

Russian Law Aspects of Insolvency



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1. INTRODUCTION

A simple, clear and effective insolvency regime is a vital element in attracting both domestic and foreign investment in a jurisdiction like Russia. To be effective, an insolvency regime has to balance the interests of various classes of creditors, as well as the interests of creditors generally in relation to other interested parties, such as shareholders or participants. An insolvency regime is expected to give the debtor an opportunity to discharge its obligations and continue its business activity. It should set forth reasonable constraints for initiating insolvency proceedings allowing this only in cases where the creditors' claims are duly proven so as to prevent technical insolvency (where insolvency of a debtor is commenced without examination of legality and justification of its creditor's claims) and other similar abuses.

The Federal Law No. 127-FZ "On Insolvency (Bankruptcy)" dated 26 October 2002 (as amended) (the "**Insolvency Law**") replaced the previous law of 1998 to better address the above concerns and to provide for a more comprehensive insolvency framework.

A brief outline of the Russian insolvency regime and the particularities of insolvency proceedings in relation to financial organisations are set out in this note.

1.1 General Provisions

The Russian insolvency regime applies to a broad range of debtors: individuals and legal entities of all legal forms except for state corporations, state-owned enterprises, political parties and religious organisations. There are also special provisions for insurance companies, professional participants in the securities market, agricultural organisations and additional specific laws for credit institutions and natural monopoly enterprises in the fuel and energy sector.

1.2 Insolvency of Credit Institutions

The Federal Law No. 40-FZ "On Insolvency (Bankruptcy) of Credit Institutions" dated 25 February 1999 (as amended) (the "**Credit Institutions Insolvency Law**") sets out special rules in relation to insolvency proceedings in respect of credit institutions. Provisions of the Credit Institutions Insolvency Law are applied in conjunction with the provisions of the Insolvency Law.

2. GENERAL COMMENTS

2.1 Jurisdiction over Insolvency Cases

Russian insolvency (bankruptcy) cases are considered by state commercial ("arbitrazh") courts. Insolvency proceedings in Russia may not be submitted to mediation, ad-hoc or any other alternative dispute resolution proceedings.

In the case of a corporate debtor, the claim should be filed with the arbitrazh court, where such debtor is located. Under the Civil Code of the Russian Federation (the "**Civil Code**") the location of the legal entity is determined by the state in which it is registered. If the debtor is an individual (natural person), the relevant arbitrazh court is the one in the state in which such debtor resides. If the application is lodged in the wrong court, the claim will be rejected. If a creditor files an application to commence insolvency proceedings, it must properly identify the debtor's location or place of residence.

2.2 Who can Initiate Insolvency Proceedings?

An application to the arbitrazh court for declaring a debtor insolvent may be filed by the following persons:

- the executive body¹ of the debtor;
- authorised federal bodies, such as:
 - federal executive bodies, authorised by the Russian Government to present, in the course of insolvency proceedings, claims regarding mandatory payments² and claims of the Russian Federation regarding monetary obligations; and
 - executive bodies of the constituent regions of the Russian Federation, municipal authorities which are authorised to present in the course of insolvency proceedings claims regarding monetary obligations of the constituent regions of the Russian Federation or municipal authorities (for example, tax authorities);
 (together the "**Authorised Bodies**"); or
- creditors in relation to monetary obligations, other than:
 - the Authorised Bodies;
 - individuals to whom the debtor is liable for causing harm to life or health or for moral damages;
 - persons to whom the debtor has to pay fees for "intellectual activities" (activities relating to the creation of objects of intellectual property); and
 - founders (participants³) of the debtor in respect of obligations arising out of such foundation (participation);

¹ For the purposes of the Insolvency Law the "executive body" means the chief executive officer or the head of the collective executive body of the debtor or any other person who is authorised under Russian law to act on behalf of the debtor without a power of attorney.

² Mandatory payments mean taxes, fees, administrative and criminal fines and other mandatory contributions due and payable to the relevant level of the budget system of the Russian Federation (the "**Mandatory Payments**").

³ The Civil Code uses "participants" as a general term which includes partners (in partnerships), participants (in limited liability companies and in supplementary liability companies), shareholders (in joint-stock companies), etc.

(together the "**Insolvency Creditors**").

2.3 When can Insolvency Proceedings be Initiated?

Insolvency proceedings are initiated by filing an insolvency petition with the relevant arbitrazh court.

Insolvency proceedings in relation to legal entities can be initiated in the following circumstances (so-called insolvency indicators):

- a legal entity fails to discharge the claims of its creditors (including the Mandatory Payments) within three months of the date when such claims became due; or
- an aggregate amount of such claims exceeds RUR⁴ 100,000⁵.

A debtor may apply to the court for voluntary insolvency where there is clear evidence that it will become insolvent.

The executive body of a debtor is obliged to bring an insolvency petition within one month of the occurrence of one of the following events:

- the satisfaction of the claims of one or more creditors makes it impossible to satisfy in full the claims of its other creditors;
- the levy of execution on the property of the debtor substantially obstructs or makes impossible its business activities;
- the decision of an authorised body or an authorised owner of the property of the debtor, being a state or municipal enterprise (commercial company established by the relevant state or municipal body and provided with state or municipal property which can be used for commercial purposes), to file a debtor's petition;
- the insufficiency of the debtor's assets (a situation where the aggregate amount of the debtor's monetary obligations and mandatory payments exceed the value of the debtor's assets); or
- the debtor ceases to discharge any part of its payment obligations or mandatory payments due to lack of funds).

The right of the Insolvency Creditor or the Authorised Body to make an application to the arbitrazh court arises at the date when a court judgment on recovery of the debtor's debts comes into force.

2.4 Formalities

An application to the relevant arbitrazh court must be accompanied by the court judgment mentioned in paragraph 2.3 above and evidence of the debtor's indebtedness and its inability to satisfy the creditors' claims. Debts in respect of the Mandatory Payments are evidenced by a decision of the respective tax or customs' authority.

In order to initiate insolvency proceedings in relation to a legal entity or individual, the applicant must pay state duty of RUR 2,000.

3. DETERMINATION OF THE CREDITORS' CLAIMS

The following claims need to be considered when determining whether the insolvency indicators described in paragraph 2.3 above exist:

- monetary obligations relating to:
 - amounts due for goods delivered and services provided;
 - principal amounts of loans and accrued interest outstanding;
 - amounts due with respect to unjust enrichment; and/or
 - amounts due for damages caused to a creditors' property⁶; and
- obligations in respect of amounts of the Mandatory Payments due or outstanding, except for the penalties imposed by the authorised state bodies for non-performance or improper performance of obligations.

Any penalties and damages that result from the debtor's failure to discharge its obligations (including fines and penalties imposed by state bodies) are not taken into account when considering the insolvency indicators.

Creditors' claims are recorded in a register with a set priority ranking, as provided by the Insolvency Law, for satisfaction at the relevant stage of insolvency proceedings. The register is kept by the insolvency officer or by a specialised legal entity, appointed at a creditors' meeting.

The claims of the creditors that have filed an insolvency application are determined as at the date of such application. If creditors lodge their claims prior to the liquidation stage (see paragraph 10 below), the court will make a determination of

⁴ RUR= Russian Rouble.

⁵ The insolvency indicators in relation to individuals are as follows: an individual fails to discharge the claims of its creditors (including the Mandatory Payments) within three months of the date when such claims became due (provided that the amount of such claims exceeds the value of the property owned by such individual), and such claims exceed RUR 10,000.

⁶ The exceptions to the listed obligations are: obligations resulting from harm caused to an individual's life or health and moral damages; obligations relating to retirement pay; payments to persons working under employment contracts; payments of fees for "intellectual activities" (see above); and obligations to the founders (participants) of the debtor arising out of such foundation (participation).

each claim and set the sum payable as at the beginning of the stage following the date on which the relevant obligation falls due. Claims arising prior to and brought after the commencement of the liquidation stage are determined as of the date when the liquidation stage begins.

4. SETTING ASIDE ANTECEDENT TRANSACTIONS

In addition to the general grounds for challenging transactions provided by the Civil Code, the Insolvency Law provides for special rules in respect of transactions entered into by a debtor prior to, or in course of, the insolvency proceedings which may be ruled void by the arbitrazh court, namely:

- shady transactions; and
- "preferential" transactions.

4.1 Shady Transactions

A shady transaction which provides for "unequal consideration" from a counterparty can be set aside by the arbitrazh court if it has been entered within one year prior to, or after, the acceptance of the insolvency application by the arbitrazh court. Unequal consideration can be determined where the price or other terms of a transaction are substantially unfavourable for the debtor compared to the price and terms appearing in otherwise standard arm's length transactions or where the market value of the assets transferred by the debtor (or obligations performed by it) substantially exceeds the value of the consideration obtained by the debtor.

A shady transaction aimed at impairing creditors' property rights can be set aside by the arbitrazh court if it has been entered within three years prior to the acceptance of the insolvency application by the arbitrazh court or afterwards. In such a scenario, the transaction may be successfully challenged if it resulted in actual damage to the creditor's rights and the counterparty under such transaction knew of the debtor's aims (which facts are presumed in certain cases).

4.2 "Preferential" Transactions

The debtor's antecedent transactions can also be challenged if they entail, or may entail, preferences to a certain creditor as compared to the debtor's other creditors. A transaction may be treated as giving a preference if it purports to secure debtor's obligations owed to a certain creditor or results in a change in priority for the satisfaction of creditors' claims etc.

The general hardening period for such transactions is one month. However, the hardening period is increased to six months if:

- a disputed transaction purports to secure debtor's obligations owed to a certain creditor and results in a

change in priority for the satisfaction of creditors' claims (e.g. entering into new pledge agreements); or

- the creditor knew of the debtor's inability to pay or insufficiency of its assets.

4.3 Exceptions

There are certain exceptions to the rules for challenging transactions in course of insolvency proceedings. For example, transactions made on a stock exchange or transactions entered into in the ordinary course of business of the debtor and not exceeding one per cent of the debtor's assets cannot be challenged on the above grounds.

5. STAGES OF INSOLVENCY (BANKRUPTCY) CASES

The Insolvency Law sets out the following stages of insolvency proceedings:

- supervision (*nablyudeniye*);
- financial rehabilitation (*finansovoe ozdorovleniye*);
- external administration (*vneshneye upravleniye*);
- liquidation (*konkursnoye proizvodstvo*); and
- amicable arrangement (*mirovoye soglasheniye*).

The status of the insolvency officer will differ depending on the stage of insolvency proceedings. It will be:

- temporary manager (*vremenniy upravlyayuschiy*) at the supervision stage;
- administrative manager (*administrativniy upravlyayuschiy*) at the financial rehabilitation stage;
- external administrator (*vneshniy upravlyayuschiy*) at the external administration stage; and
- liquidation manager (*konkursniy upravlyayuschiy*) at the liquidation stage.

The powers of the insolvency officer vary depending on the stage of insolvency proceedings in question. For instance, a temporary manager is not entitled to manage the debtor's business during the supervision stage but it is entitled to do so during the later stages.

6. SET-OFF

Under the Insolvency Law, set-off in relation to any creditor is allowed if the mandatory priority of satisfaction of the creditors' claims (described in paragraph 10 below) is observed.

However, court practice shows that in most cases, set-off leads to preferential satisfaction thus rendering set-off inapplicable and ineffective during insolvency proceedings.

Under the Credit Institutions Insolvency Law set-off between any creditor and an insolvent credit institution is prohibited during the liquidation stage.

7. SUPERVISION

The supervision stage of insolvency proceedings follows a court hearing in which the creditors' applications (not claims) are required to be:

- justified by the arbitrazh court; and
- not discharged by the debtor as at the date of the application of the filed claims.

This process is aimed at protecting the interests of the debtor and its other creditors and avoiding possible abuses. The hearing must take place within 35 days of the date of acceptance of the relevant application by the arbitrazh court.

During the supervision stage the debtor's executive or other management bodies continue to carry out their day to day functions, subject to certain limitations. The temporary manager (appointed to supervise the company during this stage) is not empowered to perform the functions of the debtor's executive body, however, his written consent is required in order to enter into certain transactions, such as:

- the acquisition or disposal of the debtor's property valued at more than five per cent of the debtor's assets;
- receiving or providing loans;
- issuing suretyships and guarantees; and
- assigning rights and transferring debts, etc.

During the supervision stage, the management of the debtor may not take decisions on certain material issues (such as the reorganisation or liquidation of the debtor, participation in other entities or the incorporation of legal entities, the establishment of branches and representative offices, the payment of dividends, the placement of bonds or the issue of securities, except for shares).

The period for this stage is up to seven months as stipulated by the Insolvency Law.

8. FINANCIAL REHABILITATION

The aim of financial rehabilitation is to allow the debtor to restore its solvency and to discharge indebtedness pursuant to a debt repayment schedule. This is achieved by allowing the debtor's management to continue to perform its functions under the control of the administrative manager.

During the financial rehabilitation stage, any person may provide security for the debtor's obligations under a debt repayment schedule. Such security may take the form of a pledge, mortgage, bank guarantee, state or municipal guarantee, or suretyship. Under the Insolvency Law the debtor's own assets cannot be used to secure its obligations.

Under the Insolvency Law, if the debtor is moved to another stage of insolvency proceedings, the security provided in relation to the debtor's obligations under the debt repayment schedule remains in place. Therefore, in case of the debtor's non-performance or improper performance of its obligations under the debt repayment schedule, the creditors may enforce the security provided at any stage of the insolvency proceedings⁷. However, the proceeds of security enforcement must be included in the debtor's assets (insolvency estate) and cannot be used to settle of the creditors' claims at the financial rehabilitation stage.

The period for the financial rehabilitation stage is limited to two years.

9. EXTERNAL ADMINISTRATION

9.1 General

External administration is a stage of insolvency proceedings also intended to allow the debtor to restore its solvency. As distinct from the financial rehabilitation stage it has the following features:

- the replacement of the debtor's chief executive officer by an external administrator;
- the restoration of the debtor's solvency through measures set out in the Insolvency Law and contained in the external administration plan (for instance, selling the debtor's property or assigning the debtor's claims to other persons,

⁷ Within a three-year general limitation period, stipulated by the Civil Code.

increasing the debtor's authorised capital, replacing the debtor's assets⁸, etc.); and

- a moratorium on the settlement of the creditors' claims.

The moratorium does not apply to:

- obligations resulting from harm caused to an individual's life or health and moral damages, payments to persons working under employment contracts and payments of fees for "intellectual activities"; and
- court costs, insolvency officers' fees, current utility and operation payments necessary to continue running the business as well as obligations which arise after the commencement of insolvency proceedings (the "**Current Obligations**"),

and respective claims can be satisfied during the stage of external administration without regard to the restrictions imposed by the Insolvency Law.

The period for the stage of external administration is 18 months with an option to extend by up to six months.

9.2 Secured Creditors in the Course of Financial Rehabilitation and External Administration

During the stages of financial rehabilitation or external administration, a secured creditor can choose either to levy execution against the property that has been pledged or mortgaged to it or to waive such execution in order to acquire voting rights at creditors' meetings.

Once insolvency proceedings are commenced, pledged property can only be sold pursuant to a court decision and secured creditors need to apply to the court conducting the debtor's insolvency proceedings in order to enforce their security.

However, the court will not allow the creditor to enforce its security if the debtor proves that such enforcement would make the restoration of its solvency impossible.

10. LIQUIDATION

On the basis of a report of the external administrator in respect of the restoration of the debtor's solvency under the external administration plan and an application by the creditors (pursuant to a resolution at a creditors' meeting), the court, at its sole discretion, can take the decision to appoint a liquidation manager, declare the debtor insolvent and liquidate

it. As soon as this decision is made, all of the debtor's monetary obligations become due and payable and interest stops accruing on them.

Once appointed, the liquidation manager must take steps to obtain possession of those assets of the debtor which are held by third parties. All of the debtor's assets are included in the pool of assets that comprise the insolvency estate, which is used to satisfy the creditors' claims.

Under the Insolvency Law, from the start of the liquidation stage, all but one of the debtor's bank accounts must be closed by the liquidation manager and all the debtor's balances must be transferred to the remaining bank account.

During the liquidation stage, the Current Obligations take priority and are satisfied before any other claims are satisfied.

The priority of claims is as follows:

- **first**, claims resulting from harm caused to an individual's life or health and moral damages;
- **second**, claims arising from failure to discharge obligations with respect to salaries and other payments in relation to employment and copyright fees; and
- **third**, other claims, except for claims under the antecedent transactions described in paragraph 4 above, which can still be satisfied after the satisfaction of all priority claims.

Creditor's claims secured by pledge are satisfied from the proceeds of sale of such pledged property. During insolvency proceedings, a pledge must be enforced through court proceedings and not by a contractual arrangement between the pledgee and the pledgor.

As a general rule, upon the sale of the pledged property through court proceedings, 70% of proceeds will be used to discharge the claims of the pledgee and 20% will be kept on a special account to satisfy the claims of higher ranking creditors in case the debtor's funds are insufficient to cover their claims. The remaining assets (and not less than 10% of the total) will be used for the payment of court costs, insolvency officers' fees etc.

Where a pledge secures the obligations of the debtor to a creditor under a loan agreement, the ratio of 80%-15%-5% applies.

The period for the liquidation stage is up to six months with an option to extend by another six months.

11. AMICABLE ARRANGEMENTS

An amicable arrangement between the debtor, the Insolvency Creditors and the Authorised Bodies may be concluded at any stage of insolvency proceedings.

⁸ The replacement of the debtor's assets is a restructuring technique whereby one or more open joint-stock companies are incorporated and the debtor's property is transferred to the authorised capital of such companies. The shares of such companies are included in the debtor's property and may be sold to raise money in order to discharge debt.

An amicable arrangement on behalf of the debtor must be entered into by:

- the chief executive officer of the debtor at the stages of supervision and financial rehabilitation;
- the external administrator at the external administration stage; and
- the liquidation manager at the liquidation stage.

The conclusion of an amicable arrangement on behalf of the Insolvency Creditors and the Authorised Bodies must be approved by a simple majority (50% + 1 vote) of the Insolvency Creditors and the Authorised Bodies at a creditors' meeting.

In order to be effective, an amicable arrangement between the parties must be approved by the arbitrazh court subject to the debtor satisfying the first and the second priority claims (as described in paragraph 10 above). The insolvency proceedings terminate once an amicable arrangement is approved.

12. INSOLVENCY OF CREDIT INSTITUTIONS

12.1 General Comments

The Credit Institutions Insolvency Law envisages a number of differences from the general rules under the Insolvency Law. For instance, it provides for only one insolvency stage, being liquidation. Supervision, financial rehabilitation and external administration are not applicable to credit institutions. Similarly, amicable arrangements (as described above) are not available where a credit institution is in liquidation.

12.2 Insolvency Prevention Measures

The Credit Institutions Insolvency Law provides for certain out-of-court proceedings implemented under the supervision of the Central Bank of Russia (the "CBR") to prevent the insolvency of credit institutions, including financial rehabilitation⁹, the appointment of temporary administration and reorganisation. The aim of these insolvency prevention measures is to improve the financial condition of a credit institution.

- Financial rehabilitation envisages restructuring methods including the following:
 - founders (participants) can provide financial aid (by way of depositing funds, issuing guarantees and

suretyships to secure the credit institution's obligations and transferring debts (if approved by the creditors) among other things);

- the restructuring of the credit institution's assets and liabilities (by, inter alia, the replacement of illiquid assets with liquid assets, the reduction of expenses, the sale of unprofitable assets, the increase of the authorised capital of the credit institution and the reduction of short-term debts);
- the change of the credit institution's structure (for example, by changing the branch network or reducing personnel levels); and
- other measures.
- Temporary administration can be initiated by the CBR both with or without revoking the relevant credit institution's banking licence. During this stage the CBR supervises the credit institution's activities by suspending or restricting the authority of the credit institution's management.

The CBR is entitled to implement a moratorium for up to three months on the settlement of the claims of the credit institution's creditors. The duration of the moratorium shall not exceed three months. The moratorium does not apply to payments of:

- obligations resulting from harm caused to an individual's life or health and moral damages;
- fees for "intellectual activities" and salaries under employment contracts;
- utility costs; and
- obligations resulting from the deposit or bank account arrangements concluded between the credit institution and individuals.

In addition to the general six-month hardening period during temporary administration of a credit institution, any transaction entered into by it within a three-year period preceding the appointment of the temporary administration may be held invalid by the arbitrazh court upon the claim of the temporary administrator or any creditor if the value or other terms of the transaction are unfavourable for the credit institution and materially differ from the value and other terms applicable to similar transactions in comparable circumstances.

Temporary administration can last for up to six months.

- A reorganisation of the credit institution must be implemented at the demand of the CBR and can take the form of merger or accession.

12.3 Who can Initiate Insolvency Proceedings in Relation to a Credit Institution?

Insolvency proceedings may be initiated by:

⁹ The financial rehabilitation stage under the Credit Institutions Insolvency Law has a legal regime which differs from the similar insolvency stage provided by the Insolvency Law (as described in paragraph 7). The main difference is that financial rehabilitation of a credit institution is not a judicial procedure and is implemented under the relevant sections of the CBR.

- the debtor;
- the Insolvency Creditors;
- the Authorised Bodies; or
- the CBR.

12.4 When can Insolvency Proceedings be Initiated?

An insolvency petition can be accepted by the arbitrazh court only after the credit institution's banking licence has been revoked, provided that the aggregate amount of claims against a credit institution is no less than a thousand minimum wages¹⁰ provided by the federal law and such claims have not been discharged within 14 days after the date on which they became due or, if after the revocation of the banking licence, the assets of the credit institution are insufficient to discharge the obligations owed to its creditors.

12.5 Liquidation of Credit Institutions

As mentioned above, liquidation is the only insolvency proceeding that can be applied to a credit institution following the revocation of its licence by the CBR.

Prior to revoking a credit institution's banking licence, the CBR may require the credit institution to implement the insolvency prevention measures described in paragraph 12.2 above.

During the liquidation stage the authority of the credit institution's management is vested in the liquidation manager. If a credit institution is licensed to take individuals' deposits, the Deposit Insurance Agency (the "**Agency**") will mandatorily take the place of the liquidation manager.

The satisfaction of the claims during the liquidation stage follows the same order of priorities as set out above in relation to companies with the following exceptions:

- the first priority is wider and includes the claims of individual depositors, the Agency and the CBR; and
- claims in respect of obligations secured by a pledge of the credit institution's property must be satisfied in priority to other claims with the exception of the first and the second priority claims and without any percentage ratios (as described in paragraph 10).

The duration of the liquidation stage is up to 12 months and may be extended for six months.

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¹⁰ In accordance with the Federal Law No. 82-FZ "On minimal wage" dated 19 June 2000 (as amended) a rate of a minimal wage is equal to RUR 100.

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