December 2015 concerning the International Financial Center 'Astana' which became effective at the end of 2015 having established a separate jurisdiction of the IFCA where legal and regulatory acts of the IFCA 'may be based on principles, norms and precedents of the law of England and Wales and (or) standards of leading financial centers' and the court of the IFCA shall be established as an independent institution beyond the Kazakhstan's judicial system to function based on procedural rules of English law [3].

Adoption of this Law marked another trend in developing of our national law which would

cause more work on reception of legal concepts which historically and traditionally belong to common law. One should note that since 1994 the Civil Code of Kazakhstan (hereinafter the 'CC RK') [4] has included special regulation of a trust management agreement as a separate type of contracts , though still our system concerning qualification and classification of property rights rejects acknowledgment of a trust ownership.

Methodology

Application of trust management agreements became popular in connection with establishing a special status of state official part of which include requirement to move their property to a third party in trust management for the entire period of performance of a state function. The practice shows that such construction is not effective and in the most cases it only means formal observance of legal rules.

The trust management agreement has been also used in private-relations sphere. In addition, motivation to use it differs from an attempt to hide personal relation to a property to an intend to move it under a professional management with the view of earning profit. However, practice shows that such types of arrangement are not sufficiently secure and do not guarantee proper protection of rights of all of its participants.

Nevertheless, some of local businessmen still seek to have a more protective arrangements based on use of a trust construction to avoid necessity to comply with legal requirements related to the concept of affiliates regulated by corporate law of Kazakhstan. In connection with this the below consideration is focused on a general issue of whether it is possible to develop any contract arrangement which would implement certain features of trust to solve those complications which local investors face in connection with the publicity related to their affiliate companies in Kazakhstan.

Basic provisions concerning trust

Trust relations assume participation of three parties involved in a tripartite arrangement, which reflects the development of situation in the following way: one party (a founder) transfers all or part of assets to a trustee who then holds these assets for a specific purpose for the benefit of one or more beneficiaries (sestuis que). Such trust is called beneficiary trust - Cestuis que trust.

The main characteristics of such relations are the following: (a) the transferred assets constitute an allocated fund; (b) the trustee is assigned the title of the owner; (c) the trustee must comply with the terms of the trust. In the future, trusti relations shall be governed by the law chosen by the trust founder, and if he fails to choose the applicable law - by the law that is most appropriate or related to the subject of relations.

The trustee is the only person who has any property rights in relation to assets transferred to the trust management, it only has exclusive control over relevant assets. However, being limited to the terms of the trust, the trustee may not have full freedom in respect to the property transferred to him for trust management, which would have had a normal owner. The property transferred for trust management is subject to a special legal regime under which the founder and the trustee are treated as property owners: one as a titleholder and another – as the beneficial owner. Whereas the founder can appoint himself as beneficiary or himself and a third person (s) as beneficiary (such trust is called Grantor trust), but trustee can never be like this.

Currently, in the context of the issue under consideration, references to the so-called «blind trust» are most popular, which represent a structure in which assets belonging to a person are transferred to under the control of another party which is not under control of a beneficiary. In this case the control means the right to manage, direct, limit, regulate, supervise, administer, observe, perform limiting or orientating impact.

Schematically, the relations in the frame of «blind» trust are as follows: a founder of «blind» trust transfers assets to the trustee's management and appoints a third person as beneficiary who does not have legal and other legitimate possibilities to influence on the activities of the designated trustee. If the founder will appoint himself as beneficiary, in this case also, the person who is under control of the founder-beneficiary cannot be a trustee. Although in the latter case, the concept of «blind» trust is not fully observed, because due to contractual structure, the lack of control over the manager by the founder will be conditional to some extent.

As a rule, this structure is used in case when by virtue of law or circumstances which require special scrupulousness, the founder should transfer assets to management and avoid the possibility of being accused that such transfer is imaginary, because the founder has influence on the trustee. Such circumstance, for example, is needed for public officials to comply with legal requirement of prior alienation or transfer of their shares to the trust.

There the following legal grounds to establish the trust can exict:

- a statement of special form of trust management: declaration of the owner of property that he owns it as a trustee for another person. This declaration is called the Declaration of Trust, which is the document by which the person who owns legal title in regard to property, recognizes and declares that he possesses it under the terms of the trust for the benefit of another person or for a particular purpose. The name of trust declaration is also used to indicate a particular contract or certain written form, which reflects this document;

- a trust management agreement: transfer by the owner of owned assets to the trustee for the benefit of this owner or other person for the whole period of life (inter vivos);

- a testament: transfer of assets by the owner to the trustee in the interests of a third party by testament;

- by virtue of law: appointment by person who has authority to such appointment of another person as trustee for the benefit of the entity, which provided the first one with such authorities, or any other person;

- a promise: promise made by one person to another person, whose rights under this promise should be transferred to the trust for the benefit of a third party.

Trust established by direct and positive free will of the parties and arranged in writing in the form of agreement, declaration, will, or otherwise in writing, is called an express trust. It differs from the trust established by law.

The founder shall determine objectives, terms and other conditions of trust management. It is allowed to establish the trust for certain period (limited trust) or for an indefinite or «eternal» period (perpetual trust), as well as for the lifetime of the trust founder, usually for the benefit or support of a third party (living trust). If the trust is established for a certain period, such period may be very short, after which expiry the trust will automatically be terminated, (short-term trust).

In terms of personality of a trust founder, individuals and their families can establish the trust. Such trust is called personal trust. In contrast, the trust established by companies or public organizations, is called business trust.

In regard to individual beneficiary, there is a private trust which is established for the benefit of a particular specified individual, group of individuals, famous persons or class of persons, clearly identified or identifiable (able to be identified), in accordance with the terms of the instrument, by which the trust was established.

For various other reasons the trust is classified into many other different types of trust [5].

Standards of legislation in Kazakhstan

Kazakh civil law does not have the institution of trust, as it was briefly described above, due to the following facts: (1) the structure in which trust manager would act in the title of property owner has not been regulated yet, the way that his activities would be efficiently supervised in order to comply with interests of the founder and the beneficiary; (2) there is no necessary legal culture of compliance with contractual obligations and actions for the benefit of other parties as own; (3) there are no legal possibilities to conceptually split ownership right so that the founder and trustee could at the same time be considered as property owners, but each of them in the frame of their status have not been formulated.

The Civil Code of the Republic of Kazakhstan, however, regulates the contract of property trust management, and clearly separates the legal status and corresponding titles of the founder, who is the full property owner, and trustee as property owner, acting in the interests of the beneficiary [6]. The Art. 883 of the CC RK includes the grounds for the establishment of trust management: (1) transactions, (2) court decisions; (3) administrative document.

CC RK includes the types of property that may be objects of trust management, form and substantial terms of agreement of property trust management. In addition, shares of joint stock companies can be objects of trust management. The CC RK also regulates the status of the trustee and limits of his authorities, because he is authorized to have property ownership and control, reporting on the activities to the founder and beneficiary. This status implies restrictions on the activities and powers of the trustee.

In Kazakhstan yet there is no a consequent and well-established business and judicial practice of legal actions under the trust management contract. However, some of the principles and features of the trust in its traditional concept can be applied in the Civil Code of the Republic of Kazakhstan at conclusion of property trust management agreement.

In general, in this case, it is possible under applicable Kazakhstani legislation, to allow the conclusion of contract of trust management of shares, based on qualification feature of the «blind» trust, involving independence of trustee from beneficiary. However, it should be noted that since Kazakhstani legislation does not provide such construction as «blind» trust or property trust management, its use for specific purposes may be considered by

regulating bodies as a system of relations in the frame of ordinary contract of trust management, and the validity is its application requires argumentation using analogies and evaluation concepts.

However, the above mentioned qualification feature which is observed during the formation of appropriate relations can contribute to recognition of real independence of the trustee from the beneficiary, provided that Kazakhstani legislation provides a clear definition of the concepts of independence and control, and under the contract the founder and the beneficiary will be really limited in their desire to influence on the trustee and demand of modification or termination of the contract, in case if they are not satisfied with the legitimate activities of the trustee.

In this regard, for proper arrangement of contract of trust management of joint stock companies shares with guarantee of legal independence of trustee from other parties of the contract, it is necessary to identify the following:

- how the legislation of Kazakhstan defines the concept of independence and control of transaction party or any object of civil legal relations; and
- how the trustee is limited in his actions by risk of early termination of the contract at the initiative of counterparties.

In this regard, attention should be paid to the fact that in Kazakhstani legislation the ability to determine decisions taken by legal entity is defined as control (see the definition of «control» in paragraph 1 of Art. 2 of the Law of the Republic of Kazakhstan dated August 31, 1995 № 2444 «On banks and banking activities in the Republic of Kazakhstan» [7] (*further - the Law on Banks*), p.5 of Article 1 and sec. 2 of Article 64 of the Law of the Republic of Kazakhstan dated May 13, 2003, № 415-II »On joint stock companies» [8] (*further - on JSC*), sec.2 of Art.12-1 of the Law of the Republic of Kazakhstan from April 22, 1998, №220-I «On limited and additional liability partnerships» [9] (*further - the Law on LLP*), sec. 6 Art.169 of the Code of the Republic of Kazakhstan from October 29, 2015, № 375-V «Entrepreneurial Code of the Republic of Kazakhstan» [10] (*further - the Entrepreneurial Code*). It is important to always remember this, because in the legislation of Kazakhstan, along with «the ability to determine the decisions taken by another person», also is used the term «the ability to make influence on the decisions of another person» (see. the definition of affiliated person in relation to the JSC, LLP, and individual according to paragraph 7 of Art. 1 and Art. 64 of the Law on JSC and Art.12-1 of the Law on LLP). In this regard, in case if the entity has no authorities of controlling other entity, any affiliated entity of particular organization can be recognized as its primary or subsidiary organization.

In this case, it is necessary that authorities of control were aimed at defining such decisions taken by subsidiary organization that relate to its affairs, formation or change in its financial situation and legal status through the acquisition and implementation of civil rights and obligations by subsidiary organization. At the same time, such changes of property and legal status of organization should take place exclusively on its will. In particular, since by virtue of Art. 37 of the Civil Code of the RK, legal entity acquires civil rights and assumes obligations only through its bodies, the possibility to determine the decisions made by legal entity, is detected depending on whether the participant (shareholder) of legal entity (or other controlling body) can make decisions on the activities of this legal entity directly or influence on such decisions taken by its bodies. For example, member of legal entity (or entity which has the authority to exercise the rights of such participant) can directly generate decisions as the highest body of the legal entity as the only participant of LLP or shareholder of JSC or take part in decision making by voting at general meeting of members (shareholders). Another way of influence of the member on decisions taken by legal entity are the actions of legal entity members that are directly or indirectly generated by such party (for example, due to election of its representatives to the JSC Board of directors, or to the LLP executive body).

One should also note that in accordance with the legislation of Kazakhstan, control over the legal entity might be direct or indirect (see, for example, paragraph 7 of Art. 1 of the Law on JSC, sec. 1 of the Art. 12-1 of the law on LLP, sec. 6 of Art. 169 of the Entrepreneurial Code). However, in view of the considered issue, relations between legal entities themselves or legal entity and its member (shareholder) are characterized, first, by direct control due to direct participation of the legal entity in authorized capital or presence of direct legal connection between them.

In order to determine the presence of control authorities, first, it is necessary to apply to those provisions of the Law on JSC, sec.1 of Art. 12-1 of the Law on LLP, which set the minimum number of votes of participants/shareholders, which is required for decision-making at general meeting of shareholders and/or (depending on situation) at the meetings of their governing bodies. The general rule is that relevant decisions of the JSC or LLP bodies are taken by a majority of votes from total number

of voters, unless the Law and (or) the JSC and LLP Charter provide otherwise (see sec. 2 of Art. 36 and sec.2 of Art. 58 of the Law on JSC, Art.. 48 of the Law on LLP).

The criterion of ownership of simple majority of voting shares or votes by participation of shares in LLP to identify control powers is also reflected in other legislation documents. For example, for the purposes of regulation of banking activity, the presence of control powers through participation in the authorized capital is determined by direct or indirect ownership «by one person independently or together with one or more persons over fifty percent of shares in authorized capital» (see. Art. 2 of the Law on Banks). Also in accordance with sec.6 of Art. 169 of Entrepreneurial Code, the possibility of determining the decisions taken by legal entity, due to using more than fifty percent of voting shares (stakes in authorized capital, shares) of legal entity is defined as the possession of authorities of direct control over such legal entity. Similar provisions are contained in the legislation documents, which regulate the activities of insurance companies, and non-governmental pension savings funds.

It should also be taken into account that control over the legal entity in terms of possessing the ability to determine its decisions can be carried out only in connection with prevailing direct or indirect participation in authorized capital, as well as on contract basis.

In particular, the linkage with the agreement by virtue of which the main organization may have the right to determine the decisions taken by subsidiary JSC or LLP, even without participation in its capital, is provided in the paragraph 9 of sec.2 of Art. 12-1 of the Law on LLP and paragraph 8 of sec.1 of Art. 64 of the Law on JSC, as well as in Art. 2 of the Law on Banks.

Moreover, the possession of predominant part of the authorized capital of organization may not necessarily mean that its member/ shareholder has authority of controlling. In some cases, one company may have the controlling interest of voting shares or shares in LLP, and other legal entity may have authority of controlling its subsidiary.

So, the decision of the Collegium of Civil Cases of the Supreme Court of the Republic of Kazakhstan dated August 27, 2009, № 3a-9 / 3-09 established that by the results of the proceedings, conclusions of Antimonopoly Committee are valid in recognition of LLP («the applicant»), which is the member of several groups of entities jointly with other market stakes, on the basis of affiliation, but only one entity, is recognized as having control over the applicant, which is part of only one of these groups. In particular, the inclusion of the applicant into one of these groups of entities, is carried out at the ground of participation of main organization in authorized capital of the applicant: the applicant is recognized as a subsidiary of the Holding Company, since the «parent company» of the applicant was the affiliated entity of the Holding [11]. At the same time, the applicant is also recognized as a part of the group of companies A. on other grounds: that is, due to the fact that by virtue of Management Agreement signed under the agreement of share purchase and sale between Holding, on the one hand, and a number of related legal entities, on the other hand, the control over the applicant within a specified Agreement period is carried out by company B., 100% participant of which is subsidiary organization of company A. According to the above agreement on management, the company A. has received an opportunity to determine conditions for the applicant's business activities and exercise the powers of the applicant's controlling body. Moreover, the parent company of the applicant based on the same Agreement on management has limited itself to the possibility of giving instructions to the applicant, administer it, or influence on its decisions concerning commercial, administrative, operating, servicing activities. In these circumstances, although the applicant is a part of the group of companies of the Holding, based on the contract of purchase and sale of shares, was recognized by the court as being under the control of the company A., as the Applicant remained under its control on the basis of the above mentioned Agreement on management.

Availability of the trust management agreement which provides the person or group of persons are provided the right to vote on more than fifty percent of allocated shares of the legal entity or the right to determine the decisions by more than fifty percent of shares in authorized capital of the entity, is directly stipulated in the legislation as a criterion for identifying the presence of control over legal entity by such trustees [12]. Examples of agreements, on the basis of which the object acquires the right of controlling over the legal entity, may also be shareholder agreements, memorandum of association, contracts on joint activities, on provision of funding, on distribution of income, on possession and use of property based on property rental or financial leasing etc.

In addition to the acquisition of control powers due to prevailing participation in capital or on the basis of concluded contracts, there may be other

legally significant circumstances, under which one legal entity gets the opportunity to determine the decisions of another legal entity, and when the presence of powers of control over the legal entity can be also qualified as the ability to determine its decisions as «otherwise». Such circumstances may be legally arranged or actually prevailing.

In the latter case, M.K.Suleymenov offers to call them «undocumented relations», but they also can be assigned to the group of relations on controlling over the legal entity, which occurred «otherwise», but not by virtue of ownership of the majority of voting shares, participation share or concluded contract. In such situation, with regard to the implementation of control over the subsidiary by virtue of other circumstances («otherwise»), M.K.Suleymenov indicates that «on the basis of the conducted research, it can be concluded that the term «otherwise» hides the entire layer of civil law (and not only) relations, which is characterized by the fact that they are not always documented. Such concepts include indirect ownership, oral agreement, acquisitive prescription, ticketless travel on transport, etc. ... These relations really exist, but they rarely come to the surface. If a dispute arises, it is difficult to prove the existence of oral agreement or possibility of influencing in «other way» [13].

However, a remarkable example of detecting such relations by court of Kazakhstan, whereby one person performs the controlling powers in respect of another person, is the position of the judiciary in case at the request of JSC «KRG» on disputing of several orders of the authorized government body, set out in the decision of the Collegium on Civil Cases of the Supreme Court of the Republic of Kazakhstan dated March 20, 2007 # 3a-12-07. The shareholders of JSC «KRG» are JSC «NK» and OJSC «GP», each of which owns 50% of voting shares of JSC «KRG». In connection with this structure of shareholders, none of them has a majority holding in the authorized capital of JSC «KRG» and, accordingly, has no control over it. Court supported the defendant's argument that two shareholders have equal influence on decision-making of JSC «KRG» bodies. However, the court treated the JSC «KRG» as a subsidiary of JSC «NK» on the basis of the fact that the 'complainant states that he was forced to file such statement [about cancellation of the orders of above-mentioned authorized body], directed by the founder, being a subsidiary dependent company of JSC «NK», thereby confirming dependence on the founder in decision making». In this case, it is clear that to determine the status of «KRG» as a subsidiary of JSC «NK», the Court recognized the existence of supervisory powers of JSC «NK» in respect of the applicant, based on the other (in fact, actual) circumstances, than availability of dominant participation in the authorized capital of JSC «KRG» or an agreement between him and JSC «NK».

The examples of such circumstances, which are legally fixed, can be found in banking legislation. Thus, according to the above instruction of the National Bank of Kazakhstan from July 4, 2012, №217, the circumstances were identified on the basis of which was revealed the emergence of possibility to determine the decisions of legal entity. In particular, in p. 2 of this Instruction such possibility, except for banking and insurance activities stipulated by legislative documents, deemed to arise in cases such as:

1) funding by one legal entity (either alone or jointly with other parties) of the legal entity, executives and (or) shareholders (founders, participants) who are employees of the funding entity (s), in amount which exceeds own capital of the financed legal entity; and

2) obtaining by person (alone or together with one or more persons), determining the decision of legal entity, of services of the legal entity that is under control and (or) has a debt to the specified person (s), which payment was at least half of the income of the legal entity that is under control, and provided these services.

Based on the above, the category «control» is sufficiently often used by current legislation, and number of regulations (including legal acts) even contain a definition. The corresponding legal definitions can be divided into two categories. The first assumes performance of functions and implementation of measures aimed at ensuring compliance with legal regulations, and other set requirements. As a rule, we have in mind the implementation of control functions by the authorized government bodies in relation to the controlled objects (e.g., provided by customs and tax legislation controlling functions of relevant bodies, budget legislation regarding the control over execution of budgets, legislation on nuclear and radiation safety, etc.,).

The second category of control definitions assumes the powers of controlling entity, opportunity or ability to determine the behavior of the controlled person, as well as determine the decisions of the latter, have a decisive impact on operations or management of activities. It is expressly provided that such control can be carried out in the presence of the following forms of relations between the controlling and controlled entities:

- participation of the controlling entity in the authorized capital of the controlled (most often - a qualified participation, for example, 25% or 50% of the vote);

– an agreement between these two entities, providing some control and influence (for example, security agreement by which mortgagee has the right to vote on shares, which allows to appoint managers, take economic and financial decisions, etc.);

– other circumstances, to which directly refer only official position of the controlling person as the director of the controlled person, family relations between them as close relatives, and family ties between the controlling person and the directors of controlled person or family relations between controlling person and administrator of the controlled person.

Such understanding of control and influence underlies the concepts of affiliated persons and related parties. In turn, the proof of affiliation or other relations between parties will prevent the realization of the above-mentioned idea of «blind» trust management.

Conclusion

Thus, the contract of trust management of legal entity's shares, aimed at elimination of grounds to consider affiliation and coherence between two companies due to the fact that the head of one of them is a major shareholder in the other, is possible, in case if the said shareholder (as the founder and beneficiary) will transfer own shares to trust management of the third party, which is:

– not a close relative of the shareholder;

– not a legal entity in which a shareholder or his close relatives are senior staff;

– not a legal entity in which the shareholder participates in authorized capital, and is not a senior staff of the legal entity;

– not related to a shareholder by memorandum of association of a legal entity or other agreement by virtue of which a shareholder may have influence on it.

For the same purpose, it is possible that shareholder transfers shares in trust management of the trustee and designates a third party as beneficiary. However, here it is also necessary to observe at least one of the following conditions:

– shareholder as founder of trust management and beneficiary are not related parties, as understood above; or (if it is not possible to observe);

– the beneficiary and the trustee are not related parties.

With regard to the independence of the trustee from the beneficiary with regard to the exceptions of pressure on him by threat to terminate trust management agreement unilaterally at the initiative of founder (shareholder), this risk is reduced to a certain extent by general and specific rules of the CC of RK. Thus, according to Arts. 401 and 890 of the CC RK, such termination is not possible if the trustee, being a legal entity, does not agree with it and it does not violate the contract, duly manages the trusted property and the agreement itself does not contain specific cases of such termination. However, according to Art. 891 of the CC RK the agreement is unconditionally terminated at refusal of the founder (shareholder) to perform the contract. This rule is mandatory; its presence gives specific grounds to consider it as factor of pressure on the trustee. However, the counter-argument could be that the trustee is not interested in the existence of this agreement, and is originally independent of the founder, and such independence is maintained for the period of contract, and therefore, legal relations by «blind» trust management is maintained. When agreement will be terminated on this ground, then the mentioned legal relations will be terminated.

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