Hogan Lovells

Basics of Russian Legal Framework for Foreign Investors

Further information
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1. INTRODUCTION

Following ten years of spectacular growth, the Russian economy has slowed with the onset of the global financial crisis. Sensitive to shifts in exchange rates and commodity prices, the investment climate has faced uncertainty as many speculative funds have withdrawn and the state has stepped up funding to key enterprises. The changing times have caused many investors to reassess their commitment to Russia while others have seen the contagion as an opportunity to acquire new assets at undervalue.

In Russia, the legal climate remains complex and ambiguous, with a rigid approach by state authorities and a system based on a number of complex mandatory rules. Russian laws are still not entirely suited to the sophisticated structures of some high-profile transactions, to overcome this, foreign investors can use a number of legal tools and procedures which we detail in this note.

One key change has been the introduction in 2008 of the Foreign Investments Law, which places tight restrictions on foreign investment in certain key "strategic" industries. While not friendly to all foreign investors, some have argued that the law promotes transparency with a clear set of criteria that will hopefully better regulate foreign investments. Meanwhile other domestic reforms have helped to expand the legal toolkit for investors with new rules for Russian joint-stock companies and limited liability companies and the enforcement of pledges.

As for Russian courts, investors have had difficulty in the past due to a lack of developed court practice, especially where the transactions or instruments in dispute are unfamiliar to Russian courts and officials. Several decisions of the higher courts leave room for accommodation of new investment concepts in the future.

2. LEGAL FORMS OF COMPANIES

From a basic point of view, any private investor interested in business in Russia will be primarily concerned with joint-stock companies ("AO" in Russian) or limited liability companies ("OOO" in Russian).

Joint-stock companies are divided into two distinct groups. They can either be open stock companies ("OAO" in Russian) or closed stock companies ("ZAO" in Russian). According to Russian legislation, the participation interests in a limited liability company, as opposed to the shares in open or closed stock companies, do not refer to defined securities.

Closed stock companies and limited liability companies are similar so far as they represent a variety of private firms, which have a limited number of shareholders. The shareholders of both these legal entities automatically possess the right of first refusal on the sale or issue of shares. The only companies which can offer shares to an unlimited group of people or entities are open stock companies. Also, only shares in an open stock company can be listed on an exchange for sale and purchase.

3. VOTING THRESHOLDS

Below are the key share stakes, which define the powers of shareholders in a Russian company:

(a) 25% plus one share in AO (more than 1/3 of the entire charter capital in OOO), gives the shareholder a negative control stake. As a result, the holder has the ability to block decisions requiring a super majority

(b) 50% plus one share in AO (more than 1/2 of the entire charter capital in OOO), gives the shareholder a positive control stake. As a result, the holder can adopt decisions requiring a simple majority and control the board of directors

(c) 75% in AO (2/3 of the entire charter capital in OOO), a stake, which practically provides ownership control, including the right to take decisions regarding the liquidation of a joint stock company (for the liquidation of a limited liability company the unanimous consent of the shareholders is required)

4. SQUEEZE-OUT

In accordance with the Russian legislation regarding the right to force a buy-out, only shareholders in an open joint-stock company can force a sale, and only after recourse to certain conditions.

In order to undertake a buy-out option, a shareholder of an open joint-stock company, along with his affiliated entities, needs to acquire 95% of the shares in such a company in accordance with the determined order provided for under Russian legislation.

A buy-out situation in a limited liability company is, however, virtually impossible, also by way of reorganisation of the company into an open joint-stock company because this reorganisation of a limited liability company also requires unanimous approval by the shareholders.

5. LIABILITY FOR COMPANY'S OBLIGATIONS

According to general company rules, the shareholders of a joint stock company or a limited liability company are not obliged to take responsibility for such company's obligations to its creditors.

The company itself bears sole responsibility for such obligations. However, this rule is not necessarily applied, for example, in the case when shareholders have not fully paid for shares in their possession. Also, a shareholder may be obliged to take responsibility when a company faces bankruptcy if it is shown that the culpable actions of shareholder have directly resulted in the company's bankruptcy.

6. CREDITOR ISSUES

In the event of a company's insolvency or liquidation, the claim of shareholders in relation to a shareholder loan is neither preferred nor subordinated, but ranks in the usual order of priority.

However, under Russian law, claims regarding obligations secured by pledges are treated differently. Loans secured by pledge have priority to general claims but are second to those resulting from personal injury and employment. This point also applies to shareholders. In essence, if the shareholder has secured his loan, then the claim of the shareholder will come before the claims of other creditors.

Amendments to the rules on the enforcement of pledges in December 2008 have introduced new ways to levy execution of pledged property out of court such as by direct sale to a third party or transfer of title in the pledged assets from the pledgor to the pledgee.

7. COMPETITION (ANTIMONOPOLY) ISSUES

Russian antimonopoly law governs activities affecting competition or fostering monopolistic activity in the Russian market.

The law has a wide scope and includes issues such as control over corporate reorganisations, acquisition of shares, assets or control. In accordance with the law as it currently stands, participants in such transactions must obtain prior or subsequent clearance from the Federal Antimonopoly Service, by filing a petition or notice. The filing process requires disclosure of extensive information about all parties to the transaction and involves handing over authenticated copies of company documents.

8. CURRENCY CONTROLS

The main restrictions on currency which affected business in recent years have been repealed.

However, it is important to note that currency operations in Russia remain on the whole under the control of government regulation. Such regulation applies to the process of executing currency transactions, especially with regard to documentation.

9. REGULATORY ASPECTS

It is important to highlight that certain companies, depending on their sphere of activity, can face additional demands from government regulations.

Affected companies include, among others, credit or insurance organisations, companies investing on the stock market and certain kinds of industrial companies.

Besides licensing and permit issues affecting certain types of activities, the demands of such regulation can require the disclosure of company information, impact on accounting procedures and execution of transactions, and even affect the choice of both management and individual employees.

Special restrictions apply to investments by foreign investors in companies that are deemed to be strategic. Foreign investors in these companies are to obtain prior Russian government clearance before, or submit a post-notification after, entering into certain transactions, and, in some cases, are prohibited from making such investments altogether.

10. COURT PROCEEDINGS AND ARBITRATION

The Russian legal system includes two main types of court. The first is known as an arbitrazh court, and the second is known as an ordinary court. The difference between them is based on what type of cases each court hears.

Arbitrazh courts are concerned with disputes regarding major areas of business activity. The exclusive function of this type of court is to cover disputes related to the creation, re-organization, liquidation and bankruptcy of companies. They also cover disputes held between companies and their shareholders, linked to the running of the business.

Ordinary courts cover all other legal issues, which are not related to business or entrepreneurial activities. These courts generally deal with civil disputes between individuals, usually linked to employment, family and inheritance issues. They also have the exclusive function of undertaking criminal cases.

There also exists in Russia another group of courts, known as arbitration tribunals which are not state courts, unlike both of the types mentioned above. Use of a tribunal is based on the prior agreement of the parties, stated clearly in contracts and agreements, to an arbitration clause. These courts cover disputes, which do not come under the exclusive jurisdiction of state courts.

11. INVESTMENT STRUCTURING ISSUES

Russian corporate legislation contains a large number of mandatory rules, which often makes it impossible to be flexible with regard to various aspects of running a company.

It is necessary to be aware of the constant need to apply rigid rules at all times. As a result of this situation, most investors decline to work directly with Russian companies, preferring to maintain a relationship based on support from different legal jurisdictions.

A number of investors operate in Russia through partnerships or investment holding companies established offshore. A typical holding structure for a private investment involves one or more 'vehicle' companies, incorporated in a jurisdiction with a favourable tax regime. Historically, Cyprus tends to be the most popular jurisdiction, mainly because it has concluded a favourable double taxation treaty with Russia and also operates a flexible corporate governance regime. It is quite common for deals involving Russian assets to effectively take

place at the level of the ultimate holding company (for example, the Cyprus parent company). Meanwhile, the Netherlands is an increasingly popular jurisdiction for setting up a joint venture because it is a well established European jurisdiction with a flexible and developing company law regime.

Currently, there is a widespread practice of Russian companies, or their immediate foreign holding companies, to enter into shareholders' agreements. The issues that are regulated in a shareholders' agreement usually comprise management, nomination of officers, voting, profit sharing, pre-emption rights, provision of additional information, certain veto rights and non-competition covenants. From our experience, such shareholders' agreements are usually entered into with the purpose of imposing requirements that are supplementary to those set out by Russian law, or to alter the procedures or rules laid down by these laws and the company's articles of association.

In most cases, the shareholders' agreement is governed by foreign law and includes an arbitration clause for dispute resolution by a reputable international arbitration tribunal. Notwithstanding this, even if the parties agree to make use of a law other than Russian law in the dispute resolution process, certain mandatory Russian provisions still have to be respected.

This includes provisions on taxation, bankruptcy, insolvency, liquidation, pre-emption rights and corporate governance where Russian entities are involved. Foreign law will be applied by a Russian court only to the extent that its provisions do not contradict mandatory legislation laid down by Russian legislation.

Meanwhile, Russian company laws themselves were changed significantly towards the end of 2008 and during the first half of 2009.

In particular, following the December 2008 amendments to the Russian laws on limited liability companies, participants of a limited liability company may enter into an "agreement on exercising participants' rights", or in other words a shareholders' agreement. The adoption of similar amendments to the Russian laws applying to joint-stock companies in June 2009 became a logical extension of the above changes in relation to limited liability companies.

Since 9 June 2009 shareholders of Russian joint stock companies may set themselves certain internal rules in relation to the performance of rights attached to the shares that they own, including issues regarding voting at a general meeting of shareholders, obligations to sell or buy shares at a predefined price and other similar matters.

It is unlikely, however, that the use of offshore vehicles will be completely abandoned in favour of direct participation in Russian companies while Russian laws still do not explicitly provide a number of concepts typically used for high-end international transactions (i.e. put or call options) or give the same level of comfort as, for example, English law does.

12. ENFORCEMENT OF FOREIGN LAW AGREEMENTS

Within the existing legal framework, the likelihood of enforcing shareholders' rights under a shareholders' agreement governed by foreign law, and the possibility of getting shareholders to observe the obligations arising out of that shareholders' agreement remain uncertain. The Russian Federation is not party to any of the multilateral or bilateral treaties concluded among most Western jurisdictions for the mutual enforcement of judgments given by state courts.

Consequently, should such judgment be obtained from a state court in any other jurisdictions, it is highly unlikely to be enacted by Russian courts. However, the Russian Federation (as successor to the Soviet Union) is a party to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards ("New York Convention"). A foreign arbitral award obtained in a state that is a party to the New York Convention should therefore be recognised and enforced by a Russian court (subject to the qualifications provided for in the New York Convention and to due compliance with the *Russian Arbitrazh Procedural Code*).

Foreign arbitral awards have to be enforced in Russia, except where carrying out the decision contradicts public order. Unfortunately, courts in Russia have not yet established a general approach to the interpretation of 'public order'. Existing precedents show that courts still tend to interpret the understanding of public order more widely than strictly necessary. More often than not, they apply closer attention to the result of arbitration with regard to Russian law, than its effect on public order. However recent decisions of the Higher Arbitrazh Court contain some guidance for the lower courts suggesting restrictive approach to the application of 'public order' notion. Yet, the evaluation of the enforcement of specific contractual provisions should be carried with the consideration of the legal nature of such a provision in light of the mandatory rules of Russian legislation.

During 2008 and first half of 2009 a number of decisions of the Higher Arbitrazh Court have shown a progressive approach in interpreting articles of the Russian Civil Code in relation to taxation and privatisation disputes and many hope that such articles will become less of an impediment to dispute resolution in future and help improve investor sentiment.

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