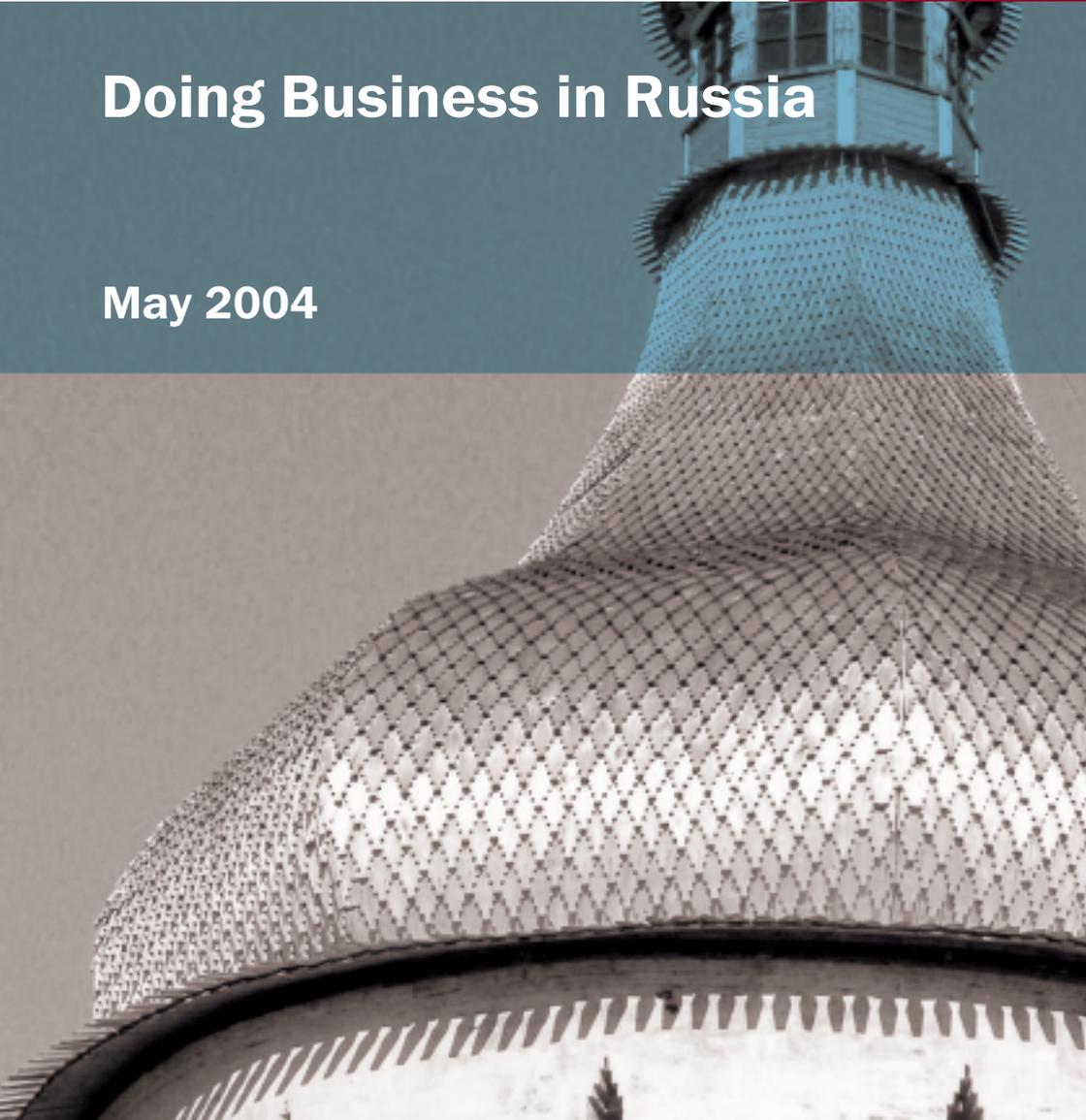


BAKER & MCKENZIE

# Doing Business in Russia

May 2004



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## **PREFACE**

Baker & McKenzie is the world's leading global law firm. We have offices in 68 locations in 38 different countries, and our 3,200 qualified and experienced lawyers have the knowledge and resources necessary to deliver a wide range of quality legal services. With over 50 years of experience, Baker & McKenzie is uniquely placed to respond effectively to the requirements of our diverse and multi-jurisdictional client base.

Baker & McKenzie has been active in the USSR/CIS for almost 40 years and became the very first foreign law firm to establish an accredited representative office in the USSR. Following the opening of the Moscow office in 1989, we opened St. Petersburg and Kyiv (Ukraine) offices in 1992, an Almaty (Kazakhstan) office in 1995, and a Baku (Azerbaijan) office in 1998. As of May 2004, Baker & McKenzie is one of the largest law firms in Russia, with the majority of legal professionals in our Moscow and St. Petersburg offices being local lawyers admitted to practise in Russia, including 14 partners (of whom five are expatriates from the UK, US, and Germany) and 43 associates and a total staff of 162. All of our legal team in Russia speak English fluently, most have Western law degrees, as well as Russian law degrees, and are the product of the substantial investment that Baker & McKenzie has made in its recruitment programs, in building its relationships with the most prominent Russian law schools, and in its professional development activities.

Baker & McKenzie's Russian offices, in close cooperation with our offices worldwide, have for over 15 years offered expertise in a wide range of legal aspects of doing business in Russia, including corporate, banking and finance, securities and capital markets, venture capital, competition, tax and customs, real estate and construction, labor, intellectual property, and dispute resolution. In Russia, we have played a major role in privatisations and have advised clients on the establishment of over 200 new companies, including numerous joint ventures with participation of foreign and Russian investors. Our key industry specializations in Russia include oil and gas, mining, manufacturing, pharmaceuticals, IT, and telecommunications.

Baker & McKenzie has been consistently rated by independent sources as the leading law firm in Russia in terms of the quality and breadth of its legal services. In European Legal 500 "Law Firms in Europe and the Middle East (2004)" Baker & McKenzie was the highest rated law firm in Russia, ranked in the top tier in no less than eight separate practice areas.

The *Doing Business in Russia* publication has been prepared by Baker & McKenzie as a general guide for companies operating or considering making an investment in Russia. The guide gives an overview of the key aspects of the Russian legal system regulating business activity in this country. We will be happy to provide you with updates on the material contained herein or to provide you with further information regarding a specific industry or area of Russian law in which you may have a particular interest.

May 2004

## **1. RUSSIA – AN OVERVIEW**

### **1.1 Geography**

The Russian Federation (“RF”) stretches across two continents: Europe and Asia. Even after the collapse of the Soviet Union, Russia remains the largest country in the world in terms of territory.

### **1.2 Population**

The population of the Russian Federation is approximately 145 million people. Although more than 80 percent of the country’s population is ethnically Russian, the Russian Federation is a multinational state and is home to numerous ethnic minority groups. The largest city in the Russian Federation is Moscow, with a population of more than 8.5 million people, followed by St. Petersburg, with a population of more than 4.5 million people.

### **1.3 Government and Political System**

The Russian Federation currently consists of 89 regions, i.e., “subjects” of the Federation, reducing to 88 on December 1, 2005. These regions are classified into six categories (republics, districts, territories, federal cities, autonomous regions, and autonomous districts). Although there are subtle differences in this classification, all regions are considered to be equal members of the Russian Federation.

As the subjects of the federal state, each of these regions has its own foundation laws, political institutions, and local legislation. Approximately half of the regions has signed bilateral treaties that regulate the relationships between the Federal Government and such regions. When conducting business transactions in particular regions, these treaty agreements must be carefully reviewed since they assign slightly different rights and privileges to individual regions.

The President is the head of the state, the commander-in-chief of Russia’s armed forces, and the highest executive authority of the government. The President is primarily responsible for domestic and foreign policy and represents Russia in international relations. The President also has the power to issue decrees, veto legislation, and appoint and dissolve the government. According to the 1993 Constitution, the President is elected for a four-year term and can serve a maximum of two terms. The current Russian President is

Vladimir Putin. In March 2004, President Putin was re-elected to the second presidential term. The next presidential election is scheduled for the year 2008.

The Prime Minister oversees the activities of the government and serves as the acting President if the President becomes ill and unable to carry out the functions of the Office. If the President becomes incapacitated or dies while in office, the Prime Minister serves as the acting President for 3 months until new presidential elections are held.

The Legislative branch of the Russian Federation is a bicameral parliament consisting of the Federation Council and the State Duma. The heads of the executive and legislative branches of each of Russia's 89 regions comprise the Federation Council. The State Duma consists of 450 representatives. One half of the Duma deputies is elected in single mandate districts. The other half is elected through a system of proportional representation in accordance with party lists. A political party must receive more than 5 percent of the national vote in order to receive any seats through proportional representation. The next State Duma election is scheduled for the year 2008.

At the top of the Russian judicial system are 3 high courts: the Constitutional Court, the Supreme Court, and the Supreme Arbitrazh (Commercial) Court. The 19 members of the Constitutional Court review all constitutional disputes. The Supreme Court reviews civil, criminal, and administrative disputes, while the Supreme Arbitrazh Court reviews commercial disputes.

The final governmental layer in the Russian Federation is local self-government. The governmental bodies at this level are relatively new and untested. In general, the overall influence of local self-government depends on how much authority has been delegated to local government by regional government. Foreign investors should be aware of the position and views of local self-government in regions where they conduct their business because, among other things, local self-government can have limited powers of taxation.

## **1.4 Economy**

Since the collapse of the Soviet Union in 1991, Russia has implemented a series of well-publicized economic reforms. These reforms were directed at removing price controls, decreasing state subsidies, reducing public-sector role in the economy, emphasizing growth in the industrial and service sectors, liberalizing foreign trade, promoting export growth, easing regulations of capital transfers

and exchange controls, and encouraging foreign investment. In addition, Russia introduced a fairly extensive privatization program during the early 1990s.

Based on these reforms, the remnants of the Soviet planned economy have largely disappeared from the Russian Federation. At the same time, it is still too early to categorize Russia as a full-fledged free-market economy although both the United States and the European Union have conferred this status upon it. Moreover, these economic reforms have not yet resulted in increased prosperity for the majority of the Russian people. On the contrary, Russia's GNP had been decreasing for years since the beginning of the reform process in 1991 and has only recently started to grow back up on a year-to-year basis. Arguably, Russia's economic difficulties are largely based on its meager inheritance from the Soviet Union. In reality, economic mismanagement, ineffective tax system, and corruption have also contributed to Russia's uneven transition to a free-market economy.

Russia's economic problems were further compounded by the financial crash of August 1998, which induced an economic crisis. On August 17, 1998, Prime Minister Sergey Kiriyenko announced a 90-day moratorium on certain foreign debt repayments, as well as a plan to restructure the government's debt owed on treasury bills ("GKOs"). The subsequent combination of default and devaluation led to the almost complete collapse of the Russian private banking sector and caused panic on the world markets.

Within the last several years, Russia appears to have weathered this most recent financial crisis. The ruble has stabilized, debt moratoria have been lifted, exports have risen dramatically, and Russia once again is receiving financial credits from the International Monetary Fund and the World Bank. In the aftermath of the August 1998 crash, new business opportunities have emerged in such sectors as telecommunications and electric power. In the new millennium, Russia remains an exciting and challenging environment in which to conduct business, and many of its economic trends are once again pointing in a positive direction.

## **1.5 Foreign Relations**

Russia is still in the process of defining its position in the post-Cold War world. One of the primary accomplishments of Russia's foreign policy has been Russia's improved relationship with Western Europe and the United States although this bond has been severely tested on several occasions. Moreover, Russia has received financial assistance from several international institutions,

including the International Monetary Fund, the World Bank, and the European Bank for Reconstruction and Development. Russia is also a party to the United Economic Space Agreement with Ukraine, Belarus, and Kazakhstan that envisages a creation of a free trade policy between the four countries. This agreement has recently been ratified but has not been implemented yet.

Russia continues to be an active member of the United Nations and has inherited the USSR's permanent seat on the Security Council. The country has also sought to strengthen relations among the former Soviet republics through the creation of the Commonwealth of Independent States (the "CIS"). Even though the CIS has struggled to establish itself as an effective and integrated body, the existence of the Commonwealth has significant ramifications for transactions between and among the member-states. The promotion of the CIS will continue to remain an important focus of Russia's foreign policy.

## **2. PROMOTING FOREIGN INVESTMENT IN THE RUSSIAN FEDERATION**

### **2.1 The Foreign Investment Law**

The RF Constitution, the RF Civil Code, and the RF legislation on joint stock and limited liability companies and their insolvency provide a general legal framework for trade and investment in Russia. Whereas foreign investments are regulated by the Federal Law on Foreign Investments in the Russian Federation, dated July 9, 1999 (the “Law on Foreign Investments”), the Law on Foreign Investments does not apply to investment of foreign capital in banks, credit organizations, or insurance companies. Foreign investments in such entities are regulated by different Russian legislation.

The Law on Foreign Investments guarantees to foreign investors a right to invest and to gain revenues, as well as a right to profits from such investments, and sets forth the foreign investors’ terms of business activity on the territory of the Russian Federation.

The goal of the Law on Foreign Investments is to involve and put to use foreign materials and financial resources, advanced machinery and technology, and management skills to improve Russian economy. The Law provides stable terms for the operations of foreign investors and requires the RF to conform to the standards of international law, as they apply to foreign investments in the RF and to international practice of investment cooperation.

The Law on Foreign Investments emphasizes that both federal and regional laws regulate foreign investments in the Russian Federation. The Law states that foreign investments shall be treated no differently than domestic investments although certain restrictions can still be imposed on foreign investments. Such restrictions may be imposed if they are necessary to defend the country, Russian constitutional system, public morality, public health, rights and legal interests of other entities, or security of the Russian state.

Notably, the Law on Foreign Investments contains several broad protections for foreign investors. Foreign investors have the right to file lawsuits in the Russian courts to defend their interests. They also can purchase stocks, participate in the privatization process, transfer their property rights to third parties, and acquire real property. After the payment of taxes and other mandatory Russian duties, foreign investors have the unhindered right to transfer profits abroad. The Law states that foreign investors have the right to export property,

electronic records, and other company documents that were originally imported into Russia as investments. According to the Law, the property of foreign investors can be nationalized, but this measure requires the adoption of a separate Federal Law regulating the procedure for any such nationalization. In cases of nationalization, foreign investors must be compensated for the lost property and any other losses.

The Law on Foreign Investments provides a certain guarantee to foreign investors, which is known as the “Grandfather Clause.” The Grandfather Clause is formulated in Article 9 of the Law and is entitled “Guarantees to Foreign Investors and Companies with Foreign Investment Against Unfavorable Changes in the Legislation of the Russian Federation” (the “Guarantee”). Such clause takes effect if the legal developments in the country lead to an increase in the cumulative tax burden or to an unfavorable change in policies and limitations with respect to foreign investments, compared with the overall tax burden and the policies that existed pursuant to the federal laws and regulations on the date when financing of a priority investment project began. Although it is still unclear how this guarantee will work in practice, theoretically the legal conditions will relate back (up to 7 years) to the commencement of the investment project. However, this Guarantee is subject to certain major restrictions. For example, this Guarantee will not be enforced if a Russian law, regulation, or other legal measure is enacted to defend the Russian constitutional system, public health, rights and legal interests of other entities, or security of the Russian state. In addition, the government has yet to establish the criteria by which it will determine that a change in legislation has had a negative impact on a foreign investor. Therefore, until the Russian government actually defines how this Guarantee will be implemented, the Guarantee will have a limited impact on foreign investments.

The unfavorable developments contemplated by the Guarantee are listed in the text of the Law and include changes in customs duties and fees, taxes, other mandatory payments to the federal budget and extra-budgetary funds, and modifications in restrictions on foreign investors. The Guarantee applies to companies with foreign investments if the contribution by foreign investors to the company’s founding charter capital exceeds 25 percent and to companies with foreign investments that carry out priority investment projects, irrespective of the percentage of the foreign investor contribution to the charter capital of such companies.

The Law on Foreign Investments provides a common procedure for Russian legal entities regarding state registration of foreign-investment legal entities

referring to the Law on State Registration of Legal Entities and Self-employed Entrepreneurs (the “State Registration Law”). According to the State Registration Law, state registration is carried out by the local divisions of the Federal Tax Service of the Russian Federation Ministry of Finance, depending on the location of the executive body of the legal entity. Moreover, recent amendments to the State Registration Law implement the “single window” principle in the state registration of legal entities, as well as in the registration of such entities for tax purposes. Under this principle, a legal entity can submit a single application to the registration authority, the Federal Tax Service, which then will record the applicant in the Consolidated State Register of Legal Entities, register it with the appropriate local tax authorities, and issue it relevant registration certificates within 5 days.

## **2.2 Production Sharing Agreements**

In addition to the Law on Foreign Investments, the Russian Federation has approved a number of other laws, which promote international trade. Russian lawmakers also continue to update the existing laws that were designed to promote international trade and to make investment climate generally more favorable. One of the most recent attempts to introduce positive changes to such legislation resulted in an enactment of amendments to the RF Law on Production Sharing Agreements, dated December 30, 1995 (the “PSA Law”).

In the Russian Federation, Production Sharing Agreements (“PSAs”) are used to provide a special legal framework for foreign investors interested in mining, oil, gas, and other sectors requiring substantial long-term investments. These agreements govern relations between federal and local government bodies and foreign investors and have been vital in attracting foreign investments to Russia’s natural resources sectors. The main objective of the PSA legislation is to provide to long-term investors in these sectors a higher degree of stability than is generally available in the current economic and political environment in Russia.

The PSA Law was originally intended to attract both Russian and foreign investments and thus promote the development of Russia’s natural resources (e.g., oil, gas, and gold). However in June 2003, a set of amendments that significantly curtailed the favorable policies embodied in the PSA Law was enacted. These changes limited the circumstances in which subsoil plots were eligible for the application of the hitherto favorable PSA policies. Since then, subsoil plot development under the PSA Law has been available only in cases where subsoil plots have been unfit for exploration and development

under the general subsoil law. This ineligibility for general development must be confirmed by an unsuccessful auction for a grant of subsurface rights on the terms and conditions specified by the RF Law on Subsoil, dated February 21, 1992.

Finally, the amendments provided that an auction must be the exclusive means of selecting an investor(s), specified more detailed and strict Russian content requirements applicable to equipment in use, established the maximum amount of extracted natural resources that may be given to investors as compensation for reimbursable expenses, and removed the exemption previously enjoyed by investors with regard to the mandatory exchange of the foreign currency revenues in accordance with the applicable currency control regulations.

Due to the restrictions imposed by the above-mentioned 2003 amendments to the PSA Law and to the PSA tax regime established at the same time (discussed in section 6.9), PSAs have, as a practical matter, become largely ineffective in terms of attracting foreign investment to Russia.

### **2.3 Free Economic Zones**

The 1991 Law on Foreign Investments in the RSFSR permitted the creation of special free economic zones within the Russian Federation. The Law contemplated certain privileges that would be available to companies investing in these free economic zones. Investors were promised that the registration process would be simplified and that special customs regulations and lower taxes for import and export of their goods would be implemented. Despite long discussions in the State Duma, the draft of the Federal Law on Free Economic Zones never came into force in the Russian Federation. However, the recently adopted Customs Code of the Russian Federation refers to the federal laws regulating special economic zones, and it is highly likely that the State Duma will adopt a new federal law on the special economic zones in the near future. Moreover, certain free-economic-zone laws and legal acts have been successfully adopted in several regions designated as free economic zones (e.g., the Federal Law on the Special Economic Zone in the Kaliningrad Region of January 22, 1996). Such laws and legal measures provide the legal and economic bases for the development and operation of such free economic zones, establishing a system of privileges for investment and business activity in such zones, including foreign trade and investment activity as compared to the general regime.

In total, 18 free economic zones have been established in the Russian Federation. Although some zones have been relatively successful, the existence of these special territories generally has not proven to be a strong incentive for foreign investment. It should be noted that the 1999 Law on Foreign Investments makes no reference to these free economic zones, raising new questions about their legal status and future development in the absence of additional legislation.

## **2.4 Regional Legislation**

Prior to investing in a region and in addition to reviewing the applicable federal legislation, potential investors should also examine the regional laws. One of the most distinctive features of the investment climate in Russia has been the competition among the various regions of Russia to attract investment, both foreign and Russian. Subjects of the Russian Federation, while striving to attract as many investors as possible to their respective territories and thus improve the social and economic conditions of their own regions, have passed a large number of laws, regulations, and other legal measures with the intent to encourage and regulate investments. In fact, some regions have made special efforts to introduce favorable conditions for foreign investment, while other regions have enjoyed no success in improving their investment climate.

One of the most progressive regional investment laws was approved in the Leningrad Oblast in 1997. The goal of this law was to develop the investment activity on the territory of the Leningrad Oblast. To achieve this goal, the law created the “most favorable treatment regime” and provided additional guarantees of the state support to investors who are involved in investment projects of major economic and social importance to the Oblast. Moreover, the law contains several substantial tax incentives for companies realizing investment projects. Other pro-investment regions include Samara, Khabarovsk, Novgorod, Saratov, and Nizhnii Novgorod. All of these regions have attracted significant amounts of foreign capital, and thus the need for foreign investors to review the relevant local legislation before investing in a particular region is emphasized.

## **2.5 International Treaties**

The Russian Federation has signed numerous bilateral, multilateral (e.g., CIS), and international treaties that influence foreign trade and investment. Depending on the country of origin, foreign investors should conduct a thorough review of these specific treaties, some of which may have an impact on their transactions in the Russian Federation.

### **3. ESTABLISHING A LEGAL PRESENCE**

In Russia, foreign investors may:

- (1) Establish a representative office or a branch of a foreign legal entity;
- (2) Establish a Russian legal entity in the form of an enterprise with foreign investment, which is either (a) entirely foreign-owned, or (b) co-owned as a joint venture with a Russian partner(s); and/or
- (3) Act directly as a pure foreign investor.

#### **3.1 Representative Office and Branch of Foreign Legal Entity**

##### **3.1.1 Legal Status**

A representative office or a branch of a foreign legal entity is not considered to be a Russian legal entity, but rather a body representing the interests of a foreign legal entity in Russia.

A representative office is entitled to carry out liaison and ancillary functions in order to promote the business of its foreign founder. Representative offices are not permitted to engage in commercial activities in Russia. Consequently, most representative offices are not subject to profit tax, unless their activities give rise to a “permanent establishment” for tax purposes, i.e., when a foreign legal entity engages in regular commercial activity through its representative office (for example, the sale of goods or the provision of services).

A branch is a subdivision of a foreign legal entity, which may fulfill all or part of the functions of its foreign founder. These functions include the repatriation of management fees earned in foreign currency, the contracting with Russian entities with payments in foreign currency and rubles, and the appointment of a sales force.

While the obligations imposed on a branch may include the same obligations as imposed on a representative office, a branch has fewer privileges than a representative office. For example, branch offices do not enjoy the VAT privileges that are extended to accredited representative offices. A branch office will be taxed on any profit attributed to its activities in Russia. Accordingly, a branch office is required to make periodic filings of profit tax, VAT, and other miscellaneous documentation.

### **3.1.2 Registration**

An appropriate accrediting body must approve representative offices. There are numerous accrediting bodies authorized to grant accreditation. Many accrediting bodies specialize in accrediting representative offices involved in a particular industry only. For example, representative offices of foreign banks are accredited by the Central Bank of the Russian Federation. Among the bodies with the authority to accredit most foreign entities are the Chamber of Commerce and Industry of the Russian Federation (the “CCI”) and the State Registration Chamber at the Russian Federation Ministry of Justice (the “SRC”).

All documents from a foreign legal entity must be notarized and legalized (apostilled) in the country of execution. Any document supplied in a language other than Russian must be accompanied by a notarized translation. Accreditation is usually granted for a period of up to 3 years with the right to extension.

An application letter for the accreditation of a representative office should be submitted to the appropriate accrediting body and must be accompanied by the following documents:

- (1) Charter or Articles of Incorporation of the foreign legal entity;
- (2) Registration certificate, Certificate of Incorporation, or excerpt from the trade register of the foreign legal entity;
- (3) Resolution of the foreign legal entity to open a representative office in the Russian Federation;
- (4) Regulations of a representative office;
- (5) Bank letter confirming good credit standing of the foreign legal entity;
- (6) Document confirming coordination with the RF regional authorities on establishment of a representative office (not required for representative offices to be located in Moscow);
- (7) General Power of Attorney issued to the chief representative;
- (8) Power of Attorney for filing the application for accreditation on behalf of the foreign legal entity;

- (9) Accreditation Card containing information about the representative office filled in according to a sample form of a particular accrediting body and signed by a representative of the foreign legal entity;
- (10) Certificate from the tax authorities in the country of the foreign legal entity's incorporation confirming that the foreign legal entity is registered as a taxpayer and specifying the taxpayer identification code;
- (11) Two letters of recommendation from Russian trading partners (government, social organizations, or 100 percent Russian-owned entities) on their official letterhead; and
- (12) Lease agreement or landlord guarantee letter, together with a document confirming the landlord's right to the property to be leased by the representative office.

Branch offices must be accredited by the SRC in accordance with the 1999 Law on Foreign Investments. An application letter for the accreditation of a branch should be submitted to the SRC and should be accompanied by the following documents:

- (1) Charter or Articles of Incorporation of the foreign legal entity;
- (2) Registration certificate, Certificate of Incorporation, or excerpt from the trade register of the foreign legal entity;
- (3) Resolution of the foreign legal entity to open a branch in the Russian Federation;
- (4) Regulations of a branch office;
- (5) Bank letter confirming good credit standing of the foreign legal entity;
- (6) Document confirming coordination with the RF regional authorities on establishment of a branch (not required for branches to be located in Moscow);
- (7) General Power of Attorney issued to the Director of a branch;
- (8) Power of Attorney for filing the application for accreditation on behalf of the foreign legal entity;

- (9) Accreditation Card containing information about the representative office filled in according to a sample form of a particular accrediting body and signed by a representative of the foreign legal entity;
- (10) Expert opinions from the respective ministries (Ministry of Energy of the RF, Ministry of Natural Resources, etc.), if provided for in the statutes of the RF; and
- (11) Certificate of payment of a registration fee.

Following the accreditation, the representative office or branch must carry out a number of procedures before it becomes fully operative, including various registrations (post-accreditation procedures), such as the registration with the State Statistics Committee of the Russian Federation, with the tax authorities of the Russian Federation, and with the Russian social benefits funds.

### **3.2 Forming a Russian Legal Entity**

The Civil Code of the Russian Federation recognizes the following main types of commercial legal entities:

- (1) General partnerships;
- (2) Limited partnerships;
- (3) Limited liability companies;
- (4) Additional liability companies; and
- (5) Joint stock companies.

Moreover, additional legislation has been passed governing the establishment of limited liability companies (“LLC”) and joint stock companies (“JSC”), i.e., the Law on Limited Liability Companies (the “LLC Law”) and the Law on Joint Stock Companies (the “JSC Law”), respectively. Since these two forms of corporate structure are the most popular with the foreign investors, the provisions of the LLC Law and the JSC Law are examined below.

### **3.3 Limited Liability Companies**

#### **3.3.1 Number of Participants**

An LLC can be established by one or more persons or legal entities (the “participants”); however, if the number of participants exceeds 50, the entity must be registered as an open joint stock company or a production cooperative. Furthermore, an LLC may not have as its sole participant another business entity consisting of a single person. The charter capital of the LLC is divided into participation interests, as set forth in the charter.

#### **3.3.2 Rights of Participants**

The participants in an LLC have the right to:

- (1) Participate in the LLC management in accordance with the LLC charter and the LLC Law;
- (2) Obtain information concerning the LLC activities;
- (3) Participate in the distribution of profits;
- (4) Sell or otherwise assign their participation interests in the LLC charter capital to one or more of the participants in the LLC;
- (5) Withdraw from the LLC without first seeking the approval of the other participants; and
- (6) Receive a portion of the assets left after settlement with creditors in case of the liquidation of the LLC.

The LLC participants may have additional rights that are set forth during the establishment of the LLC in the LLC charter or foundation documents or that are granted to them at a later time by a decision of the LLC’s General Participants’ Meeting.

The following issues need to be taken into account when granting additional rights to the LLC participants:

- (1) If additional rights are granted by the decision of the LLC’s General Participants’ Meeting, the above decision must be unanimous; and

- (2) Additional rights granted to a particular participant in the LLC do not transfer to any party acquiring all (or a part) of such participant's ownership interest in case of assignment thereof.

### **3.3.3 Obligations of Participants**

The participants in an LLC are required to:

- (1) Make contributions to the charter capital as specified in the foundation agreement (or in the decision on the establishment of the LLC, in case there is only one participant in the LLC) and within the time periods specified in the LLC Law; and
- (2) Keep confidential the information about the activities of the LLC.

The LLC participants may have additional obligations that are set forth during the establishment of the LLC in the LLC charter or foundation documents or that are imposed on them at a later time by a decision of the LLC's General Participants' Meeting.

The following issues need to be taken into account when imposing additional obligations on the LLC participants:

- (1) If additional obligations are imposed by the decision of the LLC's General Participants' Meeting, the above decision must be made unanimously; and
- (2) Additional obligations imposed on a particular participant(s) in the LLC do not pass to any party acquiring all (or part) of such participant's ownership interest in case of assignment thereof.

### **3.3.4 Charter Capital**

The charter capital of an LLC consists of contributions made by its participants. The initial charter capital may not be less than the amount equal to 100 times the statutory monthly minimum wage. (The monthly minimum wage is currently 100 rubles). At the current exchange rate of approximately 29 rubles per USD (May 2004), the minimum required charter capital for an LLC is approximately USD 345.

At least 50 percent of the charter capital amount must be paid by the date of the LLC's registration, and the balance must be paid in full within the first year of its operation. Contributions may be made in cash or in kind, and certain customs benefits may be available for in-kind contributions made by foreign investors. The charter capital may be increased only after the original charter capital has been paid in full.

### **3.3.5 Participation Interests**

A participation interest (i.e., an ownership share) in an LLC is not considered a security under the current Russian legislation. Therefore, unlike the shares of a joint stock company, LLC participation interests do not need to be registered.

Participation interests in an LLC can be sold to third parties, but they are subject to the right of first refusal of other participants to purchase the participation interests at the price offered by the third parties. The participants in an LLC also have a unilateral right to withdraw from the LLC and to be compensated for their participation interests.

Finally, a participant (participants) with more than a 10 percent ownership interest in an LLC may demand the expulsion of any participant who grossly violates his obligations as a participant or whose actions (or lack thereof) substantially hinder the LLC or make its activity impossible.

### **3.3.6 Management Structure**

Since an LLC is not required to have a Board of Directors, the members of the General Participants' Meeting comprise the highest governing body of the LLC. Almost all matters are within their exclusive competence. Even if they choose to create the Board of Directors, the General Participants' Meeting members may only delegate a limited number of matters to the Board.

The members of the General Participants' Meeting have exclusive rights to:

- (1) Amend the charter;
- (2) Define the basic goals and directions of the LLC;
- (3) Delegate to a commercial organization or to an individual entrepreneur the authority reserved to the LLC executive and approve the conditions of the agreements with such organizations or persons;

- (4) Assign supplemental rights and duties to the participants in the LLC;
- (5) Approve the annual financial report and the distribution of LLC's profits;
- (6) Change the amount of the charter capital of the LLC;
- (7) Approve the regulations governing the internal activities of the LLC; and
- (8) Reorganize or liquidate the LLC, appoint a liquidation commission, and approve the liquidation balance sheet of the LLC.

### **3.3.7 Registration**

Beginning July 1, 2002, the new Law on State Registration of Legal Entities (the "Registration Law") came into force and transferred the authority to register legal entities in Russia to the local bodies of the Ministry of Taxes and Levies of the Russian Federation. As a result, the activities connected with state registration of legal entities and with their registration as taxpayers have been assigned to the local tax inspectorates.

The following documents must be submitted to the relevant tax inspectorates for registration purposes:

- (1) Application;
- (2) Foundation agreement of the LLC (if the LLC has more than one founder/participant);
- (3) Protocol of the founders' meeting or founder's decision (if there is only one founder of the LLC) on the establishment of the LLC;
- (4) Charter of the LLC;
- (5) Excerpt from the trade register for foreign founders or any other corresponding confirmations of their legal status (i.e., excerpt from the trade register or certificate of good standing); and
- (6) Confirmation of payment of the state registration fee.

In addition, for the purposes of registering an LLC and completing post-registration formalities, a foreign legal entity participating in an LLC must provide the following documentation:

- (1) Charter or Articles of Association of the foreign legal entity;
- (2) Bank letter of good credit standing of the foreign legal entity;
- (3) Confirmation of the foreign legal entity's contribution to the charter capital of the LLC; and
- (4) Power of Attorney to represent the founders before state registration bodies.

Any Russian founder participating in an LLC must also provide additional documentation. All documents from a foreign legal entity must be notarized and legalized (apostilled) in the country of preparation. Any document supplied in a language other than Russian must be accompanied by a notarized Russian translation.

## **3.4 Joint Stock Companies**

### **3.4.1 Types of Joint Stock Companies**

The JSC Law came into force on January 1, 1996. Since it was one of the first major pieces of civil legislation in the post-Soviet Russia, a significant number of commercial organizations have been established as JSCs. The adoption of the LLC Law in 1998 introduced another option for investors seeking to establish a corporate entity. Nevertheless, JSCs remain among the most important commercial corporate forms and structures for doing business in Russia.

A JSC is a legal entity, which issues shares in order to raise capital for its activities. A shareholder of a JSC is not liable for the obligations of the JSC and bears the risk of any such loss only in the amount paid by it for the shares.

Two types of joint stock companies exist in Russia:

- (1) Closed joint stock companies; and
- (2) Open joint stock companies.

An open JSC may have an unlimited number of shareholders. Shareholders in an open JSC are entitled to freely dispose of their shares. The number of shareholders in a closed JSC may not exceed 50. If the number of shareholders in a closed JSC ever comes to exceed 50, it must be reorganized into an open JSC within 1 year. As with participants in an LLC, shareholders in a closed JSC have a right of first refusal to acquire shares sold by other shareholders to third parties at the price offered by the third parties. Shareholders in a closed JSC also have a right to acquire newly issued shares that are to be privately placed, in proportion to their existing shareholdings. Shareholders in an open JSC, however, only have a preemptive right to acquire newly issued shares that are to be publicly or privately placed, in proportion to their existing shareholdings, and do not have a right of first refusal to acquire shares sold to third parties.

All JSCs are required to maintain a shareholders' register. The register includes information about each registered shareholder and the number, category, and classes of shares held by each registered shareholder. A JSC with more than 50 shareholders must delegate the maintenance and keeping of the shareholders' register to a licensed registrar.

### **3.4.2 Formation of a Joint Stock Company**

Founders of a JSC may include individuals and/or legal entities. A company's foundation document, i.e., its charter, must include the following information:

- (1) Name, address, and type of a JSC (open or closed);
- (2) Size of the JSC charter capital;
- (3) Quantity, nominal value, and categories (common or preference) of shares, as well as the classes of preference shares issued and distributed by the JSC;
- (4) Rights of the holders of shares of each category;
- (5) Structure and competence of the JSC governing bodies and the procedure by which the JSC governing bodies make decisions;

- (6) Procedure for preparing for and holding of the General Shareholders Meetings, including a list of issues, which require either unanimous consent or a resolution adopted by a qualified majority of votes;
- (7) Information about subsidiaries and representative offices;
- (8) Information about the existence of any special right of participation in the management of the company (a “golden share”) vested in the Russian Federation, a subject of the Russian Federation, or a municipality of the Russian Federation; and
- (9) Other provisions required by law.

The charter may include other provisions, as long as they comply with applicable Russian legislation.

### **3.4.3 Charter Capital**

The charter capital of an open JSC may not be less than 1,000 times the Russian statutory monthly minimum wage (the monthly minimum wage used for the purposes of calculating the minimum charter capital of the JSC is currently 100 rubles). At the current exchange rate of approximately 29 rubles per USD (May 2004), the minimum charter capital for an open JSC is approximately USD 3,450. A closed joint stock company must have a minimum charter capital equivalent to at least 100 times the minimum monthly wage (currently approximately USD 345).

Unlike LLC founders, the founders of the JSC must pay in 50 percent of the JSC charter capital within 3 months following the JSC’s state registration. The balance must be paid off in full within the first year after state registration of the JSC.

### **3.4.4 Shares and Other Types of Securities**

A JSC can issue securities in the form of shares, bonds, and issuer’s options. In either case, such securities must be registered with the Federal Service for the Financial Markets of the Russian Federation (the “FSFM”), which has replaced the former Federal Commission for the Securities Market (the “FCSM”). A JSC can issue common shares and/or several classes of preference shares. The total value of the JSC’s preference shares may not exceed 25 percent of its charter capital.

On January 1, 2002, the concept of a “fractional share” was introduced. A fractional share is a share representing a portion of a whole share, which can come into existence when it is not possible to acquire the whole share during the consolidation of shares, when a shareholder exercises its preemptive right, or in the course of acquiring additional shares. A fractional share grants its owner the same rights that are granted by the whole share of the corresponding category or class, although on a pro rata basis.

### **3.4.5 Management Structure**

Either open or closed JSC must maintain 2 governing bodies: the General Shareholders Meeting and the Executive Body. An open JSC with more than 50 shareholders must also have a Board of Directors (sometimes called a Supervisory Board), so an open JSCs with more than 50 shareholders must have 3 governing bodies: the General Shareholders Meeting, the Executive Body, and the Board of Directors. An open JSC with less than 50 shareholders and all closed JSCs may, but are not required to, have a Board of Directors. The JSC charter defines the authority of the Board of Directors. If a Board is not provided for in the charter, the corresponding authority rests with the JSC's General Shareholders Meeting.

In addition to the foregoing governing bodies, a JSC must either establish an Internal Auditing Commission or elect an Internal Auditor to oversee the financial and economic activities of the company. The shareholders must elect members of the Internal Auditing Commission and Internal Auditor.

Members of the General Shareholders Meeting comprise the highest governing body overseeing the activities of a JSC. Their authority is outlined in the JSC Law and cannot be altered. Each common share carries one vote at the General Shareholders Meeting, and most decisions are made by a simple majority vote although for certain key decisions a supermajority of 75 percent is required.

The daily management of a JSC is the responsibility of the Executive Body, which may be comprised of one person (the General Director) or may consist of both the General Director and Management Council. The Executive Body is responsible for all matters, which do not fall within the authority of either the Board of Directors or the General Shareholders Meeting. The General Shareholders Meeting, by a majority vote, may choose to delegate on the contract basis the powers of the Executive Body to an external commercial

organization or to an individual manager. This decision may be taken only pursuant to a proposal of the Board of Directors.

### **3.4.6 Registration**

The procedure for state registration described in 3.3.7 in respect of LLCs is also applicable to JSCs. This procedure came into effect on July 1, 2002. The only extra step required in the process of establishing a JSC is to register the issuance of the JSC shares with the FSFM.

## **4. ISSUANCE AND REGULATION OF SECURITIES**

### **4.1 Introduction**

Generally, the securities markets and securities transactions are regulated by the Russian Federal Law on the Securities Market (the “Securities Law”), enacted April 22, 1996. The offering of corporate securities is regulated by the Law on Joint Stock Companies (the “JSC Law”), enacted on December 26, 1995, and to some extent, by the Law on Limited Liability Companies (the “LLC Law”), enacted February 8, 1998, and by the Law on Banks and Banking, enacted December 2, 1990 (regarding credit institutions).

During the last few years, there was a fair amount of discussion on changes to the applicable legislation and on structure of the securities markets in general. To date, this has resulted only in a new Federal Law on Mortgage-Backed Securities (the “MBS Law”), which came into effect on November 18, 2003, introducing 2 new types of securities, namely mortgage-backed bonds and mortgage participation certificates.

Only open JSCs can issue publicly-traded shares. Russian securities are also subject to a number of regulations issued by the FSFM (previously, the FCSM), the Russian Civil Code, and the regulations issued by other regulatory agencies.

### **4.2 The Stock Exchange**

In Russia, there are several well-established stock exchanges, both in Moscow and throughout the Federation. Stock exchanges are governed by regulations of the FSFM (previously, the FCSM) and other governmental bodies. However, only a small percentage of transactions occur on the stock exchanges. Most sales of securities in the Russian Federation are executed over-the-counter (“OTC”) between licensed brokers and investors. Procedures for obtaining a license to carry out broker/dealer activities and requirements for potential brokers/dealers are set forth in regulations adopted by the FCSM.

There has been a fair amount of discussion on the role of stock exchanges over the last few years, which has resulted in an expectation that requirements for listing are likely to be tightened soon.

### **4.3 Corporate Securities**

Russian JSCs may issue shares, options on shares, corporate bonds, and other securities authorized by the Russian Civil Code and the FSFM. Open JSCs may raise capital either by issuing shares to the public or by private placement. Shares of closed JSCs may not be offered to the general public.

### **4.4 Securities in General**

Unless a particular instrument is specifically recognized by law as being a security, it will not be considered to be a security. Article 143 of the Russian Civil Code provides a list of recognized securities. These securities include bonds, shares, negotiable promissory notes, checks, deposit and saving certificates, bills of lading, and securities issued in the process of privatization. In addition, option certificates have been included within the Russian legal definition of “securities.”

The Securities Law outlines the procedure for the registration of securities issuances and clarifies when a prospectus is required. A prospectus is required when either:

- (1) Securities are to be distributed to an unlimited number of holders;
- (2) The number of holders is known and exceeds 500; or
- (3) Securities are intended to be listed or otherwise publicly traded.

The Securities Law generally requires quarterly reporting of financial and other information and the publication of information describing material events, which will affect the finances or the business activities of the issuer within 5 days after the occurrence of such events. Issuers must provide such information if they have ever registered a prospectus or if they are issuers of “publicly offered securities.”

### **4.5 Regulation of the Securities Market**

#### **4.5.1 The Federal Service for the Financial Markets (the “FSFM”)**

Pursuant to the Presidential Decree No. 314, dated March 11, 2004, the FSFM has replaced the Federal Commission for the Securities Market (the “FCSM”) as the primary regulator of the Russian securities market. The FSFM functions,

which it carries out either directly or through its pre-authorized agencies, include the licensing and supervision of professional securities-market participants, the authorization of self-regulatory organizations, the registration of securities issuances and prospectuses and the approval of standards therefor, and the classification and definition of different types of securities.

The FSFM has the authority to take certain actions against professional securities-market participants who violate the securities regulations. These measures include the suspension and revocation of licenses, enforcement actions, and petitions for criminal prosecution. In addition, the FSFM has the power to fine legal entities or individual entrepreneurs for various securities law violations. Any action pursued against issuers, such as the invalidation of an issuance, must be effected through the courts. Consequently, the ultimate jurisdiction over breaches of the securities laws remains with the courts.

#### **4.5.2 Self-regulating Organizations (“SROs”)**

The requirement of obligatory membership in an SRO for professional participants in the securities market was repealed by the Presidential Decree of October 16, 2000. Pursuant to a FCSM press release dated October 23, 2000, professional participants may now apply directly to the FSFM to receive a license. According to the Licensing Regulation, the FSFM must make a decision on issuing a license to an applicant within 30 days of a direct submission of the documents to the FSFM or within 15 days if an applicant presents a recommendation from an SRO along with the documents. Since the requirement that an SRO recommendation be received prior to the licensing still exists in a number of the FCSM regulations previously adopted by the FCSM, some representatives of SROs consider an SRO membership an ongoing requirement for receipt and possession of a license.

#### **4.5.3 Regulatory Measures**

The FSFM shares its regulatory authority over the securities market with the Central Bank, the Ministry of Finance, and the Federal Anti-Monopoly Service (the “FAS”). For example, the FAS regulates trading in options and futures, while the FSFM regulates derivatives with underlying assets.

The Securities Law also imposes disclosure requirements on holders of securities and on professional securities-market participants. A holder of an issuer’s securities (other than bonds non-convertible into shares) is required to disclose its holding when such a holder possesses 20 percent or more of the

issuer's securities. Moreover, as long as a shareholder's ownership continues to be above this 20 percent threshold, such a shareholder is required to disclose any further acquisitions of 5 percent or more.

The Securities Law requires that notification be provided to the FSFM of transactions whereby foreign parties acquire shares in Russian companies, foreign ownership of which is restricted by law (e.g., the gas and electricity monopolies and insurance entities). In addition, the FSFM must approve securities issued by Russian issuers for placement and organized trading outside of the Russian Federation.

Legislation enforced prior to the passing of the Securities Law prohibited the use of "insider" information. The Securities Law provides a somewhat more sophisticated and potentially broader definition of "insider trading." The legislation refers to the utilization and passing of "inside" information for use where the information was gained by virtue of office, job position, or contract.

#### **4.5.4 Bonds**

The issuance of corporate bonds is regulated by the Russian Civil Code, the JSC Law, and the LLC Law. The public issuance and trading of bonds is governed by the Securities Law.

The above Laws introduced the concept of secured and unsecured bonds. Secured bonds must be fully secured with a third-party guarantee or suretyship, or with a pledge (or a mortgage) of the issuer's and/or third party's securities or immovable property. Only companies, including credit institutions, which have existed for a minimum of 3 years, may issue unsecured bonds. The above Laws provide that the par value of all unsecured bonds issued by a company must not exceed the charter capital of the company and that no bonds may be issued until the charter capital is fully contributed.

In April 2002, a new FCSM resolution providing, inter alia, for standards applicable to the issuance of bonds convertible into shares was adopted. These new Standards of Issuance set forth more detailed procedures for the issuance of bonds convertible into shares and further developed some relevant provisions of the JSC Law.

## **5. THE COMPETITION LAW**

The basic law regulating antimonopoly questions is the Russian Federation Law on Competition and Restriction of Monopolistic Activity in the Commodity Markets (the “Competition Law”), enacted March 22, 1991, as amended. The Russian competition watchdog is the Federal Anti-monopoly Service (the “FAS”).

The Competition Law regulates 4 areas of a particular interest to a foreign investor:

- (1) Abuse of a dominant position;
- (2) Agreements limiting competition;
- (3) Establishment of companies; and
- (4) Mergers and acquisitions.

### **5.1 Abuse of a Dominant Position**

Dominant entities are subject to certain restrictions on their activities. Determining whether a particular entity enjoys a dominant position involves a complex evaluation of various factors. The most important factor is the entity’s market share.

For entities with a market share of 65 percent or greater, there is a presumption of market dominance. If a market share is between 35 and 65 percent, there is a rebuttable presumption of non-dominance. However, the FAS may deem that such a non-dominant entity still holds a dominant position based on the stability of the entity’s market share, the market share of its competitors, the barriers to market entry, and/or other factors. For entities with a market share of 35 percent or less, there is a conclusive presumption of non-dominance.

For those in a dominant position, the Competition Law prohibits any of the following activities:

- (1) Withdrawal of goods from circulation with the intent to create or maintain a shortage in such goods;

- (2) Creation of conditions that place one or more legal entities in an unequal position as compared to other entities in their ability to access the market for particular goods;
- (3) Imposition on a contracting party of contractual terms that are disadvantageous or do not relate to the subject matter of the contract;
- (4) Creation of barriers to market entry for other legal entities;
- (5) Support of high or low prices (i.e., price fixing);
- (6) Discontinuance of production of goods for which there is a consumer demand if it is possible to produce them without a loss; or
- (7) Unjustified refusal to consummate a contract with particular customers if it is possible to produce or deliver the relevant goods to such customers.

Any of the above activities may be allowed if the dominant entity can prove that the positive effects of a particular activity outweigh its negative consequences.

## **5.2 Agreements Limiting Competition**

The Competition Law prohibits agreements, transactions, or other business activities of business entities operating in the same or similar commodities markets that lead or may lead to the following:

- (1) Control or fixing of prices, discounts, bonus payments, or surcharges;
- (2) Increase or reduction of prices or the manipulation of prices at auctions/tenders;
- (3) Division of the market by reference to territories or according to the volume of sales/purchases, the range of marketable goods, or the range of sellers or buyers;
- (4) Restriction of access to the market or the removal from the market of other entities that sell or purchase particular products; and
- (5) Refusal to conclude agreements with particular sellers or buyers.

The Competition Law further prohibits other agreements between business entities operating in the same or similar commodities markets, including agreements between non-competing entities, which will or may result in exclusion, limitation, and elimination of competition or derogation of interests of other business entities.

Finally, the Competition Law prohibits agreements or other concerted actions between non-competing legal entities (such as potential sellers and potential buyers) acting in a particular market if such agreements or other actions result or may result in the exclusion, restriction, or elimination of competition. This rule, however, only applies to legal entities with a joint market share in a particular commodity market exceeding 35 percent.

In certain cases, the above-mentioned activities may be permitted if the business entity can prove that the positive effects of the action, including effects in the socio-economic sphere, outweigh its negative consequences, or if the entity can prove that federal laws permit such agreements or business activities.

### **5.3 Establishment of Companies**

The founders of a new company must notify the FAS within 45 days following the company's registration if the aggregate asset value of the founders exceeds 200,000 times the monthly minimum wage (in May 2004 this corresponded to approximately 690,000 USD).

### **5.4 Mergers and Acquisitions**

#### **5.4.1 Mergers**

Entities involved in a consolidation or a merger must receive prior approval from the FAS if the aggregate asset value of the entities exceeds 200,000 times the monthly minimum wage. The procedures for obtaining such approval are similar to the procedures used for acquisitions.

#### **5.4.2 Acquisition of an Interest in a Russian Company**

##### *Acquisition of Shares/Participatory Shares in a Russian Company*

Entities involved in an acquisition must receive prior approval from the FAS if:

- (1) The aggregate asset value of the acquiror, its group of persons, and/or the target company exceeds 200,000 times the minimum monthly wage; or

- (2) Either the acquiror, any entity of the acquiror's group, or the target company is included in the FAS Register of Entities with a Market Share exceeding 35 percent in the relevant market.

In determining the threshold for asset values, the FAS takes into consideration not only the acquiror and the target company, but also all persons (individuals or legal entities) in the acquiror's "group of persons." The broad term "group of persons" includes all individuals or legal entities related to the acquiror as a result of controlling share ownership or through certain management contracts, familial relations, and/or other *de facto* control mechanisms.

It is common practice for a foreign investor to buy Russian shares/participatory shares and to become such a shareholder/participant in a Russian company. However, there are some legal formalities associated with the acquisition of a stake, non-compliance with which may seriously damage the interests of an investor.

The two most popular forms of organization for Russian companies are joint stock companies ("JSC") and limited liability companies ("LLC"). JSCs issue shares, which, under Russian law, are classified as securities. Therefore, Russian securities legislation provides additional regulations on transactions involving securities:

- (1) Each share issue must be registered with the Federal Financial Markets Service. A failure to register will forfeit the share purchase transaction under Article 168 of the Civil Code;
- (2) Sold shares must be paid for in full by the shareholders. Otherwise, the transaction will be deemed invalid and may be challenged by any interested party; and
- (3) Most shares exist in non-documentary form as entries in a shareholders' register, which is maintained by the JSC or by third party registrars. The title to such non-documentary shares is transferred as a legal matter only at the moment of entry in the shareholders' register. Accordingly, it is very important to receive an excerpt from the shareholders' register, confirming the buyer's title to the acquired shares.

Participatory shares in an LLC are not classified as securities and do not need to be registered. However, an existing participatory share can be transferred

only after it has been fully paid for. In addition, a buyer will obtain the participant's rights in the LLC only after the LLC is notified of the sale of the participatory share. Moreover, since all of the participants in an LLC must be included in its charter and foundation agreement, it is very important to make sure that the LLC participants approve the relevant amendments to the LLC charter and foundation agreement, naming the investor as a new participant.

The advantages of a share (participatory share) purchase scheme are that:

- (1) Exposure of the purchaser to the liabilities of the target company is limited to the nominal value of the purchased share (participatory share); and
- (2) In most cases, the procedure for the share (participatory share) purchase does not require any lengthy or onerous state registration (with the exception of the LLC itself, as to which the charter and the foundation agreement must be amended to reflect that the purchaser has become a participant in the LLC).

Unfortunately, there are also some disadvantages to such a scheme:

- (1) Due to LLC shareholders' right of first refusal, the purchaser must be approved by the existing shareholders in the company, which can be difficult if the company has shareholders other than the seller;
- (2) Potential problems may arise when returning to a foreign purchaser its investment upon the liquidation of a company (especially a JSC); and
- (3) The purchaser must complete certain corporate formalities prior to the share sale.

The purchaser of shares should take the following steps:

- (1) Perform due diligence on the target company;
- (2) Obtain prior approval from the FAS as required by the Article 18 of the Competition Law;
- (3) Ensure that the appropriate corporate procedures are followed (such as the waiver by other shareholders of their preemptive rights);

- (4) Sign a share purchase agreement and any other required documents (such as a share transfer instruction in the case of JSCs or a notification to the company in the case of LLCs); and
- (5) Ensure that the purchaser of the shares is entered into the shareholders' register of the JSC or that a new version of the charter and foundation agreement, reflecting the purchaser of a participatory share as a participant in the LLC, is properly approved and registered.

### *Acquisition of the Assets of a Russian Company*

The main purpose in purchasing assets from a third company is to use the acquired assets in one's own business.

Under Russian law, two main methods of purchasing assets are available:

- (1) Purchase of particular assets; and
- (2) Purchase of an enterprise.

The advantages of purchasing particular assets are:

- (1) The procedure is simple and does not require state registrations (except for specific objects, for example, in the case of the purchase of real estate objects and intellectual property objects, such as patents and trademarks); and
- (2) The purchaser does not acquire any of the liabilities of the seller, unlike in the case of the purchase of an enterprise or shares.

An asset purchase also has some disadvantages:

- (1) Encumbrances over pledged assets will be transferred along with the assets;
- (2) There is possibly an obligation to pay VAT; and
- (3) Acquisition of certain assets can require state registration (real estate objects, some intellectual property objects, etc.).

*Purchase of an enterprise*

An acquisition of an enterprise is advantageous because the purchaser acquires a block of tangible and intangible assets, which allows it to launch or maintain a business. The purchase of an enterprise is, in reality, the acquisition of a business.

However, there are also disadvantages to enterprise acquisition:

- (1) The purchaser acquires not only the assets but also the liabilities of the seller attributable to those assets;
- (2) Applicable Russian legislation provides for the joint liability of the purchaser and the seller of the enterprise to its creditors; and
- (3) If an enterprise owns any tangible property (e.g., a house, a car, a lake, or a satellite dish), it is necessary to register the enterprise as a real estate object and to register the purchase agreement with the body of justice for State Registration of Real Property Rights and Real Property Transactions.

A purchaser of assets and/or enterprise(s) must take the following steps:

- (1) Perform due diligence on the purchased assets (mainly, due diligence as to the title and the legal status of the seller and the powers of its officers);
- (2) Obtain prior approval from the FAS as required by the Article 18 of the Competition Law;
- (3) Ensure that the appropriate corporate procedures are followed (such as the approval of a “major transaction,” the approval of an “interested party transaction”);
- (4) Sign an asset/enterprise purchase agreement and the other required documents; and
- (5) Complete required state registrations (registrations of the rights to and transactions with real estate objects, the registration of enterprise purchase agreements, and/or the registration of assignments of patents and trademarks).

### **5.4.3 Procedures and Timing**

If the FAS determines that the establishment, merger, or acquisition may restrict competition or strengthen a dominant position, it may request additional information and documentation. The FAS may also require the parties to take measures to ensure competition.

After all documents have been submitted, the FAS must issue a written decision within 50 days. In practice, the investor can expect a much longer time period to pass before the FAS decision is issued.

## **6. TAXATION**

### **6.1 Introduction**

Starting in 1999, Russia has begun to undergo a significant tax reform that has been implemented phase-by-phase. This reform has improved procedural rules and made them more favorable to taxpayers, has reduced the overall number of taxes, and has begun to reduce the overall tax burden in the country. In 1999, Part I of the new Tax Code came into effect. Most of Part I deals with administrative and procedural rules. Certain provisions of the new Tax Code were not immediately enforceable, and a limited number of provisions of the old Tax System Law will continue to apply until Part II of the Tax Code is enacted in full. This delay in implementation is necessary in order to prevent possible conflicts between existing tax legislation and certain provisions of the new Tax Code.

In 2001, provisions regarding excise taxes, VAT, individual income tax, and the unified social tax came into force. In 2002, the new profit tax provisions and new mineral extraction tax provisions of the Russian Tax Code entered into effect. In 2003, further amendments introduced a simplified system of taxation, a single tax on imputed income, a new Chapter on transport tax, and established a special tax regime for production sharing agreements operating in Russia. A new Chapter on corporate property tax came into effect as of January 1, 2004, and replaced the former 1991 corporate property tax law. The remaining parts of the Tax Code are still under review in the course of the legislative process.

### **6.2 Types of Tax**

The Tax Code sets forth 3 levels of taxation: federal, regional, and local. Currently, corporate federal taxes include VAT, excise taxes, profit tax, unified social tax, mineral extraction tax, state fees and customs duties, and several other taxes. Regional taxes include the corporate property tax, the transport tax, the single tax on imputed income from certain kinds of activity, and the regional licensing fees, while local taxes include the land tax, the advertising tax, and the local licensing fees.

Upon the enactment of new chapters of Part II of the Tax Code (a process, which is still in progress), the list of applicable Russian federal, regional, and local taxes will change. As of January 1, 2004, several regional and local taxes,

including the sales tax, the militia tax, and the duty for needs of educational organizations were abolished.

### **6.3 Tax Audits**

Russian tax authorities may conduct chamber or on-site tax audits of taxpayers. Tax authorities may audit several different taxes simultaneously within on-site tax audits. However, except in cases of liquidation or reorganization, a tax for a given period may only be audited a maximum of once per year. The results of a tax audit relating to reviewed taxes may only be reconsidered by supervising tax authorities. In any case, however, tax authorities may only audit the 3 calendar years preceding the year of the tax audit. Also, tax authorities may collect outstanding taxes and interest on late tax payments in an out-of-court procedure, while collection of sanctions requires a corresponding court decision.

### **6.4 Corporate Profits Tax**

Prior to 2002, the maximum profit tax rate for most businesses was 35 percent, while a slightly higher maximum tax rate of 38 percent applied to banks and insurance and intermediary companies. Pursuant to the profit tax provisions of Chapter 25 of the Tax Code, as of January 1, 2002, the maximum tax rate for all companies has been reduced to 24 percent, which is currently payable at the rate of 5 percent to the federal budget, 17 percent to regional budgets, and 2 percent to local budgets. The regional authorities may, at their discretion, reduce their regional profits tax rate to as low as 13 percent. Thus, the overall tax rate can vary from 20 to 24 percent.

Chapter 25 introduced the following new tax rates on dividends:

- (1) 6 percent on dividends payable by Russian companies to Russian shareholders; and
- (2) 15 percent on dividends payable by Russian companies to foreign legal entities and on dividends received by Russian companies from foreign legal entities.

Chapter 25 also introduced special tax rates on income earned from Russian state securities and on profits of the Russian Central Bank.

Taxable profit is defined as income minus deductible expenses. Although, prior to 2002, deductions were limited and were subject to substantial restrictions, as of January 1, 2002, many of those expense limitations disappeared under the new profit tax provisions of the Tax Code. Under the current rules, a taxpayer is generally permitted to deduct all necessary and documented business expenses. Certain types of expenses are still subject to restrictions (e.g., certain advertising costs and representational, including business entertainment, and travel costs).

#### **6.4.1 Thin Capitalization Rules**

Generally, under the Tax Code, interest is deductible so long as it does not deviate by more than 20 percent from interest paid on comparable loans in the same calendar quarter. Any excessive part of the interest will not be deductible. If no such comparable loans exist, interest is deducted within certain limits; for ruble loans, the deductible interest may not exceed 110 percent of the Central Bank refinancing rate, and for loans denominated in a foreign currency, the deduction is limited to 15 percent per annum. In addition, there is a specific provision with respect to “thin capitalization.”

The Tax Code introduces a 12.5/1 debt-to-equity ratio limit for banks and leasing companies and a 3/1 ratio limit for all other companies. If the ratio of the Russian borrower company’s internal capital to its outstanding debt owed to a foreign shareholder holding more than a 20 percent interest in the Russian borrower company exceeds these limits, the Tax Code restricts the deductibility of interest paid on excess debt. Non-deductible interest is also considered to be a dividend payment to the foreign shareholder and hence is subject to a 15 percent withholding tax, unless the latter is reduced or eliminated by an applicable tax treaty.

#### **6.4.2 Asset Depreciation and Carrying Forward Losses**

Chapter 25 allows taxpayers to split assets into ten groups, depending on the type of asset and its useful life, and to apply accelerated depreciation rates; for example, the useful life for buildings under the new rules is 30 years, whereas under the old rules (pre-January 1, 2002), the period was 80-90 years. Under Chapter 25, taxpayers are able to choose between a straight-line method (somewhat similar to the old method of asset depreciation) and a new accelerated method. Land, subsoil, and natural resource assets are not subject to depreciation and hence do not reduce the tax base of the Profit Tax.

Under the old rules, an operating loss from the previous fiscal year could be carried forward over the next five years. However, such operating losses could only be carried forward in 5 equal installments, thereby limiting the ability to use such losses against current income. In addition, operating loss carry-forwards could not reduce the amount of tax paid in any one year by more than 50 percent.

However according to the new rules effective since 2002, tax losses may now be carried forward for 10 years. Also, there is no requirement to spread the loss over the entire carry-forward term. Nevertheless, in each given taxable year, the taxpayer can only reduce its current taxable base by at most 30 percent. In addition, capital losses may be offset against operating income; this deduction, however, must be evenly spread over the residual useful life of the capital asset for which the loss was incurred.

### **6.4.3 Investment Benefits**

Russian companies enjoyed various regional and local tax concessions contemplated in the 1991 Corporate Profit Tax Law and in the relevant regional and/or local laws of several regions (especially Chukotka, Kalmykia, Mordovia, and Evenkia). Chapter 25 abolished all tax incentives, including the capital investment allowance. Some types of tax benefits, including investment benefits, were grandfathered although they ceased to be effective as of January 1, 2004. Presently, regional and local legislative bodies are no longer authorized to provide tax concessions, except for regional authorities, which may reduce their regional profit tax rate by 4 percent and thus reduce the overall tax rate to 20 percent. Russian companies still succeed in effecting reduction of their effective profit tax rates to under 20 percent, mainly due to various remaining exemptions and concessions under regional and local laws and special tax regimes.

### **6.4.4 Transfer Pricing Rules**

The Tax Code contains several rules related to transfer pricing. Specifically, it sets forth the presumption that the contractual price agreed on by the parties is the “market price.” At the same time, in any of the following four exceptional circumstances, the tax authorities may exercise control over contractual prices:

- (1) A transaction between affiliated parties;
- (2) A barter transaction;

- (3) A foreign trade transaction; or
- (4) A transaction involving significant variations in prices (more than a 20 percent fluctuation) for identical goods or services within a short period of time (in practice, this term is interpreted as 30 days immediately preceding the date in question).

If a transaction falls under one of the above four categories, the tax authorities can adjust the contract price based on the market value and impute additional taxes, penalties, and late payment interest accordingly.

Finally, Chapter 25 requires taxpayers to maintain a completely separate set of books for the purpose of calculating the tax base for Profit Tax. Traditionally, Profit Tax had been calculated based on book profit adjusted for tax purposes. From January 1, 2002, however, the tax base must be calculated from tax accounting ledgers; statutory accounting is no longer the primary source of information for Profit Tax calculations.

## **6.5 Taxation of Foreign Companies**

Russian legislation taxes profits derived from a “permanent establishment” in Russia, as well as certain other types of income derived without a permanent establishment in Russia. Importantly, whether a permanent establishment exists under Russian law is unrelated to whether a foreign company’s office has been registered in Russia. A permanent establishment may exist even if the office is not registered, and the existence of a registered office may not necessarily give rise to a taxable permanent establishment. Profit derived by foreign legal entities from their having a permanent establishment in Russia is generally taxed at the same Profit Tax rates applicable to Russian taxpayers.

Chapter 25 sets forth a limited list of Russian source income not connected with a permanent establishment in Russia that is subject to Russian withholding tax. The list includes mainly passive types of income, such as royalties, interest, dividend income, and rentals. Other income received by non-Russian residents that is not specified in the list is not subject to any withholding tax.

Starting in 2002, certain new tax rates on the types of Russian source income mentioned in the previous paragraph have been imposed. Dividends payable by Russian companies to foreign shareholders are subject to a 15 percent withholding tax, unless an applicable double taxation treaty

provides for a lower rate. Other listed income received by foreign legal entities from Russian sources is subject to either a 20 percent withholding tax (for most categories of income, including royalties and most types of interest) or a 10 percent withholding tax (for income from freight and lease of transportation vehicles).

Russia is now a party to more than 65 double taxation treaties, which can provide for the reduction of the withholding tax rate on dividend income to as low as 5 percent and generally provide for a 0 percent withholding rate on other income (e.g., interest, royalties, and capital gains). For example, the 1998 Russia-Cyprus Double Taxation Treaty provides for a 0 percent withholding tax rate on interest, royalties, capital gains, and other income not related to permanent establishment, a 5 percent withholding tax rate on dividends payable to Cypriot shareholders who contributed over USD 100,000 to the charter capital of the Russian subsidiary responsible for paying out said dividends, and a 10 percent withholding tax rate on dividends payable to all other Cypriot shareholders. Cypriot shareholders may also offset taxes payable to the Russian federal budget against similar taxes paid in Cyprus.

Chapter 25 includes a provision that explicitly states that, in the event of a conflict, double tax treaties override the Tax Code. Chapter 25 contains more beneficial rules than had existed under previous laws governing obtaining tax treaty relief by a foreign legal entity. Under the new rules, taxpayers should be allowed to obtain preliminary tax treaty relief from tax withholding in Russia without any filings with the Russian tax authorities, by presenting documents evidencing the tax residency status of the taxpayer to the tax-withholding agent (usually the Russian payer). Obtaining a tax refund still requires the filing of the relevant forms with Russian tax authorities.

The profit tax is to be paid on a quarterly basis. The annual tax return and a report on activity in the Russian Federation must be submitted to the tax authorities by March 28 of the year following the close of the taxable year.

## **6.6 Double Tax Treaties**

Russia has entered into and ratified bilateral treaties for the avoidance of double taxation with the following countries:

#	Country	Dividends		Interest <sup>1</sup>	Royalties
		Individuals, Companies	Qualifying companies		
1.	Albania	10	10	10	10
2.	Armenia	10	5 <sup>2</sup>	0	0
3.	Australia	15	5 <sup>3</sup>	10	10
4.	Austria	15	5 <sup>4</sup>	0	0
5.	Azerbaijan	10	10	10	10
6.	Belarus	15	15	10	10
7.	Belgium	10	10	10	0
8.	Bulgaria	15	15	15	15
9.	Canada	15	10 <sup>5</sup>	10	0/10 <sup>6</sup>
10.	China	10	10	10	10
11.	Croatia	10	5 <sup>7</sup>	10	10
12.	Cyprus	10	5 <sup>8</sup>	0	0
13.	Czech Republic	10	10	0	10

<sup>1</sup> Some treaties provide an exemption for certain types of interest, e.g., interest paid to the state, local authorities, the Central Bank or export credit institutions, or in relation to sales on credit. Such exemptions are not reflected in this column.

<sup>2</sup> The rate applies if the value of the holding is at least USD 40,000.

<sup>3</sup> The rate applies if the recipient company (other than a partnership) owns directly at least 10 percent of the company paying the dividends and if the value of the holding is at least AUD 700,000, and the dividends to be paid by the Russian company are exempted from Australian taxes.

<sup>4</sup> The rate applies if the recipient company owns directly at least 10 percent of the capital in the Russian company, and the value of the holding exceeds USD 100,000.

<sup>5</sup> The rate applies if the recipient company owns at least 10 percent of the capital or voting power in the Russian company.

<sup>6</sup> The lower rate applies to computer software, patents, and know-how.

<sup>7</sup> The rate applies if the recipient company owns at least 25 percent of the capital in the Russian company, and the value of the holding is at least USD 100,000.

<sup>8</sup> The rate applies if the value of the holding is at least USD 100,000.

#	Country	Dividends		Interest	Royalties
		Individuals, Companies	Qualifying companies		
14.	Denmark	10	10	0	0
15.	Egypt	10	10	15	15
16.	Finland	12	5 <sup>9</sup>	0	0
17.	France	15	5/10 <sup>10</sup>	0	0
18.	Germany	15	5 <sup>11</sup>	0	0
19.	Hungary	10	10	0	0
20.	Iceland	15	5 <sup>12</sup>	0	0
21.	India	10	10	10	10
22.	Indonesia	15	15	15	15
23.	Iran	10	5 <sup>13</sup>	7.5	5
24.	Ireland	10	10	0	0
25.	Israel	10	10	10	10
26.	Italy	10	5 <sup>14</sup>	10	0
27.	Japan	15	15	10	0/10 <sup>15</sup>

<sup>9</sup> The rate applies if the recipient company owns directly at least 30 percent of the capital in the Russian company, and the value of the holding is at least USD 100,000.

<sup>10</sup> The 5 percent rate applies if the French company (1) has directly invested at least FRF 500,000 in the Russian company and (2) is subject to tax in France but is exempt with respect to dividends (i.e., participation exemption). The 10 percent rate applies if only one of the requirements is fulfilled.

<sup>11</sup> The rate applies if the German company owns at least 10 percent of the capital in the Russian company, and the value of the holding is at least EUR 81,806.70.

<sup>12</sup> The rate applies if the recipient company owns directly at least 25 percent of the capital in the Russian Company, and the value of the holding is at least USD 100,000.

<sup>13</sup> The rate applies if the recipient company owns directly at least 25 percent of the capital in the Russian company.

<sup>14</sup> The rate applies if the recipient company owns directly at least 10 percent of the capital in the Russian company, and the value of the holding exceeds USD 100,000.

<sup>15</sup> The lower rate applies to copyright royalties.

28. Kazakhstan	10	10	10	10
29. North Korea	10	10	0	0
30. Korea (Rep.)	10	5 <sup>16</sup>	0	5
31. Kuwait	5	5	0	10
32. Kyrgyzstan	10	10	10	10
33. Lebanon	10	10	5	5
34. Luxembourg	10/15 <sup>17</sup>	10 <sup>18</sup>	0	0
35. Macedonia	10	10	10	10
36. Malaysia	-/15 <sup>19</sup>	-/15 <sup>20</sup>	15	10/15 <sup>21</sup>
37. Mali	15	10 <sup>22</sup>	15	0
38. Morocco	5/10 <sup>23</sup>	5 <sup>24</sup>	0/10 <sup>25</sup>	10
39. Moldova	10	10	0	10
40. Mongolia	10	10	10	<sup>-26</sup>

<sup>16</sup> The rate applies if the recipient company owns directly at least 30 percent of the capital in the Russian company, and the value of the holding is at least USD 100,000.

<sup>17</sup> The 10 percent rate applies if the Luxembourg recipient owns directly at least 30 percent of the capital in the Russian company, and the value of the holding is at least EUR 75,000.

<sup>18</sup> The 10 percent Rate applies if the Luxembourg recipient owns directly at least 30 percent of the capital in the Russian company, and the value of the holding is at least EUR 75,000.

<sup>19</sup> The 15 percent rate applies to profits of joint ventures. Otherwise, the domestic rate applies; there is no reduction under the treaty.

<sup>20</sup> The 15 percent rate applies to profits of joint ventures. Otherwise, the domestic rate applies; there is no reduction under the treaty.

<sup>21</sup> The lower rate applies to industrial royalties.

<sup>22</sup> The rate applies if the value of the holding is at least FRF 1 million.

<sup>23</sup> The 5 percent rate applies if the value of the holding is at least USD 500,000.

<sup>24</sup> The 5 percent rate applies if the value of the holding is at least USD 500,000.

<sup>25</sup> The lower rate applies to interest on foreign currency deposits.

<sup>26</sup> The domestic rate applies; there is no reduction under the treaty.

#	Country	Dividends		Interest	Royalties
		Individuals, Companies	Qualifying companies		
41.	Namibia	10	5 <sup>27</sup>	10	5
42.	Netherlands	15	5 <sup>28</sup>	0	0
43.	New Zealand	15	15	10	10
44.	Norway	10	10	10	0
45.	Philippines	15	15	15	15
46.	Poland	10	10	10	10
47.	Portugal	15	10 <sup>29</sup>	10	10
48.	Qatar	5	5	5	0
49.	Romania	15	15	15	10
50.	Serbia and Montenegro	15	5 <sup>30</sup>	10	10
51.	Slovakia	10	10	0	10
52.	Slovenia	10	10	10	10
53.	South Africa	15	10 <sup>31</sup>	10	0
54.	Spain	15	5/10 <sup>32</sup>	0/5 <sup>33</sup>	5

<sup>27</sup> The rate applies if the recipient company owns at least 25 percent of the capital in the Russian company, and the value of the holding is at least USD 100,000.

<sup>28</sup> The rate applies if the Netherlands company owns directly at least 25 percent of the capital in the Russian company and has invested in it at least EUR 75,000 or its equivalent in national currency.

<sup>29</sup> The rate applies if the Portuguese company has owned directly at least 25 percent of the capital in the Russian company for an uninterrupted period of at least 2 years prior to the payment.

<sup>30</sup> The rate applies if the recipient company owns at least 25 percent of the capital in the Russian company, and the value of the holding is at least USD 100,000.

<sup>31</sup> The rate applies if the recipient company owns directly at least 30 percent of the capital in the Russian company, and the value of the holding is at least USD 100,000.

<sup>32</sup> The 5 percent rate applies if (1) the Spanish company has invested at least EUR 100,000 in the Russian company, and (2) the dividends are exempt in Spain. The 10 percent rate applies if only one of the conditions is met.

55. Sri Lanka	15	10 <sup>34</sup>	10	10
56. Sweden	15	5 <sup>35</sup>	0	0
57. Switzerland	15	5 <sup>36</sup>	5/10 <sup>37</sup>	0
58. Syria	15	15	10	0
59. Tajikistan	10/5	10	10	0
60. Turkey	10	10	10	10
61. Turkmenistan	10	10	5	5
62. Ukraine	15	5 <sup>38</sup>	10	10
63. United Kingdom of Great Britain and Northern Ireland	10	10	0	0
64. United States of America	10	5 <sup>39</sup>	0	0
65. Uzbekistan	10	10	10	0
66. Vietnam	15	10 <sup>40</sup>	10	15

<sup>33</sup> The lower rate applies to long term loans (minimum 7 years) granted by credit institutions resident in a respective state.

<sup>34</sup> The rate applies if the recipient company owns directly at least 25 percent of the capital in the Russian company.

<sup>35</sup> The rate applies if the Swedish company owns 100 percent of the capital in the Russian company (or in the case of a joint venture at least 30 percent of the capital in such a joint venture), and the foreign capital invested exceeds USD 100,000.

<sup>36</sup> The rate applies if the Swiss company owns at least 20 percent of the capital in the Russian company, and the value of the holding exceeds CHF 200,000.

<sup>37</sup> The lower rate applies to loans of any kind granted by a bank.

<sup>38</sup> The rate applies if the value of the holding is at least USD 50,000.

<sup>39</sup> The rate applies if the recipient company owns at least 10 percent of the capital or voting power in the Russian company, as the case may be.

<sup>40</sup> The rate applies if the Vietnamese company has invested directly in the capital of the Russian company at least USD 10 million.

Besides, Russia has entered into, but still has not ratified, bilateral treaties for the avoidance of double taxation with the following countries:

#	Country	Dividends		Interest <sup>41</sup>	Royalties
		Individuals, Companies	Qualifying companies		
1.	Botswana	10	5 <sup>42</sup>	10	10
2.	Malta	10/ <sup>-43</sup>	5 <sup>44</sup>	0	0
3.	Ethiopia	5	5	5	15
4.	Thailand	15	15	10	15
5.	Lithuanian Republic	10	5 <sup>45</sup>	10	5 <sup>46</sup> /10
6.	Georgia	10	10	10	5

## 6.7 Value Added Tax (“VAT”)

VAT is imposed on all goods imported into Russia and is also applied to the sale of goods, work, and services in the state. Current legislation imposes a VAT rate of 18 percent on the sale of most goods, including crude oil and oil and gas products, decreased from the former 20 percent rule, which was effective until December 31, 2003. A fixed 10 percent rate is applied to limited types of

41 Some treaties provide for an exemption for certain types of interest, e.g., interest paid to the state, local authorities, the Central Bank or export credit institutions, or in relation to sales on credit. Such exemptions are not reflected in this column.

42 The rate applies if the recipient company owns at least 25 percent of the capital in the company paying the dividends.

43 The rate shall not exceed the rate established for income tax purposes if the recipient company is a Russian resident.

44 The rate applies if the recipient company (resident of Malta) owns directly 20 percent in the capital of the Russian company, and the foreign capital invested exceeds USD 100,000.

45 The rate applies if the recipient company (other than a partnership) owns at least 25 percent of the capital in the company paying the dividends, and the value of the holding exceeds USD 100,000.

46 The rate applies to industrial royalties.

goods, such as pharmaceuticals, medical equipment, and certain food products and periodicals. Export of goods is subject to 0 percent VAT.

Generally, VAT paid on acquired goods, work, and services may be offset against VAT collected from customers. In order to claim a refund of input VAT paid in relation to goods that subsequently were exported and subject to 0 percent VAT, the company is required to file various supporting documents with the Russian tax authorities. In capital construction, the input VAT paid to suppliers of goods, work, and services may be offset only when the constructed assets are recorded on the taxpayer's balance sheet.

An enterprise ends up transferring to the State only the difference between VAT paid and VAT collected. As a general rule, however, a taxpayer may not offset input VAT if such VAT is incurred on the goods, work or services used by the taxpayer for the sale of goods or provision of services that are exempt from VAT. In this case, the taxpayer will be required to include such input VAT into its production costs and will effectively lose this input VAT for future recovery.

Careful planning will therefore be required to maintain full recovery when space is leased directly to representative offices of foreign legal entities accredited in Russia, as such leases are generally VAT exempt. In those cases where only a portion of certain input costs was used for the production of goods or provision of services subject to VAT, the corresponding input VAT may be offset only on a pro rata basis. Again, careful planning will therefore be required to maintain full recovery if part of a newly constructed building is to be directly leased to representative offices of foreign entities accredited in Russia.

Under the VAT provisions of the Tax Code, a taxpayer carrying out new construction, either by its own means or through contractors, can recover input VAT connected with the construction and incurred after January 1, 2001. The taxpayer can begin to recover such VAT once it has recorded the newly constructed building on its balance sheet. Under current accounting rules, the only requirement for recording a building onto a taxpayer's balance sheet is for the taxpayer to complete a standard act of transfer and acceptance for the building. In addition, however, the Russian Federation Ministry of Taxes and Levies has issued several rulings to the effect that a taxpayer must also register its ownership rights to a building with the state in order to be entitled to offset input VAT included in the cost of the building.

From 2001 until 2003, a Russian customer of a foreign company that is not registered with the tax authorities and is active (making sales or rendering

services) in Russia must withhold 16.67 percent reverse charge VAT from the amounts transferred to the foreign company and must itself remit such VAT directly to the state budget. As of January 1, 2004, due to the VAT rate decrease to 18 percent, the withholding VAT tax rate has been correspondingly reduced to 15.25 percent.

## **6.8 Mineral Extraction Tax**

Prior to 2002, licensed subsoil users had to pay, inter alia, the tax on restoration of mineral resource base and subsoil use payments. The tax base was calculated as a percentage of the value of the minerals actually extracted. Chapter 26 of the Tax Code introduced a new mineral extraction tax, which came into effect on January 1, 2002. The mineral extraction tax has replaced the tax on restoration of the mineral resource base and the subsoil use tax payable on the value of minerals extracted. Now subsoil users are required to make subsoil use payments provided that they conduct at least:

- (1) Prospecting and valuation;
- (2) Exploration of mines; or
- (3) Construction works on the minefield (not connected with mineral extraction). The law has set the minimum and maximum rates with respect to each type of activity, depending on the territory used within the subsoil activity, rather than on the value of minerals extracted (as in effect prior to 2002). Regional state executive bodies set specific rates within these limits, which shall be reflected in corresponding licenses.

The tax is basically calculated as the value of the mineral resources extracted from the subsoil based on the prices, excluding VAT and excise taxes at which the extracted minerals were sold, subject to the transfer pricing provisions of the Tax Code, effectively not lower than the market price. Taxpayers are required to calculate the tax base separately for each type of mineral resource extracted and pay it on a monthly basis. In particular, Chapter 26 sets out a tax rate of 6 percent for gold, 6.5 percent for silver, 16.5 percent for oil, 17.5 percent for gas condensate, and 107 rubles (approximately USD 3.69) per 1,000 cubic meters of gas. Subsoil users that prospected and explored an oilfield at their own expense shall pay 70 percent of the tax normally due for the natural resources extracted from the respective licensed oilfield. Subsoil users

include the mineral extraction tax paid to the state budget in their deductible expenses, decreasing the taxable base of the corporate profit tax due. Chapter 26 does not provide for any special concessions for subsoil users.

## **6.9 Taxation Under Production Sharing Agreements**

Pursuant to Chapter 26.4 of the Tax Code, effective as of June, 2003, companies extracting minerals under production sharing agreements (“Investors”) are subject to a special and completely different, in comparison with the mineral extraction tax, regime. For instance, an Investor pays 50 percent of the mineral extraction rate for oil and gas condensate until it reaches a certain limit of commercial production, specified in the PSA. Once an Investor has reached such limit, however, it pays the full mineral extraction rate for oil and gas condensate.

At the same time, Investors may be exempted from regional and local taxes (given respective decisions of regional and local legislative branches), the corporate property, and the transport tax, the latter with respect to fixed assets and vehicles used directly for the purposes of oil and gas extraction under the PSA. In addition, depending on the conditions of the PSA, Investors may get a further refund of VAT, the unified social tax, payment for use of natural resources and water objects, state fees, customs fees and duties, the land tax, the excise tax, and the ecological tax previously paid to the budget within the terms of the PSA.

The PSA taxation regime introduced by Chapter 26.4 of the Tax Code has increased the number of tax law requirements for, and taxes payable by, Investors and as a result is unlikely to make PSAs very attractive to Investors.

## **6.10 Corporate Property Tax**

As of January 1, 2004, Chapter 30 of the Tax Code on the Corporate Property Tax came into effect and replaced the former 1991 Corporate Property Tax Law. The property tax is a regional tax, i.e., its imposition is regulated by the legislation of the relevant region, to a maximum rate of 2.2 percent. The tax base includes movable and/or immovable fixed assets owned by the taxpayer in Russia and is calculated based on the depreciated book value of those assets. Taxable assets no longer include any costs or intangible assets recorded on the taxpayer’s balance sheet. Land, water objects, and such are not subject to the property tax either.

Chapter 30 of the Tax Code further exempts from taxation certain categories of property, such as assets used by religious organizations to maintain religious activities. Furthermore, when imposing property tax, Russian Federation regions may fix lower or differentiated rates for different categories of payers and/or types of taxable property. Corporate property tax is payable on an annual basis, with advances due every quarter. However, Russian Federation regions may excuse certain categories of payers, including both Russian and foreign organizations, from the obligation to assess and make such advance payments.

### **6.11 Unified Social Tax**

Effective January 1, 2001, one unified social tax replaced employers' contributions to four separate social benefit funds (the Pension Fund, the Social Security Fund, the Mandatory Medical Insurance Fund, and the Employment Fund). The Tax is paid centrally and is afterwards distributed among three of the above funds (the Employment Fund has been abolished). The unified social tax has a regressive tax scale from 35.6 percent to 2 percent of an employee's salary, with the lowest rate applicable to the portion of an employee's annual salary in excess of 600,000 rubles (approximately USD 20,690). The tax period is one year, and the tax is paid on a monthly basis.

In the past, the salaries of foreign citizens employed or acting as individual entrepreneurs in Russia were exempt from the Unified Social Tax, provided that under Russian legislation or the relevant employment/service contract those expatriates were not eligible for Russian state pensions, social benefits, and state-subsidized medical treatment. However, this tax exemption has ceased to exist as of January 1, 2003, and expatriate salaries have become subject to the Unified Social Tax under the same general rules outlined above.

### **6.12 Personal Income Tax**

Individuals who are defined as "Russian tax residents," i.e., those who have been in the country for 183 days or more (in any calendar year), are subject to personal income tax on all their income, both that earned in Russia and that earned elsewhere. Individuals who do not meet this criterion are subject to a tax on any income received from Russian sources. From January 1, 2001, Russia has enacted various income tax rates, including a 13 percent flat rate applicable to most types of income, a 35 percent rate applicable to income from gambling, lottery prizes, deemed income from low-interest or interest-free loans, certain insurance payments, and excessive bank interest, and a 30 percent rate

applicable to Russian-source income received by non-residents. Notably, dividend income is taxed at the rate of 6 percent.

By April 30 of the following year, the taxpayer must file a tax return based on his/her actual income for the previous year, as well as settle tax obligations for that year. Foreign individuals are required to file annual tax declarations with the tax authorities by April 30 of the year following the reporting year only if they receive income from non-Russian sources or income where no income tax was withheld at the source of payment. Those foreign individuals who leave the country during a calendar year should file a tax declaration for the relevant taxable period no later than one month prior to departing Russia.

### **6.13 Regional and Local Taxes**

Regional and local legislative bodies may, at their discretion, introduce various tax incentives and credits in regard to regional and local taxes. These taxes currently include property tax, land tax, and advertising tax. Although these taxes are set locally, the federal legislature has enacted limits upon their overall rates. The sales tax levied at the maximum rate of 5 percent that existed in many Russian regions was also phased out as of January 1, 2004.

## **7. CURRENCY REGULATIONS**

### **7.1 Introduction**

Article 140 of the Russian Civil Code declares that the ruble is the national currency of the Russian Federation. Although agreements may refer to the ruble value equivalent of foreign currency, all transactions conducted inside the Russian Federation, as a general rule must be settled in rubles. Article 317 (3) of the Civil Code, however, permits the use of foreign currency in cases provided for by law.

The main piece of federal legislation regulating currency transactions is the Law on Currency Regulation and Currency Control (the “Currency Law”) of October 9, 1992. The Currency Law governs “foreign currency transactions,” such as the transfer of ownership or other rights to foreign currency. The Currency Law also regulates the powers of currency control agencies and the rights and duties of individuals and legal entities to possess, use, and dispose of “currency valuables,” and imposes liability for the violation of currency legislation. Currency valuables include foreign currencies, securities in foreign currencies, precious metals, and precious stones.

On June 17, 2004, the Currency Law will be replaced with the new Federal Law No. 173-FZ, On Currency Regulation and Currency Control (the “New Currency Law”), dated December 10, 2003. It is expected that in the meantime certain implementing regulations will be adopted by the Russian Government (the “Government”) and the Central Bank of Russia (the “CBR”). The New Currency Law is an important step in the process of removing most of the currency control restrictions, which removal is expected to occur in 2007.

Foreign investors must monitor currency regulations very carefully since these rules change frequently in the Russian Federation. In light of the high penalties for failing to observe the Currency Law, foreign investors should seek the most up-to-date legal advice to ensure that they are in compliance with all Russian currency requirements.

### **7.2 Resident vs. Non-resident Status**

The Currency Law gives the CBR authority to regulate the possession and use of foreign currency by individuals and legal entities on the territory of the Russian Federation. The Currency Law divides individuals and legal persons into 2 groups: residents and non-residents. Residents include Russian citizens

and other individuals whose permanent place of residence is the Russian Federation, legal entities created in accordance with Russian legislation, representative offices (branches) of Russian legal entities outside of Russia, and enterprises/organizations that are not legal entities but are located inside the Russian Federation. Non-residents are defined as individuals whose permanent place of residence is located outside of Russia; legal entities incorporated outside Russia, and representative offices (branches) of foreign legal entities in Russia. The distinction between residents and non-residents is retained in the New Currency Law with minor changes.

### **7.3 Bank Accounts**

A non-resident company may open the following types of accounts in the Russian Federation:

- (1) A ruble “convertible” account (“K” account);
- (2) A ruble “non-convertible” account (“N” account);
- (3) A foreign currency account; and
- (4) A special purpose ruble account for state-issued securities and certain “blue chip” corporate securities issued by Russian companies (“S” account).

A non-resident company can open any of the above accounts regardless of whether it is accredited to do business in Russia or not. Certain restraints are imposed on N accounts and S accounts. Funds from N accounts, for example, may be used for the purchase of foreign currency not earlier than 365 days after presenting a purchase order to an authorized bank. Cash withdrawals from both K and N accounts may be effected only for the purposes authorized by the CBR, while cash withdrawals from S accounts are prohibited.

The New Currency Law does not expressly provide for such limitations. However, it remains to be seen whether the limitations existing under the current currency regime will continue after June 17, 2004.

## 7.4 Movement of Capital

The Currency Law divides foreign currency transactions into two categories: capital movement currency transactions and current currency transactions. Capital movement currency transactions include:

- (1) Direct investments;
- (2) Portfolio investments, i.e., the acquisition of securities;
- (3) Money transfers to pay for the title to buildings, real estate, land, and other property;
- (4) Grant or receipt of a payment deferral of more than 90 days for the import and export of goods; and
- (5) Extension or receipt of a financial credit (loans) for more than 180 days.

Capital movement currency transactions must be carried out pursuant to a CBR authorization for which only resident legal entities can apply, unless otherwise exempted by the CBR. Examples of such exemptions, which are conditional upon satisfying certain requirements, include, among others:

- (1) Foreign currency transfers by resident individuals to and from Russia in amounts not exceeding USD 75,000 during the course of a calendar year in order to acquire foreign currency denominated securities or to exercise rights in such securities;
- (2) Loans from non-resident entities; and
- (3) Transfers of currency by non-residents to resident entities under Russian real estate sale or lease contracts.

Current currency transactions do not require a CBR authorization. Such transactions include:

- (1) Foreign currency transfers to and from the Russian Federation making immediate settlements of payments for import and export of goods;
- (2) Settlements connected with credits granted for not more than 90 days for import-export transactions;

- (3) Extension or receipt of financial credits (loans) (not to exceed 180 days);
- (4) Transfers to and from the Russian Federation of interest payments, dividends, investments, credits, and other transactions linked to the movement of capital; and
- (5) Transfers of a non-commercial nature, including the transfer of wages and salaries, pensions, alimony, business trips expenses, inheritances, and other similar transactions.

The New Currency Law abolishes the distinction between current transactions and capital movement transactions. The New Currency Law will also substantially limit the authority of the CBR to restrict currency operations in Russia. Firstly, it provides for an exhaustive list of currency operations subject to administrative regulation and establishes a “free hands” regime with respect to other currency operations between residents and non-residents. Further, it limits the list of regulators to the CBR and the Government of the Russian Federation and clearly states that these bodies may not introduce new requirements to the currency regime established by the New Currency Law, except as provided by the New Currency Law itself. Finally, the New Currency Law explicitly prohibits imposing of any requirements to obtain individual permits for a particular type of currency transaction.

Instead of individual permits and requirements, the New Currency Law introduces new types of limitations, namely “special account” and “mandatory reserves.” A special account should be used for conducting certain types of foreign currency transactions. The regime for such accounts is yet to be defined. The requirement to keep a mandatory reserve would be imposed on residents and non-residents according to a number of currency operations specified in the law. Residents or non-residents thus may be required to block a certain amount of money in rubles (up to 100 percent of the value of the relevant currency operation as may be determined by the CBR or the Government) in a separate non-interest-bearing account with a Russian authorized bank for a certain period of time (e.g., 2, 12, and 24 months). The authorized bank will further reserve an equivalent sum at the CBR. In most cases, such reserves shall be established not later than the day of the currency operation subject to a mandatory reserve. However, in certain cases (e.g., purchase by non-residents of securities issued in Russia, by residents of securities issued abroad, or by residents of participation interest in foreign companies), residents and non-residents may be required to establish such reserves in advance.

## **7.5 Liability for Violation**

Persons violating Russian currency regulations may be subject to civil, administrative, and criminal liability. Administrative penalties for the violation of Russia's currency regulations are currently provided for in Articles 15.25 – 15.26 of the Russian Federation Code of Administrative Offences, which entered into force on July 1, 2002. These penalties are mainly fines that may be imposed upon different types of offenders: individuals, officers of enterprises, and legal entities. The amounts of fines vary from 1/10 to the entire amount of profit gained as a result of the illegal currency transaction. In addition, violators, particularly authorized banks, can be fined for failure to submit the proper documents to the authorities and can also lose their licenses to conduct foreign currency transactions.

## **8. EMPLOYMENT**

### **8.1 Introduction**

Foreign investors should be aware of the broad set of laws regulating labor relations between employers and employees that currently exist in Russia. The principal piece of legislation governing labor relations in Russia is the Russian Federation Labor Code (the “Labor Code”), effective February 1, 2002. In addition to this core legislation, labor relations are regulated by the 1992 Russian Federation Law on Collective Agreements and Accords, as amended (currently through 2001), the 1995 Russian Federation Law on the Procedure for Resolving Collective Labor Disputes, as amended (currently through 2001), and the 1996 Russian Federation Law on Professional Unions, Their Rights and Guarantees of Activities, as amended (currently through 2003), as well as Russian legislation on minimum wages and labor safety and other related laws and numerous regulations.

A written employment contract in Russian, setting out the basic terms of the employment relationship, must be entered into by each employee working in Russia. The Labor Code provides all employees with minimum guarantees that cannot be superseded by any other agreements between the employer and the employee. Accordingly, any provision in an employment contract that diminishes an employee’s position from that set forth in such guarantees will be invalid.

As a general rule, employment contracts are to be entered into for an indefinite period of time. A definite term employment contract may also be entered into, but such a contract cannot be enforced for a term longer than five years in duration, and it may only be executed in the circumstances specifically provided for by Article 59 of the Labor Code. Such situations usually occur when the nature or conditions of work make it impossible for the parties to enter into an indefinite term contract. Further, an employee cannot be prohibited from holding a second job in addition to his/her full-time employment with certain limited exceptions provided by Federal law.

Under Russian labor legislation, relevant employment duties and obligations should be defined in the employment contract. It is important that these duties and obligations are broadly defined because an employee cannot be required to perform tasks outside of the scope of duties described in his/her employment contract. Similarly, an employer cannot make unilateral changes to an employee’s obligations. Moreover, the employer must notify an employee

2 months in advance of any changes that would be made in the fundamental employment terms and conditions.

## **8.2 Employment-related Orders**

Employers in Russia are required to issue an internal order (decree) each time an employee is hired, transferred to a new job, granted a vacation, disciplined, or terminated, and also in several other cases. For example, Article 68 of the Labor Code expressly requires that the order of hiring must be issued and given to the employee for countersignature not later than 3 days after the employment contract has been executed. When an employee is terminated for any reason, the order of termination must be issued and given to the employee for countersignature on the last day of employment.

## **8.3 Labor Books**

A labor book is a document that contains information about a person's employment history, as well as certain other information. An employee must make sure that a note of employment is made in his/her labor book by an employer when the employment lasts for over 5 days. The labor book is vital because it confirms an employee's right to a state-provided pension and other benefits. Employers are responsible for keeping their employees' labor books and making all recordings in it in a timely manner. The employer must return the duly completed and stamped labor book to the employee on the last day of employment. If this is not done, the employer may be penalized.

## **8.4 Probationary Period**

An employer has the right to establish a three-month probationary period for a newly hired employee. As an exception to the above rule, an employer may establish a six-month probationary period for employees hired for certain top executive positions (e.g., head of an enterprise, chief accountant and his deputies, head of a sole division of an enterprise). The imposition of a probationary period must be specifically stated in the employment contract, as well as in the order of hiring. If during the probationary period an employer determines that an employee does not meet the criteria established for the job position for which he/she was hired, the employee can be dismissed by the employer without payment of severance and with only three days' written notice. The above-mentioned notice to the employee must provide reasons for the employee's failure to pass the probationary period. However, an employee

is entitled to resign during the probationary period without stating any reason with three days' written notice to the employer.

## **8.5 Minimum Wage**

Wages may not be lower than the minimum monthly wage established by the applicable Russian legislation. The amount of the minimum monthly wage is subject to frequent indexation. Thus, the minimum monthly wage was established at 600 rubles as of October 1, 2003.

## **8.6 Work Time**

Employers are required to keep a record of all time worked by each employee, including any overtime. The regular workweek is 40 hours. Any time worked over 40 hours is classified as overtime and may only be demanded by employers in extraordinary circumstances, as specified in Article 99 of the Labor Code, and upon an employee's prior written consent. The Labor Code limits the total amount of overtime for each employee to 120 hours a year, and an employee may not be required to work more than 4 hours of overtime in two consecutive days. Overtime must be paid at the rate of 150 percent of the regular hourly rate for the first 2 hours of overtime worked during one day and at the rate of 200 percent of the regular hourly rate thereafter. Upon an employee's written request for such, an employer must compensate overtime work by granting the employee additional time off instead of payment of overtime compensation. Such time off shall be not less than the time worked as overtime.

Note that certain limitations regarding overtime work apply to protected categories of employees, including employees under the age of 18, pregnant women, women with children under the age of 3, disabled employees, and certain other categories as defined by Federal laws.

## **8.7 Holidays and Days Off**

In Russia, there are 11 public holidays. The length of weekend time off shall be not less than 42 hours. As a rule, employees may be required to work on a day off or on a public holiday only in extraordinary circumstances, as specified in the Labor Code, and only upon the employees' prior written consent. As a general rule, employees shall receive payment of not less than twice the regular rate for any work performed on a day off or on a public holiday or receive another day off instead.

Certain limitations connected with working on days off and on public holidays apply to the protected categories of employees, including employees under the age of 18, pregnant women, women with children under the age of three, disabled employees, and other categories as defined by Federal laws.

## **8.8 Vacations**

Employees in Russia are entitled to an annual paid vacation of at least 28 calendar days per one year of work. An employee is entitled to use his/her vacation time (in full) once he/she has worked for an employer for at least six months. The Labor Code requires that the dates of annual vacation of each employee should be indicated in the schedule of vacations for the calendar year. The employer must approve this schedule by mid-December of the preceding year. The Labor Code further requires that employers notify their employees in writing at least 2 weeks before the vacation is to start. An employee's vacation allowance should be paid out to the employee at least 3 days before the vacation is supposed to start.

## **8.9 Sick Leave**

In Russia, the system of sick leave requires an employee to submit a medical certificate (so-called "sick leave list") only after his/her recovery. Generally, employees cannot be terminated by their employer during a sick leave period and are entitled to receive sick leave compensation. Sick leave compensation is covered by the Russian State Social Insurance Fund, which is funded by the employer's contributions that are retained as a percentage of its employees' salaries in the form of the Unified Social Tax.

Under current rules, sick leave compensation must be paid to an employee in the event of his/her illness, injury (labor-related or other), and in cases when an employee is looking after a sick family member, as well as in some other instances. Currently, the amount of compensation paid to the employee during such sick leave is set at between 60 and 100 percent of the employee's earnings, depending on the employee's uninterrupted work history and other circumstances. In cases of a labor-related injury or occupational disease, the amount of sick leave compensation is 100 percent of the employee's earnings. On February 11, 2002, the Russian Federation Law on the Budget of the RF Social Insurance Fund for the Year 2002 No. 17-FZ was enacted, which, in effect, put a ceiling on sick leave compensation for employees in Russia. Pursuant to the Law, the amount of sick leave compensation for the period of a full calendar month cannot exceed 11,700 rubles (approximately USD 403).

The above limitation does not apply to certain defined categories of employees for whom sick leave compensation cannot be limited according to Federal law.

### **8.10 Maternity Leave**

Paid maternity leave starts to accrue a minimum of 70 calendar days prior to the birth and continues to accrue for additional 70 calendar days after the birth. Paid maternity leave is provided for a longer period in the event of complications while giving birth or in cases of multiple births. Maternity leave compensation is covered by the Russian State Social Insurance Fund, which is funded by the employer's contributions that are retained as a percentage of its employees' salaries in the form of the Unified Social Tax. A child's caregiver (the employee who has given birth, the father, grandmother, grandfather, or another relative who is actually taking care of the child) may request partially paid childcare leave until the child is 3 years of age. During the entire period of paid/unpaid leave, the employee retains the right to return to his/her job, and the full leave period is included when calculating the employee's length of service.

### **8.11 Dismissal**

An employment relationship may be terminated by an employer only on the specific grounds provided in the Labor Code, including reduction in force, the employee's repeated failure to fulfill his/her employment duties without justifiable reasons (if the employee was disciplined within the preceding 12 months), and the employee's unjustified absence from the workplace for more than 4 consecutive hours during 1 working day. An at-will termination of an employment relationship by an employer is not allowed. Employers when terminating employment for any reason must strictly comply with specific procedures and documentary requirements provided by the Labor Code. The Labor Code gives additional protection to a number of specific categories of employees, including minors, female employees, employees with children, trade union members, and various other categories. However, employees are entitled to terminate their employment at any time, without stating any reason, and, as a general rule, with only two weeks' written notice to the employer.

### **8.12 Compensation**

Salaries must be paid to employees at least once every half a month. Employers are obligated to pay salary and other employment-related payments on a date set by the internal labor regulations or by the individual

employment contract. An employer will be obligated to pay compensation (i.e., interest) for delaying the payment of salary and other employment-related payments in accordance with the rules established by Article 236 of the Labor Code. In addition, employees have the right to stop working, with prior written notice to their employer, if their employer has delayed payment of their salary for more than 15 days. Employees in Russia must be compensated in the currency of the Russian Federation (Russian rubles). As a general rule, employment-related payments in a foreign currency, both in cash and by bank transfer, are prohibited.

### **8.13 Foreigners Working in Russia**

The prior permission of the appropriate migration authority is required for entities employing foreign nationals for work in Russia. In addition, a valid Russian work visa and a work permit are required for foreign nationals before they may commence working in Russia. The same rule applies to foreign nationals working in Russia under civil-law contracts for performance of works or provision of services (e.g., sales representatives). The permission to hire foreign nationals and individual work permits are issued to the employing entity for a period of up to one year. Currently in Moscow, the procedure for obtaining a permission to hire foreign nationals and individual work permits may take from 3 to 5 months to complete. In other constituents of the Russian Federation, this procedure may take significantly less time.

In addition, foreign nationals working in accredited representative offices of foreign firms should obtain a personal accreditation card from the representative office's accrediting body.

## **9. PROPERTY RIGHTS**

### **9.1 Introduction**

Both the Constitution of the Russian Federation and the Civil Code of the Russian Federation uphold the right to own private property. The Land Code of October 2001 and other federal laws adopted as a follow-up to the Land Code are another important step ensuring that this policy becomes a reality.

President Vladimir Putin and the Government of the Russian Federation have always recognized the importance of statutory regulation of the status of land. As a result, the Land Code was adopted by the State Duma, approved by the Federation Council, and signed by the President on October 25, 2001. As provided in the Federal Law on Implementation of the Land Code No. 137 FZ of October 25, 2001 (the “Implementing Law”), the Land Code came into force on the date of its publication, October 30, 2001. The Land Code, together with the Federal Law No. 101-FZ On Circulation of Agricultural Lands of July 24, 2002 (the “Circulation Law”), which entered into force in January 2003, put an end to the political debate as to whether land ownership in Russia is possible.

At the present time, land is treated separately from buildings under Russian law although there are plans to develop a concept of a single object of real estate on the basis of the rights to land. The Land Code sets out the principle of a single approach to land and buildings that are located on such land. The implementation of this principle will, however, require further extensive changes in the existing laws and regulations.

Under current Russian law, investors have choices in terms of using, leasing, and owning property. In addition, Russia’s recent economic growth has introduced new opportunities to those investors that are interested in participating in the Russian real estate market. However, in looking at these details, it is important to understand that there are, for the moment, different regulations for land and for buildings.

### **9.2 Ownership of Land**

The general principles of land ownership are set forth in the Constitution of the Russian Federation, which was adopted in December 1993. Article 9 of the Constitution proclaims the principle of private ownership of land but does not, however, stipulate the procedure for the transfer of land (which had historically

been owned by the state) into private ownership. This legislative vacuum has prompted the rise of a number of regional laws and regulations, as well as the Presidential Decrees adopted in an attempt to regulate various land issues. Regional initiatives raised, however, a more serious concern with respect to the overall validity of all of the regional laws on land ownership. According to Article 72 of the Constitution, decisions on issues on the possession, use, and disposal of land are the joint responsibility of the Federation and its subjects (constituent members). Article 76 of the Constitution further provides that a federal law must govern such issues of joint responsibility. Such federal law may be supplemented by laws and other regulations that the subjects of the Federation may issue in compliance with the federal law in question. In addition, Article 36 of the Constitution provides that a federal law must determine the “terms and procedures of land use.”

The Land Code therefore represented a significant reform, particularly, because of the federal sanctions and encouragement that it gives to the creation of private ownership rights in land. Although fundamental terms and procedures of land use are determined in the Land Code, it provides that other Federal laws will have to be adopted. The Land Code has limited applicability to agricultural land as it expressly provided that the circulation of such land is the subject of a separate Federal law.

Possession, use, and disposal of land plots designated for agricultural use are regulated by the Circulation Law. Not all agricultural land, however, is subject to the Circulation Law. It does not extend, for example, to those land plots, which were provided to individuals for the construction of individual homes or garages, or for carrying on a smallholding or dacha garden. Such land plots are covered by the provisions of the Land Code. Agricultural land plots may be held by right of ownership, perpetual (indefinite) use, lifelong inheritable possession, or free fixed-term use, and such plots may also be leased. Ownership of land plots in state or municipal ownership is to be awarded to individuals and legal entities, as a rule, through bidding by tender or auction. Such bidding is also to be held during such land plots’ lease when they are claimed by 2 or more potential lessees. The way the corresponding tenders or auctions should be organized is described in Article 38 of the Land Code.

Although there is no express provision permitting land ownership by foreigners, the Land Code may clearly be interpreted as allowing such ownership, except in cases where it is specifically prohibited. The rights to acquire land ownership rights under existing buildings or for construction are equally applicable to foreigners subject to the following restrictions set out in the Land Code:

- (1) The relevant rights must always be paid for and can never be granted free of charge; and
- (2) Foreigners are specifically prohibited from owning land plots in border areas, a list of which is to be drawn up by the President, or in other special territories of the Russian Federation pursuant to other federal laws. Additionally, the President may establish a list of types of buildings and other structures to which pre-emptive buy-out or lease rights to land plots for foreigners may not apply. Under the Implementing Law and pending the preparation of the Presidential list, the border restrictions apply to all border areas. Foreigners are also prohibited from owning agricultural land. The Circulation Law further specifies the rights to agricultural land that may be granted to foreign nationals and foreign legal entities (and stateless persons). Those in this category may only lease agricultural land plots. This restriction on foreign legal entities also extends to Russian legal entities in which the equity participation of foreign nationals, foreign legal entities, and/or stateless persons exceeds 50 percent. Pursuant to recent amendments to the Federal Law on Mortgages (Real Property Pledges), it may now be possible for foreigners to mortgage certain categories of agricultural land. Mortgage rights do not, however, automatically entail ownership rights.

Under the Land Code, the rights to land now consist of ownership (by the State, municipalities, private individuals, and legal entities), perpetual or indefinite use, free fixed term use, lease, lifelong inheritable possession, and easements.

In the future, new rights of perpetual or indefinite use may only be granted to state and municipal institutions, Federal Treasury-owned enterprises, and state and local authorities. Legal entities (other than those listed in the previous sentence) with existing rights of perpetual use will no longer be able to transfer these rights. Under the terms of the Implementing Law, these entities will have until January 1, 2004, to convert and re-register their rights as (at their option) either lease or ownership rights. Recently, the term for conversion of the rights as either lease or ownership was extended until January 1, 2006, in accordance with Federal Law No. 160-FZ of December 3, 2003. Presently, any legal entity looking to transfer its land rights to another legal entity, such as a joint venture, will first need to upgrade its rights accordingly before contributions can be made.

The Land Code sets out detailed procedures for acquiring rights over land, which is intended for new construction. In particular, the Land Code

distinguishes two scenarios. Under the first, a land plot must first have been “prepared” for sale or lease: its boundaries defined; a cadastral number (a special number assigned to land plots indicating their area, location, type category, etc.) assigned; and technical conditions for the utilities connections determined. In such cases, the Land Code provides either for acquisition of land directly into private ownership or for lease.

The second scenario for the allocation of land for construction purposes will be used when a new project will require a thorough investigation of ecological, sanitary, architectural, and other issues, and a specific request for land rights from an investor. This may involve the investigation of public opinion regarding construction in the area. In such cases no tender is required. The land will, however, be given on lease only.

A particular interest to owners of existing buildings and structures is an option to privatize or to obtain land lease rights over the land plots on which their buildings are located, where such land plots are owned by the State or a municipality. Owners of existing buildings, facilities or structures located on land owned by a third party will now enjoy the pre-emptive right to purchase or lease the land plot beneath such buildings.

### **9.3 Ownership of Buildings**

The current Russian law permits both Russian and foreign nationals and legal entities to own buildings. In general, the rules relating to the use, disposal, and sale of buildings are set forth in the Russian Civil Code, which guarantees the freedom to sell, rent, and carry out other transactions with buildings. The process of the acquisition of buildings through privatization is also less complicated. In general, provided that the building in question was recorded on the balance sheet of the state enterprise at the time when it was privatized, the successor company has the right to own such building.

In the past, state-owned buildings were granted to state-owned enterprises for economic management or use. During privatization, however, such buildings and other structures were usually transferred into the ownership of those enterprises that operated and used them on the basis of various use rights. Thus, the newly privatized enterprise would “inherit” such buildings and structures from the state-owned enterprise, provided that they were recorded on the company’s balance sheet and were included in the privatization documentation.

The special authority that is in charge of the state registration of the rights to real estate must issue an ownership certificate certifying the right of ownership of buildings and structures (see section 9.5 below). In accordance with the Civil Code, the rights to real estate arise after the state registration of such rights, except in the case where such rights have been obtained prior to the adoption of Federal Law No. 122-FZ of July 21, 1997, On State Registration of Real Property Rights and Real Property Transactions, as amended (the “Registration Law”). In this case, the owner is not obligated to register the rights unless it wants to enter into any transaction related to the real estate object. Obtaining the relevant certificate is a fairly straightforward, although sometimes a lengthy, process, as long as the private company that is seeking to obtain such certificate can clearly demonstrate that the buildings in question were purchased or privatized in accordance with the prescribed procedures. Before an ownership certificate is issued, the local office of the Bureau of Technical Inventory (“BTI”) needs to carry out a detailed assessment of the building and to produce an updated BTI “technical passport” for the building. Quite often, this becomes a problem since no such updated BTI “technical passport” exists and building owners are often reluctant to incur the costs involved in securing the required BTI assessment.

#### **9.4 Leases**

Foreign legal entities may be granted either land leases or building leases. Such leases on state or municipally owned property are usually based on a standard local form. Although the Civil Code does not stipulate a statutory maximum length of time, the current practice is that such lease terms rarely exceed 49 years.

However, in Moscow the recently adopted Moscow City Law No. 27 on Land Uses and Construction in the City of Moscow of May 14, 2003, which came into force on June 26, 2003, fixes those periods for which leases may be obtained for Moscow-owned land plots. Lease terms for sites free of any capital buildings, structures, or facilities may not exceed 5 years. Land plots on which such property is located are, however, available for leases of 25–49 years, confirming existing practice. In some cases, in extension of current practice, they may even be leased for as long as 99 years. This will require a Moscow Government decision in respect of projects of special significance to the city.

The level of rent payments for the majority of land leases granted by the state or municipalities is set either by a general local decree or by a specific decree for the lease in question. In Moscow, where the demand for land

remains relatively high, a lessee must pay rent calculated on the basis of a formula. In addition, a Moscow lessee must pay for the right to lease any land in excess of the area of the existing building on that land. In St. Petersburg, the level of rent is determined by a decree of the Governor; the levels differ depending on the location of the site and the type of activity of the lessee, and in some instances, it is possible to negotiate the lease rent with the local St. Petersburg authorities.

The basis for granting a lease for a municipal or state-owned building, as well as the rental payments, is normally established by a local decree. The parties themselves may negotiate leases for a part of or for the entire privately owned building. To date, few office and retail-sector leases have exceeded a 10-year term; with 5-year terms being the most common. Longer leases of 25 years or more have executed in the industrial sector. All three markets, however, are changing rapidly. Subleases are also permitted, subject to any contractual restrictions in the primary lease.

Whether the lease concerns land or a building, the Land and Civil Codes provide a lessee with certain basic rights. When the property is transferred, it must be in the condition required by the lease. Thereafter, unless the lease specifies otherwise, the lessor is liable for the repair of defects on the premises. If the lessor fails to carry out the necessary repairs, the lessee's options include compensation and the right to terminate the lease. A lessee that properly fulfills its obligations under the lease has a priority right of renewal at the end of the term. The renewal rights of a lessee under a land lease are to be treated in conjunction with the pre-emptive rights to purchase or lease the land plot that are granted to the owners of the existing buildings and structures.

Significantly, the provisions of the Civil Code, in so far as they apply to land leases, are supplemented by the Land Code in a number of areas. In particular, the Land Code sets forth a series of modified rights for land lessees. Their applicability will in part depend upon the precise drafting of a lease. For example, the presumption under Article 615 of the Civil Code that a lessee needs a lessor's consent to sublease has been reversed for lessees of land. Of particular significance is the provision that lessees of state- or municipally-owned land under lease, with a term exceeding 5 years, now have a free right to assign their rights, subject only to the delivery of a notice to the lessor. In other land leases, this rule will also apply (in contrast to the provisions for prior consent under Article 615(2) of the Civil Code). A notable improvement is also made in conveyancing procedures with the new provision that the assignee of a land lease does not need to enter into a new land lease.

Both the lessor and the lessee may terminate the lease contract, but only with a court order. The Civil Code also suggests that the lease contract may provide for other termination opportunities. Additional protection is given to the lessees of residential premises. The Land Code contains new provisions that deal with the termination of land leases in conjunction with a court order. Presently the following will also constitute grounds for termination:

- (1) Misuse of the land plot (a more stringent test than that under Article 619 of the Civil Code, which requires either substantial or repeated violations);
- (2) Use of the land plot that results in a decline in fertility of agricultural land or, important for industrial users, a material deterioration in the environmental situation;
- (3) Failure to correct a range of other intentional environmental violations of applicable land use regulations; and
- (4) Failure to use the land plot for its designated purpose for a period in excess of 3 years.

Most leases must be state-registered to be valid. The only exception is for leases of buildings for a period of less than 1 year, which do not need to be state-registered to be valid. The principles and procedures of state registration are discussed below.

## **9.5 State Registration of Rights to Immovable Property**

As discussed above, the right to real estate arises only from its state registration. The current Russian legislation contains a specific procedure for the registration and identification of rights (title) to immovable property. In many cases, such registration is a prerequisite for the validity and enforceability of transactions involving immovable property.

According to the Registration Law, transactions involving immovable property (buildings, land, etc.) are also subject to state registration, and they become effective and enforceable only upon such registration. The registration authorities in the place where the immovable property is located carry out the registration process. The registration authorities maintain the Unified State Register of Rights to and Transactions With Real Property, which indicates the history and the current status of the immovable property in question. This

Register also records various encumbrances over immovable property, including leases. The registration authorities issue a certificate in a prescribed form that certifies the rights to immovable property. Information on state-registered transactions with immovable property is also included in the Register.

Land plots are also required to undergo the cadastral registration. The procedures and rules of the state cadastral registration of land are outlined in Federal Law No. 28-FZ On the State Land Cadastre, dated January 2, 2000 (the “Land Cadastre Law”), which came into force in July 2000. The State cadastral registration applies to all land plots located in the Russian Federation, regardless of the form of ownership, the designation, or the authorized use of the land plots. Under the Land Code, only land plots that have State cadastral registration can be the subject matter of a sale-purchase transaction. In practice, especially in Moscow, this applies to all transactions with land plots. The Unified State Register of Land (the “Land Register”) is established pursuant to the Land Cadastre Law and contains detailed information on land plots, including their cadastral number, location, land category and authorized use, the borders of the land plots, the registered proprietary rights and encumbrances over the land plots, and information about any immovable property on the land plots. The information from the Land Register is open to the public. The Land Cadastre Law states that such information will also be provided in the form of extracts and copied documents from cadastral files. Additional regulations and rules will define the procedures for filing the relevant applications to obtain such information.

## **9.6 Classifications of Real Estate**

Russian real estate is classified on the basis of its intended use (i.e., either for residential or nonresidential purposes). The specific use should be identified in the lease, the certificate of ownership, or the act of permanent use, as well as in the BTI. The use of buildings is also governed by the decree or other document that was originally issued in relation to that building. The property of a privatized enterprise may also be subject to additional use restrictions imposed by its specific privatization plan.

It should be noted that all real estate construction requires state permits and consent.

## **9.7 Payments for Real Estate**

At present, when a foreign investor purchases or simply leases real estate from Russian residents, payments for the real estate purchased and, usually, lease payments effected in foreign currency are classified as “capital transfer transactions.” Previously, every such capital transfer transaction required a specific license from the Central Bank of the Russian Federation (the “CBR”). However, the licensing requirement for foreign currency payments by foreign tenants to Russian landlords or sellers has been recently abolished. Furthermore, under the new Federal Law on Currency Regulation and Currency Control, the greater part of which will come into effect on June 17, 2004, foreign currency payments made by foreign investors to Russian residents in consideration for purchased or leased immovable property will no longer be deemed “capital transfer transactions.” This development certainly testifies of further liberalization of Russian currency control legislation. Additionally, when both the seller and the buyer, or the lessor and the lessee, are foreign legal entities, a payment in foreign currency to an offshore bank account is also possible. Such transactions, however, may have tax consequences, particularly with regard to withholding tax.

## **9.8 Residential Real Estate**

By now, many apartments have been privatized and are in private ownership. Federal Law No. 72-FZ of June 15, 1996, On Partnerships of Home Owners (the “Condominium Law”), provides the basis for the formation of condominiums, including those formed by a developer prior to their construction, although such ventures are limited to buildings that consist primarily of residential premises. Additional regulations are also required some of which have already been passed in Moscow and St. Petersburg. Presently, simple condominiums are also being registered.

## **9.9 Mortgage of Real Estate**

Federal Law No. 102-FZ On Hypothec (Mortgage of Real Property) of July 16, 1998 came into effect on July 22, 1998 and was subsequently amended on a number of occasions (the “Mortgage Law”). The Mortgage Law significantly improves the importance of a mortgage as a creditor’s instrument for securing its investment. It is important to note that buildings and structures can be mortgaged only simultaneously with the land plots on which such buildings and structures are located.

The concept of a mortgage under Russian law differs from that in common law jurisdictions. In Russia, a mortgagee cannot automatically acquire rights to the mortgaged property if default occurs under the secured obligation. In most cases the mortgaged property must be sold at a public auction. The proceeds will then be used to repay the debt. There are two types of foreclosure on mortgaged property: judicial and extra-judicial. The parties may also enter into a contract for the transfer of the mortgaged property to the mortgagee to set off the secured obligation. However, such an agreement can be concluded only after the default has occurred under the secured obligations.

In order to be valid, a mortgage agreement must be certified by a Russian notary and registered with the relevant state real property registration authority. The local office of the state real property registration authority and all of the land committees can provide information on the absence or presence of a valid mortgage over immovable property.

According to the Mortgage Law, the following types of property can be subject to a mortgage:

- (1) Land plots (with those exceptions stated in the Mortgage Law);
- (2) Enterprises registered as real estate;
- (3) Buildings, structures, and other immovable property that are used for business activities;
- (4) Residential houses, apartments and parts thereof, consisting of 1 or several isolated rooms;
- (5) Cottages, garages, and other structures for personal use;
- (6) Aircraft, sea and river vessels; and
- (7) A lessee's interest in leased real estate, which may be the subject of a "leasehold mortgage."

The terms and conditions of a mortgage may restrict the owner's or user's capability to dispose of the property, including its contribution to charter capital and/or lease to third parties. Therefore, confirmation of the absence or existence of a valid mortgage over the property is important. If there is a valid mortgage, the purchase can be effected only with the consent of the mortgagee.

Even then, notwithstanding such consent, the mortgage will follow the immovable property unless and until the primary obligation secured by the mortgage is performed, and the property is released from it.

The Mortgage Law as amended includes some significant changes, which are specifically important for securing financing through mortgages. Thus, revised Article 78 of the Mortgage Law provides that foreclosure by the mortgagee on a mortgaged residential house or apartment and disposal of such property constitutes grounds for termination of occupancy rights of a mortgagor and his family members residing together in this residential house or apartment, provided that this residential house or apartment was mortgaged under a mortgage agreement to secure the return of a loan granted for the purchase or construction of this residential house or apartment.

This means that now (unlike prior the revision of the Mortgage Law) a mortgagee can demand that a mortgagor vacate the mortgaged property if the mortgagee intends to foreclose on it. However, this rule would apply only if the mortgaged property was mortgaged to secure the repayment of a loan taken by a mortgagor to purchase or construct the property. It is also important that those individuals who occupy the mortgaged property, pursuant to a lease or a “naim” agreement (under Russian law, a specific type of residential lease where the lessee is a private individual), cannot be moved out upon foreclosure on the mortgaged property. Such a lease or a “naim” agreement concluded prior to the mortgage agreement will remain in force and can be terminated only in the specific circumstances provided for by the Russian Civil Code or applicable housing legislation.

Some changes were introduced in the Mortgage Law as amended in respect to the extension of an existing mortgage on a newly constructed building. The previous version of Article 65 of the Mortgage Law provided that a mortgage did not extend to buildings and structures constructed on the mortgaged land plot unless otherwise stipulated by the mortgage agreement. Based on this provision of the Mortgage Law, real property registration authorities demanded that an addendum to the existing mortgage be signed each time the existing mortgage was to be extended to cover a newly constructed building or structure. This slowed the process down and increased the cost, specifically a notary fee of 1.5 percent of the mortgaged property value had to be paid each time such an addendum was executed. Currently, according to Article 65 as amended, the existing mortgage of a land plot automatically extends to cover a building or a structure erected on this land plot by the mortgagor, unless otherwise provided by the mortgage agreement. The revised Article 65 of the

Mortgage Law allows a mortgagee to extend the mortgage over a land plot to all buildings and structures that may be constructed on the plot without need for a subsequent addendum.

The amendments to the Mortgage Law introduced by Federal Law No. 1-FZ of February 5, 2004 now permit to mortgage any land plot, including agricultural land, unless it has been withdrawn from or is limited in circulation, or if it is held in state or municipal ownership.

## **10. PRIVATIZATION**

### **10.1 History of Privatization**

In general, the privatization process in Russia can be roughly summarized as occurring in 3 progressive stages. The first stage, “voucher-assisted privatization” together with “shock therapy,” lasted from 1992 to 1994 and included the privatization of state property on a massive scale. Although at this early stage the first privatization law of July 3, 1991 was fairly undeveloped and the country lacked experience in all privatization matters, the government’s rush to privatize companies through the allocation of vouchers resulted in a very large percentage of the state-owned entities being transferred into private hands. This first privatization scheme allocated vouchers to state employees and, at a later time, these vouchers were transformed into shares in the capital structures of newly established (privatized) joint stock companies.

The second stage of the privatization process lasted from 1995 to 1996 and can be referred to as “money-earning” privatization. The principal objective of this scheme was to replenish the state budget and to attract domestic and foreign investment into Russia. Unfortunately, this objective was never achieved because:

- (1) Most of the financially viable and attractive businesses had already been privatized during the first stage of development;
- (2) Domestically, large-scale investors did not exist because most local investors were still limited by a lack of capital and were already having a difficult time supporting the existing privatized entities; and
- (3) Foreign investors were still skeptical and wary of large-scale capital injections into Russian entities (particularly due to the volatile political environment in Russia at the time).

As a result of the difficulty in attracting investment during this second stage, so-called “pledge auctions” were held (this idea was promoted by Russian banks and was also referred to as the “loans for shares” scheme). The outcome of these auctions was that a limited number of Russian businessmen were able to acquire state property at artificially low prices.

The third stage, which lasted from 1997 to 2001, can be characterized as the stage of stabilization or, at least, consistency because during this time

period there were very few major developments within the sphere of privatization. Although the second privatization law, aimed at filling the gaps in the regulatory environment, was enacted on July 21, 1997, the State Duma vetoed a new government-proposed privatization program. During this third stage, the process of privatization dwindled. This was partly because the most attractive state property was already in private hands and partly because of the bitter opposition of the State Duma's significant leftist-Communist faction to initiatives involving the privatization of certain state-owned sectors and entities. Nevertheless, some profitable (i.e., high-priced) privatization arrangements were made during this period, which included the sale of state-owned shareholdings in major Russian joint stock companies.

## **10.2 De-privatization**

It should be noted that in the first half of 2000, the policy of "de-privatization" (i.e., actions by the state to reclaim its ownership of unlawfully privatized state property) attracted a high degree of interest.

The idea of de-privatization became quite popular among many Russians and has been enthusiastically exploited by various diverse left-wing parties. Russians have become skeptical and unhappy about the results of privatization auctions for many reasons, some of which include:

- (1) The original theory behind the distribution of vouchers as part of the initial privatization efforts was to distribute property ownership into the hands of "ordinary people." In practice, this did not turn out to be the case since only high-ranking managers and private investors were able to acquire important enterprises and, in most cases, the entities were sold at below market (i.e., real) value.
- (2) Another fault in the privatization process has been the inability of the new owners to attract further investment into, and to establish successful development strategies for, their privatized companies after privatization. In many cases, the new owners have revealed themselves as being new Russian capitalists who are much more interested in acquiring further shareholdings in other companies and repaying the loans obtained to finance the original property purchases than in investing funds into the development of the entities they already own.

- (3) Unfortunately, the privatization period in Russia coincided with the difficult period of restructuring the economy. Due to poor economic conditions, virtually all Russian industries experienced a significant drop in their output and income. Regardless of whether this was directly attributable to their privatization or not, in the public's mind the drop in economic development was directly attributed to poorly structured privatization efforts.

On the other hand, there were sufficient legal reasons for de-privatization schemes. The absence of the legislation and experience necessary to govern the process of privatization, combined with widespread corruption among Russia's bureaucrats, caused some companies that were slated for privatization to become subjects of conspiracy between Russian private investors and government officials. As a result, it is difficult to find a company in Russia that was privatized without breaches of the applicable legislation. The privatization law provided for a single fundamental sanction for the failure to abide by the privatization rules, i.e., that the corresponding transaction could be declared void, and the property unlawfully acquired would have to be returned to the state. Furthermore, the privatized entities and procedures could be challenged and declared invalid for up to 10 years. Therefore, returning to the state those companies that had been privatized in gross violation of the applicable legislation appears to be justifiable from both legal and political points of view.

Of course, de-privatization could become a very difficult and complicated process. If a company were de-privatized, the current shareholders would most likely be unable to take legal actions against the original owners. In such cases, the original groups that purchased the newly privatized entities acted as intermediaries during the sale of the shares. At the present time, these companies either no longer exist or do not have any assets in Russia against which the court judgments could be enforced. Furthermore, since privatized companies often issued additional shares, the legitimate investments have become intermixed with "questionable" ones, and it would be rather difficult at this point to segregate state property in its "original" form. Lastly, it would also be difficult to determine which companies were privatized in accordance with or in breach of the law. In many cases, the privatization documents have been lost or destroyed; therefore, claims would need to be issued without any documentary support. With the lack of any actual documentary support, the de-privatization of individual entities on an ad-hoc basis could cause a panic in the Russian marketplace, discouraging any future investment.

There are indications that the Russian Government is aware of the negative effects of de-privatization process. President Vladimir Putin has stated on several occasions that he would not allow any further reviews of previously held privatization proceedings.

### **10.3 Current Status**

On December 21, 2001, the President of Russia signed the third privatization law, which entered into force on April 26, 2002. In contrast to the former law and in line with the policy of the Russian Government with respect to the sale of land, the new privatization law allows the privatization of land plots beneath real estate objects. This law also established a number of new privatization methods, including, for example, the sale of shares of open joint stock companies on stock exchanges and the sale of such shares outside of Russia. At the same time, some of the previously well-known and widely used methods of privatization, such as the sale of shares of open joint stock companies to their employees or the buyout of the leased state property by the lessees, are now expressly excluded from the new privatization law. By doing so, the government of the Russian Federation is now trying to eliminate the use of the “cheap” methods of privatization. This appears to be a reasonable and long-expected result of the bygone, and obviously not very successful, stages of Russia’s privatization process.

The current law on privatization clearly demonstrates an overall increase of state control over the privatization process, the specific forms of which, in many instances, are yet to be developed, and therefore one should not expect a new privatization boom in Russia anytime soon. It is also increasingly evident that the process of de-privatization will not be started in the near future, if ever.

## **11. LANGUAGE POLICY**

Under Article 68 of the Russian Constitution, the state language throughout the territory of the Russian Federation is Russian. All official election materials, legislation, and other legal acts must be published in the official state language. In addition, the Constitution upholds the rights of each of the individual republics within the Russian Federation to establish its own state language. Thus, regional state bodies and local institutions of self-government within Russia's 21 republics may conduct official state business in two languages: Russian and the republic's national language.

Foreign investors should be aware of some of the restrictions, which govern the use of the Russian language. For example, the Law on Advertising requires that all advertising in the Russian Federation must be either in Russian or in the particular state language of the individual republic in which the advertising is conducted. The one exception to this rule is for trademarks, which may be in the original language of the trademark. In addition, the use of the word "Russia" in the name of a company exposes that company to certain tax consequences if it is directly translated from English into Russian.

## 12. CIVIL LEGISLATION

The adoption of the new Russian Civil Code represents one of the landmarks in Russia's transition to a market economy. Part I of the Civil Code came into effect on January 1, 1995, and Part II entered into force on March 1, 1996. Together, these two parts serve as the legal basis for virtually every transaction in the Russian Federation.

Part I of the Civil Code upholds such rights of the citizenry as the rights to own and inherit property, to engage in entrepreneurial activity, to establish independent legal entities, and to protect their intellectual property rights. Part I also goes on to define such fundamental concepts as securities, contractual rights, and the power of attorney. Part II further expands on these new civil relationships. It contains provisions governing certain types of agreements and provides additional details about the rights to sign contracts, to rent property, to receive loans, and to be compensated for injuries.

Although Parts I and II of the Russian Civil Code have been signed into law, several provisions within the Civil Code required the passage of additional legislation before they could be fully implemented. Most of the major laws have already been adopted, such as the Law on Joint Stock Companies, the Law on Limited Liability Companies, and the Law on State Registration of Legal Entities. In several instances, however, the appropriate legislation has not yet been adopted. One of the most glaring examples of such a legislative gap is the absence of a mutual insurance law. Russian legislation must still be improved to provide for all the economic rights and opportunities that are outlined in the Russian Civil Code.

On March 1, 2002, Part III, the final part of the Russian Civil Code, entered into force, covering the law of succession and international private law rules. Thereby, Russia has completed the major revision of its fundamental codified statute governing civil relationships, and the Soviet era Civil Code has become void in its entirety.

Section V ("Inheritance Law") extends the rights of citizens to dispose of their property; in particular, it strengthens the freedom of will. Moreover, priorities are changed: testamentary succession is described prior to legal succession. Additionally, Section V provides for confidential wills and wills made in a simple written form. The legislation increases the number of priority categories of legal heirs from 4 to 8. Entities and the state may now, *inter alia*, act as heirs. Furthermore, irrespective of the contents of a testator's will, the testator's minor

or disabled children, as well as their disabled spouse, parents or dependents are entitled to a compulsory inheritance of at least 1/2 of the amount they would have been allocated under the Civil Code had there been no will.

Section VI (“International Private Law”) regulates “civil relations with a foreign element.” These are relations involving conflict of laws, i.e., cases in which either a foreign national is engaged or an object of civil rights is abroad. Section VI contains a number of essential innovations, for instance, the principle of public order that provides for the application of imperative norms protecting state and social interests of the Russian Federation, despite any contradictory provisions of the law to be applied on the basis of conflicting laws and norms. Further, Section VI introduces the term “personal statute” (*lex personalis*), i.e., application of the law of the country of the individual’s citizenship or the country of incorporation of a legal entity. Moreover, the general scope of the conflict law legislation has broadened. Thus, some new norms appear, such as provisions applicable to agreements involving the participation of a consumer, assignment of a right pursuant to the agreement of parties, obligations arising from unilateral transactions, interest accrued on monetary liabilities, liability for quality defects in goods, works, or services, and liability for unfair competition and unjust enrichment.

## **13. BANKING**

### **13.1 Legal Framework**

The system of banking legislation in Russia is somewhat complex. The foundations of the Russian banking system are provided in the Federal Law No.395-1 On Banks and Banking Activities, dated December 2, 1990 (the “Banking Law”), and Federal Law No.86-FZ On the Central Bank of the Russian Federation, dated July 10, 2002 (the “CBR Law”). The issues of bank insolvency are regulated by a special Federal Law No. 40-FZ on the Restructuring of Credit Organizations, dated February 25, 1999. At the end of 2003, a new act in the sphere of deposit insurance was adopted and came into effect: Federal Law No. 177-FZ On Insurance of Deposits of Individuals in the Banks of the Russian Federation, dated December 23, 2003 (the “Deposit Insurance Law”).

The Central Bank of the Russian Federation (the “CBR”) is responsible for regulating Russian banking activities. Through its instructions, regulations, and other acts, the CBR establishes rules, standards, and requirements obligatory for banks and non-banking credit organizations throughout the territory of the Russian Federation.

The role of self-regulation in the Russian banking system continues to be very insignificant; however, some steps to encourage it are being developed.

### **13.2 Regulatory Bodies**

The primary regulatory body over the Russian banking sector is the CBR. The CBR is one of the few institutions that are under the control of the Russian legislative (not executive) branch. The State Duma must not only approve the nomination of the Chairman of the CBR, but also approve the resignation of the Chairman. However, the CBR Law provides for the establishment of a special body within the structure of the CBR, the National Banking Council (the “NBC”), comprised of representatives of various executive and legislative bodies. The NBC exercises control over the CBR’s Board of Directors and participates in establishing the basic principles of Russian banking and financial policy.

The CBR and the Russian government share authority over monetary policy. The CBR is charged with responsibility for the circulation of monetary funds and for ensuring the stability of the Russian ruble. As part of its general oversight role, the CBR establishes state registration and licensing

rules, determines minimum capital and reserve requirements, and also approves the appointment of the senior management of all banks (including branches of foreign banks). The CBR maintains regional offices located throughout the Russian Federation.

The financial rehabilitation of credit organizations is administered by the specialized Agency on Restructuring of Credit Institutions (“ARKO”). Among the self-regulatory banking organizations, the Association of Russian Banks (“ARB”) is considered to be the largest.

### **13.3 Credit Organizations in the Russian Market**

Pursuant to the Banking Law, there are two main groups of credit organizations: banks and non-banking credit organizations. The bank is a credit organization, which may engage in all types of banking activities, subject to obtaining appropriate licenses (See. 13.5. below). Thus in Russia, there is no system of specialized bank institutions (e.g., mortgage banks and investment banks). Conversely, the non-banking credit organization is an entity, which is entitled to perform only certain banking operations that are specified by the CBR. Banks and non-banking credit organizations may participate in banking groups (if the controlling company is a credit organization) and banking holdings (if the controlling company is a non-credit organization).

Foreign banks are allowed to establish branch offices in Russia and to invest in Russian banks. The participation of foreign banks in the Russian market, however, is subject to certain restrictions. The most notable restriction is the requirement for non-residents to obtain a CBR approval prior to acquiring a share in a Russian bank, regardless of the amount of the investment. Conversely, Russian residents only need to apply to the CBR for such approval if they acquire 20 percent or more of a bank’s shares.

### **13.4 Banking Activities**

According to the Banking Law, the list of banking operations includes raising and investing funds, depositing precious metals, maintaining accounts, settling bank accounts of individuals and legal persons, collecting money, exchanging foreign currency, issuing bank guarantees, and transferring money.

Banks are also entitled to perform certain non-banking operations, inter alia, providing financial suretyship, purchasing third party rights, managing property as a trustee, performing operations with precious metals and stones,

renting safe boxes, participating in leasing operations, and providing consultancy and other informational services.

Credit organizations are prohibited from engaging in any industrial, trade, and insurance activities.

### **13.5 Licensing**

All Russian and foreign banks must receive a license from the CBR before they can commence their operations. Newly established banks can receive the following licenses:

- (1) A license to carry out banking operations with monetary funds in rubles only (without the right to attract individual deposits);
- (2) A license to carry out banking operations with monetary funds in rubles and in foreign currency (without the right to attract individual deposits); and
- (3) A license to deal with precious metals.

A registered bank that has held a license for a period of not less than 2 years is entitled to obtain the following additional licenses:

- (1) A license to attract individual deposits in rubles;
- (2) A license to attract individual deposits in rubles and in foreign currency; and
- (3) A general license, which covers all of the above activities (except for operations with precious metals).

### **13.6 Deposit Insurance**

The newly adopted Deposit Insurance Law is meant to protect the interests of individual depositors. It contemplates that all banks accepting individual deposits must become members of the deposit insurance system. Member banks will have an obligation to make contributions to the special deposit insurance fund. These contributions will be calculated as a percentage of the average daily balance of individual deposits maintained with a particular bank and are generally subject to an upper limit of 0.15 percent. All individual depositors keeping their deposits

with member banks will be entitled to 100 percent compensation for amounts up to RUR 100,000 (approximately USD 3,450). The Agency for Deposit Insurance is responsible for supervising the bank deposit insurance system.

### **13.7 Money Laundering**

On the basis of recommendations made by the Financial Action Task Force on Money Laundering (the “FATF”), the State Duma adopted Federal Law No. 115-FZ On Combating Money Laundering (the “Money Laundering Law”), which came into force on February 1, 2002.

The Money Laundering Law requires banks and a wide range of financial institutions to report any cash or electronic transactions involving 600,000 rubles or more (approximately USD 20,690) or any kind of suspicious transaction (i.e., that may be related to criminal activity) to a central executive agency. The Money Laundering Law establishes requirements governing the supervision and reporting of suspicious transactions, including internal record-keeping and customer identification procedures, for financial institutions, such as banks and non-banking credit organizations, securities market professionals, insurance and leasing companies and postal, and other non-credit organizations that deal with the transmission of money. The rules governing a financial institution’s internal record-keeping and the reporting of suspicious transactions include an obligation to investigate all complex or unusual transaction schemes that have no apparent economic or lawful purpose. Financial institutions are exempt from legal responsibility for breach of any obligatory information disclosure restrictions when such a breach is necessary for compliance with the Money Laundering Law. The Money Laundering Law requires financial institutions to ascertain the actual identity of their customers and to disallow creation and maintenance of anonymously held accounts. Failure to comply with the requirements of the Money Laundering Law may serve as a basis for revocation of a bank’s license.

### **13.8 Transition to International Accounting Standards**

According to the CBR official notices, as of January 1, 2004, all banks on the territory of the Russian Federation have made the transition to International Financial Reporting Standards (“IFRS”), formerly International Accounting Standards (“IAS”). During the transitional period, which will last until January 1, 2006, accounting documentation is still to be prepared pursuant to both standards: Russian Accounting Rules and IFRS. After the transitional period, documents will only comply with IFRS.

## **14. INTELLECTUAL PROPERTY**

### **14.1 Regulatory Environment**

The primary legislation regulating intellectual property in Russia was passed in 1992. This legislation included laws on the protection of trademarks, computer programs and databases, patents, and the topology of integrated circuits. The Law on Copyright (the “Copyright Law”) was passed in 1993. During 2002 - 2003, significant amendments were made to the Law on Trademarks, Service Marks, and Appellation of Origin of Goods and the Patent Law.

Any foreign legal entity or natural person may use and seek protection for its/his/her intellectual property rights in Russia under these laws, provided that the requirements of these laws are satisfied.

Russia is a signatory to several international treaties on intellectual property rights, including the Universal Copyright Convention, the Berne Convention for the Protection of Literary and Artistic Works, and the Paris Convention for the Protection of Industrial Property.

### **14.2 Patents**

Patent protection is given to an invention if it is novel, inventive, and industrially useful. The maximum duration of patent protection for an invention is 20 years from the date of the application. A patent application is filed with the State Patent Office (“Rospatent”), which examines it and grants the patent if the invention meets the above criteria.

A utility model is granted patent protection if it is new and industrially useful. The term of protection is 5 years from the filing date of the application and may be extended for an additional 3-year period.

Industrial designs are characterized by the artistic and structural form of the article, which determines its external appearance. Patent protection is granted for 10 years if the industrial design is new, original, and industrially useful. This protection may be extended for an additional 5 years.

Patents may be assigned and/or licensed by their owner(s) to natural persons and legal entities. However, any assignment or license contract must be registered with the State Patent Office in order to be valid. Infringement carries civil, criminal, and administrative liability.

### **14.3 Trademarks, Service Marks, and Appellation of Origin of Goods**

The right to a trademark or service mark is based on registration with the State Patent Office. If registered, trademark or service mark protection is granted for a period of 10 years and may be renewed for additional 10-year periods. Assignments and licenses of trademarks and service marks must also be registered with the State Patent Office.

Legal protection is given to an appellation of origin of goods based on its registration with the State Patent Office. The term of protection is 10 years, which may subsequently be extended for 10-year periods. The certificate owner may not grant licenses for the use of the appellation of origin of goods. Violation of the rights to a trademark, service mark, or appellation of origin of goods carries civil, criminal, and administrative liability.

### **14.4 Copyrights and Neighboring Rights**

The Copyright Law protects works of science, literature, and the arts (copyright), as well as stage productions and phonograms of radio broadcasting or cable TV organizations (neighboring rights). Copyright protection is generally granted to the author without any registration requirements. The right to use a copyrighted work may be assigned. Copyright is protected for the lifetime of the author(s), plus 50 years after his/her (their) death(s).

### **14.5 Computer Programs and Databases**

The Copyright Law also applies to computer programs and databases. Computer programs enjoy protection as literary works, while databases are protected as anthologies. Although registration is not mandatory for protection, an author may voluntarily register with the appropriate agency.

As with copyrighted materials, the computer program or database is protected for the lifetime of the author(s) plus 50 years after his/her (their) death(s).

### **14.6 Topologies of Integrated Microcircuits**

Legal protection is applicable to an original topology of an integrated microcircuit, developed as a result of the author's work. The author enjoys the exclusive right to use the topology as he/she sees fit, including the prohibition of unauthorized use. Property rights in a topology may be transferred fully or

partially to others under a written contract. Although the registration of a topology is not mandatory for its protection, an author may voluntarily register it with the appropriate agency. The exclusive right to use the topology is effective for 10 years from the date of its initial use or from the date of the topology's registration, whichever is earlier.

## **15. BANKRUPTCY**

### **15.1 Legislation**

Bankruptcies are governed by Part I of the Civil Code of the Russian Federation (Article 64), the Federal Law on Insolvency (Bankruptcy), dated October 26, 2002 (the “Bankruptcy Law”), and by several specialized laws, including the Federal Law on Insolvency (Bankruptcy) of Lending Organizations, dated February 25, 1999, and the Federal Law on Insolvency (Bankruptcy) of Natural Monopoly Companies in Fuel and Energy Complex, dated June 24, 1999 (in force until January 1, 2005, when the relevant provisions of the Bankruptcy Law will come into force), as well as by a number of rules and regulations adopted by the government, the Federal Bankruptcy Service, and various state bodies and agencies.

### **15.2 Bankruptcy Criteria**

The Bankruptcy Law applies to, and bankruptcy proceedings may be instituted against, all legal entities, except government-owned enterprises, political parties, and religious organizations.

Under the Bankruptcy Law, a legal entity may be subject to bankruptcy proceedings if it has failed to satisfy the “monetary claims” of its creditors or to make “obligatory payments” in full within 3 months of the due date, provided that the overdue amount exceeds 100,000 rubles (approximately USD 3,450). Individuals may be subject to bankruptcy proceedings if their debts exceed the value of their assets and the overdue amount is at least 10,000 rubles.

A “monetary claim” within the context of the Bankruptcy Law denotes any claim under a civil law transaction, as defined in the Civil Code, including amounts owed for goods delivered or work/services provided, loans (both principal and interest), amounts payable as a result of undue enrichment, and damages. Debts to individuals for personal damages, amounts owed as severance pay and salaries, authors’ fees, and dividends (or similar payments due to shareholders) are not taken into consideration when determining whether or not bankruptcy proceedings may be instituted against a debtor.

An “obligatory payment” denotes an amount due as taxes, duties, and any other obligatory payment to the government (into various budgets and non-budgetary funds), excluding penalties and other sanctions.

### **15.3 Initiating Bankruptcy Proceedings**

Bankruptcy proceedings may be initiated by a creditor(s), a governmental authority (ies), or the debtor itself by filing a bankruptcy petition at an arbitrazh court (i.e., a commercial government court) within the debtor's district. A creditor may file a bankruptcy petition if, as of the day when the petition is filed, the amount owed to it by the debtor exceeds 100,000 rubles (not including penalties for breach of obligations) and has been confirmed by a decision in force of a government court or arbitration tribunal. In addition, 30 calendar days must have elapsed since the creditor attempted to enforce the claim through Russian bailiffs.

The Bankruptcy Law obligates legal entities or self-employed individuals to file a bankruptcy petition and initiate proceedings within 1 month of determining that, upon satisfying the claims of one or more creditors, they would be unable to recompense other creditors and/or make obligatory payments.

### **15.4 Bankruptcy Procedures**

Legal entities may be subject to the following bankruptcy procedures:

- (1) Supervision;
- (2) Financial rehabilitation;
- (3) External management;
- (4) Bankruptcy liquidation; and
- (5) Composition.

Individuals may be subject to:

- (1) Bankruptcy liquidation; and
- (2) Composition.

### **15.5 Supervision**

Once the arbitrazh court accepts a bankruptcy petition, it convenes a hearing to review the claims against the debtor. After such a hearing, if the claims are deemed

valid, the court may appoint a provisional manager who will be responsible for reviewing the debtor's financial standing, drawing up a claims register, calling the first creditors' meeting, and ensuring that the debtor's assets are preserved. At this stage, the regular governing bodies of the company retain their decision-making powers, albeit with several important restrictions. While under supervision, a legal entity cannot make decisions to reorganize or participate in other legal entities and associations of legal persons, to enter into joint activities agreements, to establish branches and representatives offices, to place bonds and other securities except shares, and to pay dividends. Moreover, any transactions involving a debtor's property valued at more than 5 percent of the book asset value, as well as any loans, guaranties, assignments, and trust management agreements require written approval from the provisional manager. The latter retains his powers until the court makes a decision (pursuant to a resolution by the creditors' meeting) to move on to the next bankruptcy procedure.

## **15.6 Financial Rehabilitation**

This bankruptcy procedure may be introduced by the arbitrazh court if so resolved by the creditors' meeting or if requested by the debtor's shareholders or a third party (ies). Financial rehabilitation may last no longer than 2 years and is aimed at restoring the debtor's solvency and ensuring that its debts are repaid. The court order initiating financial rehabilitation should set a schedule for the repayment of overdue debts.

The governing bodies of the debtor company retain their powers. However, any corporate reorganization requires the prior approval of the creditors' meeting and the person(s) who provided security for the repayment of the overdue debts. Any assignments, loans, or transactions, which result in an increase of the debtor's accounts payable (as of the date of introduction of financial rehabilitation) by more than 5 percent, or disposal of the debtor's assets (except goods sold or services provided in the ordinary course of business), require prior approval of the administrative manager appointed by the court.

From the date of introduction of financial rehabilitation, the debtor is relieved from paying financial sanctions for non-performance or overdue performance of its obligations that became due prior to the introduction of financial rehabilitation. Instead, interest is charged on the principal, applying the refinancing rate of the Central Bank of Russia.

## **15.7 External Management**

If the arbitrazh court resolves that the debtor's solvency is restorable, it may decide to replace the debtor's governing bodies and introduce external management for a period of up to 18 months, which may be extended by another 6 months (i.e., appoint an external manager to manage the debtor's business). Upon the introduction of external management, all creditors' claims that were due prior to the date of the introduction of external management become subject to a moratorium. The external manager must draft an external management plan setting out measures designed to restore the debtor's solvency within a specified time period. The plan must be approved by the creditors' meeting. The external manager may terminate those contracts of the debtor that prevent the restoration of its solvency and/or cause the debtor to incur losses.

While under the external management, the debtor may issue new shares and may incorporate new open joint stock companies by contributing the debtor's assets to such companies.

## **15.8 Bankruptcy Liquidation**

If the court determines that the debtor's solvency cannot be restored, it must declare the debtor bankrupt and liquidate it. As soon as this decision is made, all of the debtor's monetary obligations become due and payable, interest stops accruing, and a court-appointed collector must take measures to repossess those assets that are held by third parties. All of the debtor's assets become part of the bankruptcy estate, which is used to repay creditors' claims.

During bankruptcy proceedings, creditors' claims are ranked in 3 categories. Claims of each category must be satisfied in full prior to satisfying the claims of subsequent categories. If there are not enough assets to satisfy all creditors of one priority, payments are made on a pro rata basis to those creditors.

Court expenses, remuneration to bankruptcy managers, on-going expenses, creditors' claims that arose after the filing of the bankruptcy petition, and other expenses associated with the bankruptcy liquidation of the debtor are satisfied ahead of any other claims. All other claims are satisfied in the following order:

First Priority:        Claims of individuals for personal injury, as well as for moral damages;

Second Priority: Claims of employees for severance pay and unpaid wages, as well as payment of royalties to authors;

Third Priority: Other creditors' claims.

Claims for taxes and other fees payable to Russian governmental bodies that were due prior to the filing of the bankruptcy petition are considered to be third priority claims.

Creditors whose claims are secured with pledge(s) over the debtor's assets enjoy priority over other creditors in satisfying their claims from the proceeds of the sale of pledged assets, except for those creditors of first and second priority whose claims originated prior to the execution of the relevant pledge agreements.

## **15.9 Composition**

Composition may be concluded at any time during bankruptcy proceedings if supported by a majority of the bankruptcy creditors, subject to the unanimous agreement of the secured creditors. The composition shall be approved by the relevant arbitrazh court, but only after the repayment of all creditors of first and second priority.

## **15.10 Bankruptcy of Banks and Other Lending Institutions**

The Central Bank of Russia must first revoke the license of a bank or other lending institution before the liquidation process can begin. Once the license has been revoked, the court may order the bank to be liquidated. Unlike in the case of bankruptcy of companies, external management and composition are not available for banks and other lending institutions. This is due to the fact that banks are not permitted to engage in business following the revocation of their licenses.

In a case when a bank is declared bankrupt, the order of priority in the satisfaction of its creditors' claims is the same as that described above, with one important exception: the claims of individual bank depositors must be satisfied as a matter of first priority. Also, subordinated claims (i.e., those that are based on credit (loan) agreements with a maturity date of not less than 5 years, which cannot be terminated before the maturity date and which have an express provision stating that they are subordinated) may be satisfied only after payments to all other creditors have been made in full.

## **16. THE RUSSIAN COURT SYSTEM**

### **16.1 Introduction**

The Russian court system consists of the Constitutional Court, the courts of general jurisdiction, and the state arbitrazh (commercial) courts. The Constitutional Court generally resolves issues relating to the compliance of federal and regional laws and regulations with the Russian Constitution. Courts of general jurisdiction hear criminal cases, civil disputes between individuals, and disputes arising from the administrative relationships between individuals and state bodies. Disputes regarding business activity are heard before the state arbitrazh courts.

### **16.2 State Arbitrazh Courts**

The name “arbitrazh court” is not related to arbitration tribunals but originates from an old Soviet tradition, whereby disputes between state enterprises were heard before the so-called “state Arbitrazh.” In the USSR, it was assumed that under a planned economy no disputes could arise between socialist enterprises, as all enterprises ultimately had the same owner, and any differences, which did arise, could be settled by intermediary, the state Arbitrazh, which was a quasi-judicial Government institution.

The procedural rules applicable in the Russian arbitrazh courts are based on the general principles of procedural law adopted in continental Europe, i.e., the procedure is inquisitorial and not adversarial as in common law jurisdictions.

However, the new Arbitrazh Procedural Code (the “Code”), adopted in July 2002, made this procedure more adversarial by limiting the abilities of the courts to collect evidence independently from the parties. The Code supersedes the previous procedural statute that was issued in 1995. The new Code sets out in more detail the day-to-day functioning and procedures of arbitrazh courts; these issues previously were dealt with by judges at their own discretion. With the adoption of the Code, some changes regarding the competence of arbitrazh courts have been made. For example, now some types of disputes involving individuals must be resolved by arbitrazh courts rather than courts of general jurisdiction as before.

Russian Arbitrazh Courts have an important advantage: the trial period in these courts is relatively short, i.e., under the current regulations, courts must consider cases within 3 months of the receipt of the petitioner’s application.

However, arbitrazh courts also have disadvantages, most notably the judges' lack of independence and impartiality.

### **16.3 International Arbitration**

As an alternative to the state arbitrazh courts, foreign investors may refer disputes to a private arbitration tribunal, including ad hoc and institutional arbitration tribunals located either within or outside of the Russian Federation. The arbitration proceedings may cover a wide range of issues, with the exception of disputes arising from administrative relations (e.g., tax and customs) and disputes, which fall within the exclusive jurisdiction of the Russian arbitrazh courts (e.g., disputes relating to objects of real estate located in Russia, aircraft and ships registered in Russia, and disputes arising from bankruptcy proceedings, or other disputes specifically enumerated in the Code).

The principal rules of international arbitration are governed by the Law on International Commercial Arbitration, enacted July 7, 1993; these rules are identical to provisions of the Standard UNCITRAL Arbitration Rules.

In addition, the international commercial arbitration provisions of various international treaties to which the Russian Federation is part and, in particular, the European Convention on International Commercial Arbitration of 1961 and the New York (United Nations) Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958, also apply in Russia.

### **16.4 Enforcement of Judgments**

Judgments of the Russian courts of general jurisdiction and of the Russian arbitrazh courts are enforced through the bailiff service.

A foreign court judgment may be enforced in Russia only if such judgment has been recognized by a Russian court. Such recognition is available only if supported by a relevant international treaty and federal law that applies. The execution of a foreign court judgment on the basis of reciprocity is not practiced in Russia.

Russia is a party to the Kiev Convention on the Procedure for Resolving Disputes Relating to Business Activities (the "Convention"). According to the Convention, judgments rendered by the state courts of certain CIS nations are enforceable in Russia. Russia is also a party to a number of bilateral agreements concerning the recognition and enforcement of court judgments.

Judgments rendered by the courts of most other countries might not be recognizable or enforceable in Russia. A foreign litigant may be forced to commence new proceedings before a Russian court even in a case when a judgment has already been awarded outside of Russia. The judgment of a foreign court can, in theory, be submitted as part of a new claim in Russia, but the Russian court is under no obligation to uphold that judgment. The Russian court is free to rehear the case on its merits.

Arbitral awards rendered by arbitration tribunals located within or outside of Russia are also executed by the bailiff service after such decisions are recognized and ordered to be enforced by the Russian courts. In cases falling under relevant international treaties, Russian courts may not reverse any decision of an arbitration tribunal on the merits of the case. Rather, the grounds for the refusal by courts of general jurisdiction to recognize and enforce foreign arbitral awards are generally the same as those set forth in the New York Convention.

At the same time, there is, unfortunately, a negative trend whereby Russian courts have refused to recognize and enforce foreign arbitral awards, based on the argument that the recognition or enforcement of such awards would be contrary to the public policy.

## **16.5 Alternative Dispute Resolution**

Although mediation and other forms of alternative dispute resolution (ADR) are fairly widely discussed in the legal community, there is no established practice for invoking such procedures in Russia. Nor is any legislative regulation available for this kind of ADR (apart from commercial arbitration). There is no statutory provision, for example, that states that documents received by the parties in the course of mediation may not later be used as evidence in the courts, or that the ADR mediator may not subsequently be called as a witness in legal proceedings between the parties.

**NOTES**

**WORLDWIDE****Europe and Middle East**

Almaty	Cairo	Paris
Amsterdam	Dusseldorf	Prague
Antwerp	Frankfurt/Main	Riyadh
Bahrain	Geneva	Rome
Baku	Kyiv	Stockholm
Barcelona	London	St. Petersburg
Berlin	Madrid	Vienna
Bologna	Milan	Warsaw
Brussels	Moscow	Zurich
Budapest	Munich	

**Asia Pacific**

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Beijing	Kuala Lumpur	Sydney
Hanoi	Manila	Taipei
Ho Chi Minh City	Melbourne	Tokyo
Hong Kong	Shanghai	

**North and South America**

Bogota	Juarez	San Francisco
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Buenos Aires	Miami	Sao Paulo
Calgary	Monterrey	Tijuana
Caracas	New York	Toronto
Chicago	Palo Alto	Valencia
Dallas	Porto Alegre	Washington, D.C.
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