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# Russia/Central Europe Executive Guide

Including  
Coverage of  
Eastern Europe  
and Central Asia

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Even the most seasoned examiners can find due diligence in Russia daunting. Many Russian enterprises keep two sets of books, an old practice from Soviet times; laws that should require disclosure of important information are often weak or missing altogether. A seasoned practitioner gives practical advice on the ways to succeed despite the challenges. Page 3

### Important Improvements to Russia's Business Environment

Last year Russia made significant improvements to laws and regulations that affect the business environment for foreign investors. The most noteworthy, but little reported changes, include the amendments to Russia's corporate laws, changes that permit land to be bought and sold, and tax cuts. Page 7

### New Changes to the Tax Code of Azerbaijan

Effective on January 1, 2002, Azerbaijan's tax rates have been lowered and accelerated depreciation on capital improvements is allowed. Significant changes have also been made to VAT rules and social security contributions. Page 6

### Does the Russian Tax Authority Have the Last Word?

Not necessarily. Taxpayers can contest the actions and decisions of Russia's tax agencies by going to court or filing appeals directly with the tax authorities. The procedures and grounds for filing appeals are examined. Page 9

### Staying Clear of Ukraine's Antitrust Agency

Companies must obtain clearance from the Antimonopoly agency in cases of mergers, changes in corporate control, and creation of a new company, when the value of the operation meets the triggering threshold. In many cases not only are the thresholds low, in dollar terms, but the antimonopoly agency also has wide discretion to find monopoly power exists even when a company share of a market is below the threshold levels. Page 15

## The Devil's in the Details

### 2002 Amendments to the Czech Commercial Code

by Tomas Richter

Exactly one year after the enactment of a major reform of Czech corporate law, the corporate section of the Czech Commercial Code has been amended once again.

The amendments, enacted as of December 31, 2001, under number 501/2001 Coll., have long been labeled as "technical." Indeed, many of the amendments are aimed at fixing previous drafting shortcomings and clarifying issues that have been the source of controversy in practice. Yet the amendments also contain several substantive changes, some of which may rightly be considered reversions of only recently promulgated policies.

#### Corporate Governance

By far the most important change in respect of governance relates to disqualification of directors upon insolvency (s. 31a). Although we still consider the statute far too restrictive and thus probably a hindrance to efficiency in the management of Czech corporations, it has now at least been amended such that it is clear that shareholders (or the supervisory board) may confirm the retention of disqualified directors in their office by a two-thirds majority resolution.

In relation to litigation on invalidity of resolutions of general meetings, the amendment retracts from the concept of a court-appointed litigation trustee as was introduced by the 2001 amendments (s. 131 (10) and (11)). Where litigation that has been commenced on a shareholder petition (or a petition of another person having standing to sue under s. 131(1)) is to be discontinued as the result of a withdrawal of the initial plaintiff(s), the court will not stop the proceedings where, in the view of the court, there are important shareholder interests worthy of legal protection. In such a case, the court will notify shareholders of the details of the pending litigation, and the proceedings will be stopped only if no shareholders join in the action within three months from the notification.

Shareholders will no longer be generally banned from voting on their shares where the general meeting is to approve contracts to be entered into between the shareholders and the company outside the normal course of business (s. 127 (5)(c), s. 186c (2)(c)).

Where the members of the board of directors are appointed by the supervisory board (rather than the general meeting), the supervisory board (and not the general meeting) will now also approve the terms of their service contracts and their remuneration (s. 194 (1)).

A safe-harbor for persons whose influence over Czech companies stems from agency, asset management, or other commercial contracts was removed from the definition of "controlling persons" (s. 66a (2)). This exposes professional and other

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***A number of amendments have been introduced in order to remove some of the technical obstacles to equity financing of Czech companies.***

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advisers of Czech companies to an increased risk that they will be found to exercise *de facto* control over their clients.

#### Corporate Financing

Rather surprisingly (and without any convincing explanation in the legislative report), the amendment has placed the issuance of bonds within the powers of the general meeting (s. 187(1)(c)). Yet other forms of borrowing remain within the powers of the board of directors.

A number of amendments have been introduced in order to remove some of the technical obstacles to equity financing of Czech companies. The most notable among these are:

- a fast-track court registration procedure for an increase in registered capital where the board of directors certifies to the court that subscriptions have been properly made and that the issue price of the new shares has been fully paid in cash. In the absence of general procedural irregularities, the Commercial Register will approve the registration of an increase of registered capital within three business days (s. 206 (2) and (3));
- the ability to issue receipts in lieu of fully paid shares while the registration of an increase in registered capital is pending (s. 204b);
- the ability to simultaneously reduce and increase the registered capital where this is required in order to bring the par value of the company's shares into line with the market

Tomas Richter is with the Prague office of Allen & Overy.

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## Protection of Minority and Majority Shareholders' Rights in Russia

### *Vital Components of Effective Due Diligence*

by Max Gutbrod and Vladimir Khvalei

#### **Purpose of a Legal Due Diligence Investigation**

In international business, legal due diligence is an essential part of the process of a growing number of transactions, including company acquisitions, joint ventures, general investments and financings. As a matter of fact, this practice has become so well established that transactions concluded without a prior legal due diligence review are unusual. However, if company shares are acquired on the stock market where the investor obtains information about its target company from other sources, there is no specific due diligence reporting; the same tends to be true of share purchases via auctions and various other deals.

Even though legal due diligence is recommended and necessary in most large business transactions, its purposes

may vary from case to case. Prior to acquiring a Russian company, investors should use caution and take into account that the company not only represents a certain position in the marketplace and a certain sales volume, but it also holds a certain legal status with various rights and risks. In most cases to minimize risk and uncertainty, it is essential to conduct a full-scale legal due diligence investigation covering both the company's corporate status as well as operations (employment, production, and safety record). Even when a company is acquired into full ownership, the extent of the investigation of individual matters of interest can still vary from case to case—industry to industry—depending on the company type. For example, if an oil company is acquired, the due diligence would focus on the company's production license; notably, the way it was obtained; whether its terms and conditions are fully complied with; and the risks of its potential loss. With an Internet company, on the other hand, the investigation would concentrate on protection

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## Due Diligence *(from page 3)*

of intellectual property rights, as well as employment issues—specifically terms of contracts.

### **Due Diligence Problems in Russia**

#### ***Differences in Business Practices of Russian and Foreign Companies***

We believe that the main problem in conducting a legal due diligence investigation in Russia lies not so much in legal difficulties companies can face but more so in the difference in business practices and approaches between Russian companies and foreign investors. Legal due diligence investigations are still a novelty to Russian companies; therefore, in many cases, Russian companies often do not know how to provide the required information and, furthermore, they often do not understand why such information should be disclosed in the first place.

For example, fairly often, Russian companies, especially in the defense industry, pay minimum attention to executing and registering their rights to real property, evidently regarding the whole process as an unnecessary

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***The main problem in conducting a legal due diligence investigation in Russia lies not so much in legal difficulties, but in the difference in business practices and approaches between Russian companies and foreign investors.***

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formality. This practice is based on a historical explanation dating back to Stalin's time when the rights to land plots were handed to many of the defense entities by Stalin himself, thus, no one has ever dared to make any claims against these land plots. Very often, defense industry companies (this is especially true of companies located outside Moscow and other major cities) simply do not have any title documents to buildings they occupy. In these cases, the absence of duly recorded rights to real property can come as a shock to foreign investors who are not familiar with Russian business practices and who are likely to ask, "How can the contribution of buildings to charter capital be negotiated in a situation when there is no title?" In reality, however, this problem is not a particularly serious one and can easily be overcome.

#### ***"Parallel Bookkeeping" by Russian Companies***

Since the political and economic situation in Russia over the past decade has remained unstable, and since

tax and currency legislation are far from perfect, most Russian companies combined legal and "semi-legal" methods of doing business. For example, before the income tax rate was reduced to 13 percent, virtually all Russian companies used to pay employees both officially—that is to say duly reflecting compensation amounts on the accounts—and unofficially, by means of distributing an agreed portion of the wages/salaries "under the table." The latter part of compensation came from cash proceeds, receivables from transfer pricing and other revenues that were not recorded on the books (understandably, no income tax was paid on such amounts).

Given that a substantial portion of revenues is transferred to affiliates and since there is still the need to keep true and accurate business accounts, many Russian companies maintain parallel accounts with one balance sheet—an official one—intended for tax and other supervisory authorities, and the other balance sheet—unofficial—reserved to reflect the real accounts and the business control. Hence, it is likely that in a due diligence report the actual accounts reviewed, being the official accounts, do not necessarily reflect the actual business situation. For example, one of our clients, an international company interested in acquiring shares in a Russian manufacturing plant, was surprised to learn that the value of the plant was far beyond what they had initially predicted. In negotiating a possible share price, all parties agreed to use a slightly adjusted EBIDTA standard as the basic criterion of business evaluation—when the Russian company in question was audited and the average annual profit was estimated at \$1 million, the auditors then proceeded to use the agreed business appraisal formula to estimate the profit at \$10 million. The Russian side, however, disagreed and quoted \$50 million. Our client was shocked at this figure—with all of the preliminary due diligence reporting complete, and the accounts reviewed, the client felt that it had a good idea of what to expect; this, of course, was not the case. The situation became somewhat transparent when the Russian seller explained that in addition to \$1 million in profit—officially reflected in the company's balance sheet—the plant yielded another \$4 million, which was channeled into offshore accounts and that, in accordance with the agreed formula, the value of the company's undertaking in reality amounted to \$50 million rather than the \$10 million.

It should be noted that in terms of criminal law, parallel accounting books at minimum could bring criminal actions based on tax evasion, to say nothing of the possibility of criminal prosecution for false accounts. As a result, Russian companies find themselves in ambiguous situations when trying to sell business undertakings to foreign investors. On the one hand, companies are not willing to disclose both sets of books in fear of criminal prosecution; on the other hand, without revealing true figures, a company cannot insist that an investor pays in accordance with the real value of the company.

*Continued on page 10*

## Update of Russian Legislation

by Eric Michailov

### Leasing

On January 29, 2002, the president signed Federal Law No. 10-FZ "On Amendments to the Federal Law 'On Leasing.'"

The Amendments to the 1998 Federal Law "On Leasing" define leasing as an investment activity whereby a lessor purchases certain property from a seller and leases it to a lessee for a certain period of time for payment.

The Amendments generally give more discretion to the lessor and lessee to define their rights and obligations in a leasing contract. They also remove the licensing requirement for leasing companies, and define new requirements for the content of a leasing contract. According to the Amendments, the amount of lease payments can be changed every three months upon the consent of the parties to the contract.

The parties are now allowed more flexibility to agree to the terms and conditions on which the leased property may be transferred to the ownership of a lessee either prior to or at the end of the term of a lease contract. However, certain restrictions envisaged by law may apply to the transfer of leased property from a lessor to a lessee.

The Law came into force on February 4, 2002.

### Banking

On January 22, 2002, the Central Bank issued Letter No. 7-T "On Certain Issues Connected with Application of the Federal Law 'On Banks and Banking Activity.'"

This Letter discusses individuals holding management positions in two or more lending organizations.

Article 11.1 of the Law "On Banks and Banking Activity" lists those positions (including the office of general director, his or her deputies, members of the management board, chief accountant, and the head of the branch of a lending organization) that cannot be occupied by the same person in two or more lending organizations, or be occupied by this person in any insurance company, leasing company, or securities broker.

The restriction does not apply to members of the board of directors as they do not enter into employment contracts with their respective lending organizations.

### Court Practice

#### Employment

On January 24, 2002, the Constitutional Court issued Resolution No. 3-P "On Review of the Constitutionality of Articles

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170(2) and 235(2) of the Labor Code of the Russian Federation [...]."

The Resolution of the Constitutional Court deals with the Labor Code that was in force until February 1, 2002. However, since the new Labor Code contains similar provisions, conclusions made by the Constitutional Court in this Resolution are still of relevance.

According to Articles 170(2) and 235(2) of the Labor Code, employers are not allowed to dismiss employees who have disabled dependent children even if such employees violate rules and regulations that may constitute grounds for termination of employment. By this Resolution the Constitutional Court held Articles 170(2) and 235(2) to be unconstitutional because they violate the rights of an employer as a party to an employment contract.

The Resolution of the Constitutional Court is final and enters into force immediately.

#### Lease

On January 11, 2002, the Higher Arbitrazh Court (HAC) issued Information Letter No. 66 "Overview of Practice of Resolving Disputes Connected to [Real Estate] Leases."

By reviewing some recent examples from court practice, the HAC provides its recommendations on resolving disputes connected to real estate lease transactions. The Letter discusses the conclusion and termination of a lease contract, its term, lease payments, change of ownership in relation to the leased property, preemptive rights of a tenant, and sublease issues.

In particular, the Letter says that a landlord may request the early termination of a lease contract based on the grounds listed in the contract even if there is no breach of the tenant's obligations. A lease contract may provide for early termination upon request from a landlord even if only one lease payment is made late (while the Civil Code states that a lease contract may only be terminated by a landlord if a tenant makes a late payment twice).

Also, before filing a lawsuit for early termination of a lease contract for breach of obligations by a tenant, a landlord is obliged to warn the tenant in writing.

Further, the court may review terms and conditions of a lease contract and consider it to be a "major" transaction (in light of the Joint Stock Companies Law), for which approval of the landlord's board of directors is required.

The Information Letter of the HAC will operate as an interpretative recommendation and guideline for lower arbitrazh courts when dealing with lease-related disputes. □

# Important Tax and Social Security Changes

by S. Alum Bati

The Azerbaijan Republic recently introduced a number of important tax and social security changes. The changes to the Tax Code took effect from January 1, 2002.<sup>1</sup> Last year also saw a number of other important tax and social security changes.

## Income Tax

*Income tax reduced:* The income tax bands have been modified by removing the 20 percent and 30 percent bands.<sup>2</sup> There are now four tax bands (0 percent, 12 percent, 25 percent and 35 percent). The thresholds have also been raised. The revised income tax table for employees and the self-employed are as follows:

Taxable monthly income (AZM)	Tax
Up to 100,000	No tax
100,001-1,000,000	12 percent of amount exceeding 100,000
1,000,001-5,000,000	108,000 + 25 percent of amount exceeding 1,000,000
Over 5,000,000	1,108,000 + 35 percent of amount exceeding 5,000,000

The income tax rates for annual income (e.g., self-employed income) are as follows:

Taxable annual income (AZM)	Tax
Up to 1,200,000	No tax
1,200,001-12,000,000	12 percent of amount exceeding 1,200,000
12,000,001-60,000,000	1,296,000 + 25 percent of amount exceeding 12,000,000
Over 60,000,000	13,296,000 + 35 percent of amount exceeding 60,000,000

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The U.S. dollar is equal to approximately 4,677 Azeri manats (AZM).

*Sick leave payments:* Sick leave payments are explicitly made taxable.<sup>3</sup> Although, previously, the tax authorities maintained this position, there was a good argument based on Article 102.1.4 of the Tax Code, 2000, that sick leave payments were not taxable.

## Profits Tax and Tax on Entrepreneurs

*Capital investment relief* (essentially a double deduction for capital investment) has been abolished.<sup>4</sup>

*Accelerated depreciation:* The taxpayer may elect to apply accelerated depreciation of up to four times the standard rate for capital investments.<sup>5</sup>

Depreciable fixed assets (i.e., assets with a useful life of more than one year) are now divided into 7 (previously 5) classes:<sup>6</sup>

1. buildings and structures—10 percent per annum on a reducing balance basis
2. machinery, equipment and computing technology—25 percent per annum on a reducing balance basis
3. motor vehicles—25 percent per annum on a reducing balance basis
4. working animals—20 percent per annum on a reducing balance basis
5. geological survey costs and works preparatory to the extraction of natural resources (including the costs of

## ***The simplified tax regime is no longer simple.***

intangible assets incurred in order to acquire the right to carry out geological surveys and the treatment or exploitation of natural resources<sup>7</sup>)—25 percent per annum on a reducing balance basis

6. intangible assets with a life of more than one year<sup>8</sup>—at 10 percent per annum on a reducing balance basis. Previously, this method was used only where it was not possible to determine the useful life of the asset—in other cases intangible assets were depreciated on a straight-line basis over their useful life
7. other fixed assets<sup>9</sup>—20 percent per annum on a reducing balance basis

Classes 3 and 4 are entirely new and class 6 has been modified as described above.

Investment in assets in the above classes (other than classes 4, 5 and 6) may be accelerated by up to four times the specified rate.

Depreciation is calculated in respect of each class of assets, with each building / structure being regarded as a separate class. The residual book value of any class at the end of the previous tax year is increased by purchases during the year or decreased by sales. The relevant depreciation rate is then applied to that class, thus giving the amount of deductible depreciation for the year.

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## Work Permits for Management Board Members

by the Warsaw Office of KPMG

Individuals who are members of a management board and who will stay in Poland for more than 30 days in a calendar year, are required to obtain a promise of employment (*przrzeczenie*) and a work permit (*zezwolenie*) in Poland. The deadline for obtaining work permits for management board members is March 31, 2002.

The procedure for obtaining work permits for management board members is more complicated where the Polish company employs less than 50 people. In this situation, a positive decision of the head of the Voivodship is required based on the local labor market situation.

The procedure is less complicated for foreign individuals who represent their foreign employer in a branch or representative office in Poland. In this case,

the decision of the head of the Voivodship does not need to take account of the local labor market.

According to information we received from the appropriate authorities, they will now adopt a much stricter approach to breaches of the regulations.

### Health Insurance

The health insurance rate remains at 7.75 percent of an individual's taxable income for 2002.

### Social Security Cap

Pension and disability fund contributions are only calculated on income up to PLN 64,620 in 2002.

### Tax on Funds Transferred Abroad by Individuals

From January 1, 2002, until the end of 2003, funds treated as "capital turnover" (as defined in the Foreign Exchange Law) transferred abroad will be subject to 2 percent tax. The tax will be withheld by the financial institution where the transfer is made. If the transfer is made without the involvement of a financial institution, the obligation to pay the tax rests with the taxpayer. □

## RUSSIA

## INVESTOR PERSPECTIVE

## Reforms Are Real, but Attention Is Scant

### *The Problem with Good News*

by Bruce W. Bean and Zheniya Shpak

2001 was the best year yet for legal reform in Russia. Legislation introduced by Vladimir Putin's government and enacted by the Duma has made Russia more attractive to investors, including foreign investors. Many critical areas have been affected by the 2001 reform program, including tax, land reform, abuse of minority shareholders, business licensing and judicial reform. This is real news—but it has not been deemed newsworthy.

The popular press has its conventions and priorities. We do not read that "3.5 million people commuted to work this morning on the Moscow Metro and all but one made it home safely." Rather, we will read: "Com-

muter Crushed to Death under Wheels of Speeding Soviet-Era Train." This derives not only from the cut-throat competition in the media business ("If you can't say something sensational, try again"), but also from our collective memories of Russia in the Cold War.

Can we even imagine a headline: "Putin's Economic Miracle" or "More Genuine Legal Reform from President Putin"? Give the Western press some credit,

***Tax reforms and curtailment of the power of tax authorities will encourage accelerated investment in Russia.***

though, since September 11, Putin is no longer always referred to as the "former KGB spy."

Prior to considering the achievements of Putin's government last year, we should note that his presidential administration has worked closely and effectively

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**Reforms** *(from page 7)*

with the Duma. This, too, may not be newsworthy, but it is a remarkable change from Russia's first eight years. Much of the credit here must go to Russia's hard-pressed electorate who, in December, 1999, elected a Duma more inclined to economic progress than to opposing everything President Boris Yeltsin suggested.

For better or worse, Russia's president, Vladimir Putin, is not only a "former spy" but was also trained as a lawyer. Putin's "Petersburg Mafia" of advisers, some of whom have prominent roles in the presidential administration, includes a number of very sharp lawyers who prepared the comprehensive legislative reform package enacted last year. What was accomplished?

**Tax Milieu Improves**

Crucial to Russia's overall investment and business climate are the very real, liberalizing changes contained in Part II of the Tax Code. Effective January 1, 2001, Russia implemented a flat tax on personal incomes of 13 percent; effective January 1, 2002, Russia's profit tax rate was dropped from 35 percent to 24 percent, and Russia came much closer to allowing deductions for what we know as "ordinary and necessary" business

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***Legislation introduced by Vladimir Putin's government and enacted by the Duma has made Russia more attractive to investors, including foreign investors.***

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expenses. Combined with the noticeable taming of tax authorities over the past four years, this will certainly encourage accelerated investment in Russia.

Currency control law developments in 2001 now allow Russian individuals to purchase up to \$75,000 per year in foreign securities. This will simplify, and in some cases legitimize, participation by Russian executives in employee benefit plans involving stock and equity of their foreign employers. Other foreign currency payments for goods and services purchased abroad by Russians have also been made more reasonable.

One area of Russian law that had long been in dire need of modernization was the Russian Labor Code, enacted in 1971 as the law of the Russian Soviet Federal Socialist Republic. Now thoroughly updated, the new Labor Code recognizes and accommodates many of the basic needs of Russia's rapidly evolving labor market. For example, the Labor Code provides new grounds for termination of labor contracts by employers (e.g., disclosure by an employee of a commercial secret), and it recognizes the need to be able to terminate the employment of the chief executive officer and

other senior officers in the event of a change of control of a company. Fixed-term employment contracts are now more easily concluded. Not all is perfect with any law, but the new code is a much more realistic foundation for labor relations in a market economy.

**Business Laws Revamped**

Another area of major importance for the overall investment climate are the amendments to corporate and related business laws. Russia's Joint Stock Company Law has been in place only since 1996 and has worked fairly well. However, three-quarters of its provisions were changed last year, many of them with the aim of limiting abuse of minority shareholders.

Expanded pre-emptive rights in both "closed" and "open" offerings will make dilution of minority shareholders through offerings of new shares much more difficult. Eliminating certain shareholdings and "asset-stripping" through corporate spin-offs and split-ups have also been curtailed. Fractional shares are now authorized, thus terminating the reverse split as a technique for removing small shareholders from the shareholder list.

In the many changed articles of the JSC Law are other improvements that benefit non-controlling shareholders and generally enhance the corporate governance environment. These include enhanced access to shareholder lists and accounting records, the right to nominate candidates for board and management positions and an easing of the requirements for removing a company's general director/CEO. General business creation should also be facilitated by reduced licensing requirements and a new five-day deadline for registering new legal entities.

A bitter ten-year struggle over the sale of land was substantially resolved with the passage of the new Land Code last fall. While the 49-year land lease has proven to be completely effective for foreign and domestic investors, those who feel more comfortable with full title to land will now be able to satisfy that itch.

**No Restrictions on Ownership**

The Land Code does not apply to sales of agricultural or forest land, but the land that it does regulate includes practically all industrial facilities and virtually 100 percent of urban industrial, office, and residential sites. Since the market reforms of the 1990s, ownership of buildings by domestic and foreign parties has been permitted without any important restriction. While there have been no real problems with owning a building on leased land, the Land Code now expressly permits ownership of the land as well. Foreigners may purchase, mortgage, lease, and otherwise deal in land just as Russians can, except for land located near border regions.

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## Reforms *(from page 8)*

Do these and the many other legislative accomplishments of Putin's government in 2001 mean "All's well"? No. After all, starkly absent from the above description of progressive Russian legislation is any good news on PSA normative acts or helpful progress on the proposed PSA tax provisions. Chechnya, press freedom and "spy" scandals are also missing from the above review. But then, the press has kept us up-to-date on

these more "newsworthy" negative developments. The positive legislative developments of 2001 for Russia's business and investment climate are undeniable.

Adoption of the bills currently in the legislative pipeline, including the completion of much needed judicial reform and pension reform, enactment of inside trading rules and others, should be carefully watched for this year.

Just don't expect them to make the headlines of your local paper. □

## Review of Taxpayers' Appeals Prior to Litigation

by Olga Lebedeva

Taxpayers may appeal decisions and actions of the tax authorities either by appealing to the tax authorities or by going to court. The Ministry of Taxes and Duties (MTD) has described the appeals procedure to the tax authorities in its order No. BG-3-14/290 of August 17, 2001.

Appeals may be submitted where the taxpayer disagrees with:

- findings of tax audits, decisions based on the results of tax audits, tax assessments, responses to taxpayers' written inquiries and other similar documents;
- actions of the tax authority;
- resolutions on calling company officials to account.

Depending on the type of appeal, it should be submitted either to the local tax authority or to a higher tax authority. Thus, for example, an appeal against an act following a tax audit may be considered by either the head of the tax inspectorate or the head of the Regional Department of the MTD, whereas an appeal against the decision of the head of the tax inspectorate on calling an entity to account must be considered by a higher tax authority only.

### Deadlines

Appeals are accepted provided that the appealing party has complied with the following terms.

1. The appeal must be submitted within the following time frame:

- within three months of the action of the tax authorities or the day the tax authorities;
- within ten days of a resolution being issued on an administrative violation of the law.

If the deadline for submitting an appeal is missed with good reason, this period may be extended. To pro-

long a deadline, the taxpayer should apply to the head of the local tax authority or to a higher tax authority.

2. The reason for the appeal should be clearly stated and the claims should be substantiated.

3. The appeal should be submitted by the head of the company or another individual authorized to act on behalf of the taxpayer.

The local tax authority has a right to refuse an appeal if it has been already accepted by a higher tax authority, or if the appealing party has not complied with the terms mentioned in items 1 to 3.

If the tax authorities do not accept an appeal they must inform the taxpayer of this within ten days of receipt.

If the tax authorities refuse to accept an appeal because of a violation of the terms specified in item (2) and/or (3) above, the taxpayer may submit an amended appeal (e.g., indicating the reason for the appeal if it has

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***The new procedures issued by the Ministry of Taxes and Duties should result in a fairer and speedier resolution of many tax disputes.***

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not been stated before) provided that the deadline for submission, specified in item 1 above, has not expired.

The submission of an appeal does not give grounds to suspend the performance of the document or action being appealed against. However, the performance may be suspended if the tax authority considering the appeal regards the document or action in question as non-compliant with the law.

Appeals made by taxpayers against documents or actions of the tax authorities are generally considered within one month of receipt and appeals by company officials against resolutions on administrative violations within ten days.

All appeals to the tax authorities are sent to legal subdivisions and considered by a special Commission led by the head of the tax authority or his deputy.

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## Appeals *(from page 9)*

If the Commission has sufficient reason to recognize an act or action of the tax authorities as non-compliant with legislation, it should meet with the representatives of the taxpayer, of the tax authority's methodology subdivisions and, if necessary, of the lower tax authority. This meeting is documented in a protocol that is signed by all of the participants.

Based on the results of the Commission's consideration of the appeal, the head of the tax authority or his deputy makes a decision regarding the appeal. The taxpayer is informed of the decision in writing within three days of the decision.

The MTD now has a detailed procedure for considering taxpayers' appeals that should provide for a more efficient and fairer resolution of disputes between taxpayers and the tax authorities before initiating litigation proceedings. □

## Due Diligence *(from page 4)*

### Absence of Document Control

In addition to parallel accounting books, the absence of orderly record management procedures is a real problem in Russian companies. For example, on a very basic fundamental level, it is sometimes difficult to even determine the number of powers of attorney that the company has issued to its representatives. In general, such information has not historically been compiled, since such

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***It can be difficult to ascertain what movable property has been pledged.***

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document control is not a requirement under the Russian legislation. Likewise, it can be difficult to ascertain what movable property has been pledged. Although formally Russian law requires each company to maintain a pledge register in order to record all instances of pledge over its property, failure to do so does not entail any legal consequences; hence, many Russian companies often do not have a pledge register.

### *Inadequacy of Russian Legislation*

It should be noted that with regard to Russian companies, legal due diligence is also required because Russian legislation is silent on certain important matters and as a result, a foreign company can only obtain certain types of necessary information in the course of a due diligence investigation.

In this respect, examples of the main inadequacies of the Russian legislation are outlined below:

*Absence of Trade Registers*—Unlike in European countries, which maintain trade registers to record information about persons authorized to represent a company in transactions, the State Register where Russian legal entities are recorded does not contain this information. Without a formally-recorded record, finding out who is authorized to represent a Russian company in various dealings can be a rather difficult task. Furthermore, in many situations a company can have two opposing boards of directors, two shareholder meetings and two general directors. Not infrequently, such situations have led to armed clashes between representatives of opposing shareholders. One recent example of such a conflict in Russia is the Moscow Distillery, Kristall, which has two managing directors. Not surprisingly, each director argues that he is the sole person authorized to represent the distillery. Another example is NTV television company, whose shareholders meeting appointed a new general director only to be frowned upon by minority shareholders who refused to recognize the new manager's powers and authority.

The foregoing examples are among the most graphic illustrations of this problem. Nevertheless, even if there is no overt confrontation within a company, this sort of a problem could still exist. Since there is no true and open way to find out who can and cannot represent a company in a transaction, investors should be aware that if a person who lacks the power of attorney, regardless of the individual's status in the company, concludes a transaction, the transaction would be completely invalid in the Russian courts.

*Failure to Disclose Important Information in Accounts*—Failure to disclose important information in accounts (notably, information about guarantees provided by the company or its potential liability) is another problem and, alongside the absence of trade registers, should be viewed as part of the Communist heritage.

Under Russian accounting rules, a company is not obliged to disclose in its balance sheet guarantees it provided to secure performance of obligations by third parties; unfortunately, in many cases it would only take one of such a guarantee to bankrupt a company overnight. Likewise, a Russian company is under no obligation to disclose any pending lawsuits filed against it.

Nor does the balance sheet of a company mention pledged property. Considering the fact that third-party pledge is permitted (that is to say, a company is entitled to pledge its property to secure performance by a third party, even though the company is not a party to the obligation thus secured), the consequences of not knowing this can be devastating to an investor.

*Absence of Laws and Regulations Requiring Disclosure of Essential Information*—Even though Russian securities legislation has recently undergone substantial changes

*Continued on page 11*

## Due Diligence *(from page 10)*

and the Federal Securities Market Commission has in many cases lately sided with investors, the current standards of information disclosure by security issuers still leave much to be desired. The information that security issuers are currently required to provide to the Federal Securities Market Commission and which is open to the public is still not comprehensive enough, nor is it sufficient to adequately describe an issuer and its business. For example, one of our clients filed several lawsuits against a major oil company (claiming in total over \$100 million). Unfortunately for investors of the oil company, these lawsuits were never mentioned in any of the information provided to the Federal Securities Market Commission. Further to this, our client directly notified the Federal Securities Market Commission to inform them of what was going on; the Commission, however, refused to accept this information, leaving potential investors in the dark.

*Current Registration of a Company Does Not Legalize its History*—There are no provisions under Russian law pursuant to which new registration of a company would nullify the company's founding history, meaning, if the company was initially established in breach of a legal act, it may at any point be forced into liquidation based on problems with the initial start-up regardless of how many times the company has changed ownership. The Investor Protection Law actually made the first attempt in solving this problem by providing that the issue of shares by a company may be contested within no more than one year. However, in cases where registration is effected in consequence of an invalid (void) transaction, such company registration remains contestable for a period of up to 10 years—a factor that may lead the company to be forced into liquidation if it can be proven that irremediable flaws occurred during its establishment.

In other words, if an investor purchases shares in a company founded less than ten years ago, there is a chance that this company could be forced into liquidation by reason of irremediable breaches of the law that occurred at the time of its establishment. This could happen regardless of the current legitimacy of the company or the amount of times it changed ownership.

*State Property Privatized in Violation of the Procedure Set Forth in the Privatization Laws May Be Recovered from Any Person, including a Bona-fide Purchaser, Within 10 Years*—Because 10 years ago substantially all Russian enterprises were state owned, the overwhelming majority of Russian companies today are in fact previous state-owned property. As the laws that were in effect during the implementation of the large-scale privatization campaign in Russia had certain inconsistencies, as well as many other flaws, violations throughout the privatization campaign were so common that we have never come across a company that was privatized with full due re-

gard for the law. Unfortunately, the violations committed during the privatization efforts may be used as grounds for the return of the “illegally” privatized assets to state ownership, including by way of its recovery from *bona-fide* purchasers.

Therefore, a foreign investor may acquire shares from a Russian enterprise in good faith, but in time find itself in a bad situation when the Russian government voices a claim (a recall) against the Russian enterprise based on illegal privatization.

### Conditions for Effective Due Diligence

In view of the above, performing a due diligence investigation in Russia is not an easy task; nevertheless, it is extremely important to gain the full picture

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***Legal due diligence investigations are still a novelty to Russian companies; therefore, in many cases, Russian companies often do not know how to provide the required information and, furthermore, they often do not understand why such information should be disclosed in the first place.***

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of the actual state of affairs. This may become a critical factor for a successful transaction.

### How to Perform an Effective and Efficient Due Diligence Investigation in Order to Obtain Adequate Information about the Target Company

There are several components required to ensure successful work product:

#### *Obtaining Information about the Target Company from Several Sources*

Effective due diligence requires thorough preliminary research.

First of all, information about the target company should be obtained not only from the company itself but also from other public sources of information. The following sources should be utilized:

- *mass media/local press*—few Russian enterprises have managed to avoid the press. Although certain publications are not always trustworthy, the nature of the information may still alert an investor to certain problems. For example, when a due diligence exercise was performed by a potential investor interested in a Russian enterprise, a local trade union publication revealed that the Russian enterprise was in violation of various laws during its privatization; further investigations based on this lead revealed that this was

*Continued on page 12*

## Due Diligence *(from page 11)*

in fact the case and that the enterprise could be in danger of a governmental take back;

- State Registration Chamber—even though the information provided by the State Registration Chamber is fairly limited, it could still be fairly important;
- *Federal Securities Commission*—this source is transparent and contains a lot of useful information about any target company;
- *Internet*—interestingly enough, company Web sites often contain information prepared by marketing specialists, however, in many cases this information can more accurately reflect the company's status than documents provided by the legal department.

### *Cooperation during Due Diligence*

One of the most essential conditions for performing an efficient due diligence is the establishment of a certain degree of trust between the investor and the managers of the Russian company. Therefore, an absence of such

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***Companies are not willing to disclose both sets of books in fear of criminal prosecution; on the other hand, without revealing true figures, a company cannot insist that an investor pays in accordance with the real value of the company.***

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trust and failure to provide the information required should most definitely be taken seriously. Another important source of information is the degree of openness managers show toward a due diligence exercise.

An example of this can be illustrated by the following case: while performing a due diligence of a confectionery plant our legal team could not obtain the required information from management; in fact, after spending a couple of days at the enterprise, we were only able to obtain a balance sheet. The managers continued to send us on wild document chases, which resulted in much wasted time. At the end of the day, our team advised the client against the investment. In general, the mere fact that the lawyers involved in a due diligence are denied direct access to fundamental documentation is a significant indication of a problem.

In another case, while performing a due diligence our legal team was issued a set of documents that were in perfect condition, in fact, they were so great that upon further investigation, we wanted to question the company's employees to confirm that everything was really perfect. Unfortunately, the management of the com-

pany forbid us from communicating with any of the local employees. This of, course, caused us some concern, so we insisted; upon further review of the documents and some interviews with a selected group of employees, it became very clear that the company had a lot to hide and the risk to our client would be too great.

### *Cooperation with Auditors*

When performing a due diligence, it is advisable to work in coordination with the auditors. In spite of the fact that the aim of a due diligence is somewhat different from those of an audit, cooperation enables both teams to reach their objectives in a more efficient manner.

### **Decision to Continue Transactions**

An investor's decision to continue the transaction should be greatly influenced by the results of the due diligence investigation. Unfortunately, due diligence often reveals facts that prevent a transaction from being continued, however, a bad transaction is far worse than no transaction at all. Yet, in most cases the transaction can still be completed; however, based on the results of the due diligence, the investor is able to better tailor the deal. For example, the results of a due diligence may influence the value of the transaction, the amount may decrease to compensate for the risks involved, further, the transaction can be structured to reduce the investor's risks to the smallest extent possible. Also, violations revealed in a due diligence may constitute grounds for establishing conditional clauses to the deal; and, many other issues can be addressed and resolved before the transaction is completed.

The due diligence process is an essential part of doing business in Russia and should not be underestimated or overlooked. □

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## Act on Banks

by Weinhold Andersen Legal, Bratislava

In this article, we summarize some key aspects of the new Act on Banks (Act). The Act is quite elaborate and its exhaustive coverage is beyond the scope of this article.

The main purpose of the new regulation is to harmonize the Slovak legislation of the banking sector with European Union law and to provide more detailed rules.

### Scope of the Act

The Act regulates in particular the establishment, organization, management, operations, and winding-up of banks that operate in the Slovak Republic.

### Bank and Branch of a Foreign Bank

A bank is defined as a legal entity established in the form of a joint-stock company that accepts deposits, provides credits/loans, holds a bank license and has its registered seat in the Slovak Republic.

Banks may also perform other activities that are specifically listed in the Act, e.g., making payments via bank account transfers, trading with securities, financial leasing, providing bank guarantees. Other non-banking activities can be performed only if they relate to the bank's operation and only with the consent of the Central Bank (National Bank of Slovakia).

Banking services may be provided by Slovak banks as well as by the branches of foreign banks.

A branch of a foreign bank is defined as a branch office of a foreign bank situated in the Slovak Republic.

A foreign bank is a legal entity with its registered seat outside the Slovak Republic holding a license to provide banking activities in its home country.

The Act bans entities that do not hold a bank license from accepting deposits, providing loans, making payments via bank accounts and issuing bank cards.

### Bank Licenses

Bank licenses are granted by the National Bank of Slovakia (NBS).

Each bank license is granted for an indefinite period and is not transferable to another person; neither is it assignable to a legal successor.

The extent and manner of banking activities can be limited in the bank license.

A bank license cannot be granted if it would be in conflict with an international treaty that is binding for the Slovak Republic.

The Act differentiates between the requirements to be met by a Slovak bank and the ones for a branch of a foreign bank.

In order to obtain a bank license, a Slovak bank must meet all the requirements explicitly stated by the Act, e.g., it must:

- invest a minimum amount of registered capital of SKK 500m in the form of a monetary contribution. If the bank intends to provide mortgages, the minimum amount of registered capital is SKK 1bn;
- prove that the origin of the capital is transparent and reliable;
- provide a suggested list of members of the Board of Directors and Supervisory Board;
- provide a proposal of the bank's Articles of Association;
- prove the professional competence of the members of the Statutory Body, Supervisory Body, managers, controllers and internal auditors (professional competence is defined by the Act);
- provide a business plan;
- provide information regarding the transparency of a business group and close relationships, and state which law governs the relationships in the group;
- prove the financial ability of the founders to overcome any financial problems of the bank.

A branch of a foreign bank must meet, for example, the following requirements:

- prove the credibility and financial ability of the foreign bank;
- provide a description of the Group where the foreign bank is a member;
- prove the professional competence of the persons entitled to act on behalf of the branch.

A branch of a foreign bank may provide mortgages only if the foreign bank is entitled to do so in its home country.

A branch of a foreign bank must identify itself as a branch of a foreign bank.

### Bank Supervision

The activities of the banks are under the supervision of the NBS.

Banks and the branches of foreign banks are required to allow NBS supervisors to participate at their General Meetings, meetings of their Supervisory Boards, Boards of Directors or Management Boards of the branches of the foreign banks.

The NBS is also entitled to supervise the branches of the banks operating in other states if the foreign law and an agreement concluded between the NBS and the foreign Supervisory Body allows it.

The NBS is obliged to notify the police if it suspects that a crime has been committed.

The Securities Center is obliged to provide the NBS with the information it needs to supervise the banks.

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Weinhold Andersen Legal has law offices in both Prague and Bratislava. The firm provides specialized legal services in all areas of commercial and financial law.

## **Banks** *(from page 13)*

### **Branch of a Foreign Bank with a Registered Office in the EU**

As of the day the Slovak Republic becomes a member of the EU, the foreign banks with registered offices in the EU will be able to provide banking services through their branches in the Slovak Republic. They will not need a bank license when they hold a bank license in their home country. In addition, these foreign banks will be able to provide services without establishing a branch in the Slovak Republic based on the opinion of their home country supervisory authority, which must be submitted to the NBS.

All the branches of a foreign bank will be regarded as one branch for the purposes of registration.

### **Representative Offices of Banks/Foreign Banks**

According to the Act, a Slovak bank can establish representative offices outside the Slovak Republic and foreign banks may have representative offices in the Slovak Republic.

A representative office of a bank is defined as a branch office of a Slovak or foreign bank promoting banking services/activities and gathering information on the possibilities of business cooperation.

Slovak banks must notify the NBS about any representative offices they establish abroad. Foreign banks must also register their representative offices in the Slovak Republic.

A representative office of a bank may not conduct banking activities.

### **Bank Organization and Management**

Every bank must include in its Articles of Association the organizational structure, management system, relationships and cooperation between the Statutory Body, Supervisory Body and top management who are not members of a body. The Articles of Association must also regulate powers and responsibilities for specified matters precisely defined by the Act, e.g.:

- creation, performance, monitoring and controlling of business intentions of the bank
- internal control
- risk management
- performance of loans and investments
- risk monitoring
- internal and external information systems
- protection against money laundering

Banks must establish a department of internal control and department of internal audit.

### **Special Legal Limitations**

Banks have significant limitations regarding their business activities. Banks cannot control another company that is not a bank, financial institution or a company conducting supporting banking services.

The Act also sets out limitations concerning the acquisition of shares in other companies.

### **Members of the Statutory Body**

Banks and branches of foreign banks are required to conclude written contracts with every member of their Statutory Body or the Head of the Branch.

The members of the Statutory Body or the Head of the Branch are liable for damages caused by a breach of their legal obligations.

Neither banks nor branches of foreign banks may at their own cost insure members of their Statutory Body, Supervisory Body or the Head of the Branch.

Should the members of the Statutory Body, Supervisory Body or the Head of the Branch be recalled due to their noncredibility as per the Act, the bank/branch of the foreign bank may not provide them with the remuneration agreed or stipulated by internal rules.

### **Commercial Documentation**

Banks and branches of foreign banks are required to keep a commercial book in which the bank operations are daily registered. Every bank operation must be entered into the commercial book on the day of its realization.

### **Measures for Corrections and Penalties**

As mentioned, the NBS is the supervisory body of banks and it is empowered to regulate the conditions of bank licenses, to issue binding decrees, and to impose measures for corrections and penalties.

The Act defines several different types of measures for corrections, and penalties of up to SKK 20m.

### **Liquidation**

The Act introduces a special provision on the liquidation of banks. Only the NBS can suggest the appointment/revocation of the liquidator and also his/her remuneration.

The Act also precisely determines the persons who may not be liquidators due to their relationship to the bank.

### **Mortgage Banking**

The Act introduces some important changes regarding mortgages.

A mortgage loan is defined as a long-term credit with a maturity of at least four years and at most thirty years, secured by a lien over domestic real estate, even that being built.

The bank can provide mortgage loans for the following purposes:

- purchase of a building or part of a building
- construction or reconstruction of buildings
- maintenance of domestic real estate
- repayment of a loan that is not a mortgage loan, only for the above purposes

The banks can also provide a municipal loan, which is defined as a long-term credit with a maturity of at least

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### **Banks** *(from page 14)*

four years and at most thirty years, secured by a lien on real estate that is owned by a municipality.

#### **Bank Secrecy**

Bank secrecy applies to all information and documents relating to a bank/branch of a foreign bank's customers that are not available to the public, in particular information on transactions, the balances of current and deposit accounts. Banks are obliged to keep this information confidential and protect it against disclosure, misuse, damage, loss or theft.

Banks and branches of foreign banks must ask customers for their identification cards when performing each bank transaction and must refuse to conduct transactions on an anonymous basis.

Moreover, banks and branches of foreign banks must, in the case of transactions exceeding SKK 100,000, verify the origin and ownership of the funds used in the transaction.

#### **Proceedings**

The Banking Act introduces a provision regarding the NBS proceedings.

The proceedings have two stages. The bank supervisory units of the NBS are entitled to decide the cases in the first stage, and the bank counsel of the NBS handles the appeal. Each NBS decision can be reviewed by the highest court of the Slovak Republic.

#### **Effectiveness**

The Act came into effect on January 1, 2002, except for the special provisions regarding foreign banks with registered offices in the member states of the EU, which will come into effect as of the day the Slovak Republic becomes a member of the EU. □

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## UKRAINE

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### **Antimonopoly Clearance for Mergers, Acquisitions, and Company Start-ups**

by Scott E. Brown and Valeriy Semenets

#### **Introduction**

The Antimonopoly Committee of Ukraine (AMC) is responsible for ensuring the state protection of competition in business activities within Ukraine. As part of the executive branch of government, the AMC is subordinate to the president and reports annually to the Ukrainian Parliament regarding its activity. In order to protect Ukrainian business from unfair competition and trade practices, the AMC requires that any business receive consent to a certain transaction if such transaction may or will lead to an economic concentration on a specific segment of the Ukrainian market.

#### **When Consent of the AMC Is Required**

Three key pieces of legislation govern competition issues in Ukraine: (i) the Law of Ukraine No. 3659-XII "On the Antimonopoly Committee of Ukraine," dated

November 26, 1993; (ii) the Law of Ukraine No. 2132/92 "On Restricting Monopolies and Preventing Unfair Competition in Entrepreneurial Activity," dated February 18, 1992 (as lastly amended on June 30, 1999); and (iii) Order No. 134-r "On the Regulations on the Control Over Economic Concentration," dated May 25, 1998, registered with the Ministry of Justice of Ukraine under No. 409/2849 on June 30, 1998. In addition, there are numerous other subordinate acts of legislation referred to from time to time in the above Laws, which must be taken into consideration.

The AMC's consent to a transaction is required only upon the occurrence of certain triggering events. These

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***The AMC may, at its discretion, determine a monopoly position of a business entity whose market share is less than 35 percent.***

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events include mergers, the direct or indirect acquisition of shares of stock or assets, the acquisition of control in any manner, the expansion of an association of businesses and the creation of a business entity. For each category, Order No. 134-r "On the Regulations of the Control Over Economic Concentration," dated May 25, 1998 (Order No. 134-r), sets forth the thresholds that require companies to receive the AMC's consent for a particular transaction.

According to Article 13 of Order No. 134-r, a company or an entrepreneur need not receive the AMC's pre-

*Continued on page 16*

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## Antimonopoly *(from page 15)*

liminary consent to a so-called “planned concentration” (i.e., potentially monopolistic transaction). As a practical matter, the interested parties usually include a provision in relevant agreement that the closing of the transaction (i.e., the date when the agreement comes into force) is contingent upon obtaining the AMC’s consent. Since the procedure for receiving the AMC’s consent is complicated and lengthy, the parties should begin the process of procuring such consent in the early stages of the transaction. Accordingly, the closing of a transaction will be suspended until the AMC clears the transaction and puts forth its consent in writing.

In order to receive the AMC’s consent, the relevant party must submit an application in the required form. The party must include a vast amount of information about itself in the application, including the founding documents of the applicant(s); the agreement that could

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***Since the procedure for receiving the AMC’s consent is complicated and lengthy, the parties should begin the process of procuring such consent in the early stages of the transaction.***

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possibly result in a concentration on a market; registration, statistic, economic and financial information about the parties to the transaction; a description of the transactions and its targeted results; the principal activities of the parties; the balance sheet of the applicant(s); and information on the entities controlled by the applicant(s).

### ***Triggering Thresholds***

In a nutshell, the thresholds for notifying the AMC regarding the major types of transactions are as follows:

- Merger—where at least one party has a monopoly position (market share generally above 35 percent) or the parties’ combined market shares are greater than 35 percent; or, the parties’ combined assets or turnover exceeds \$12 million and at least each of two parties have assets or turnover exceeding \$1 million;<sup>1</sup>
- Share acquisition—where one party (the purchaser) acquires 25 percent to 50 percent of the votes on the board of the target company, provided the parties’ combined assets or turnover exceed \$12 million and both of the parties (the buyer and the seller) each have assets or turnover exceeding \$1 million; or at least one party (either the seller or the buyer) has a monopoly position;<sup>2</sup>
- Asset acquisition—where acquired assets exceed \$1 million or at least one party has a monopoly position;<sup>3</sup>

- Acquisition of control in any manner—where the parties’ combined assets or turnover exceed \$12 million and (a) each of at least two parties have assets or turnover exceeding \$1 million or (b) at least one party has a monopoly position or (c) the parties’ combined market shares exceed 35 percent;<sup>4</sup>
- Expansion of an association—where the joining parties’, the association’s and the existing participants’ combined assets or turnover exceed \$12 million or at least one of the participants (parties) or the association itself has a monopoly position, or the parties’ combined market share will exceed 35 percent;<sup>5</sup> and
- Creation of a business entity—where the parties’ combined assets or turnover exceed \$12 million and at least two non-affiliated parties each have assets or turnover exceeding \$1 million or the parties’ combined market share exceeds 35 percent or one party has a monopoly position or the joint venture will have a market share exceeding 35 percent.<sup>6</sup>

### **Other Criteria**

In addition to these thresholds, the AMC uses other criteria for determining whether a certain transaction will lead to a monopoly on a particular market. For example, regarding the 4th bulleted point above, Article I of the Law “On Restricting Monopolies and Preventing Unfair Competition in Entrepreneurial Activity” (Law No. 2132/92) defines “control” as “a deciding influence of a legal or physical entity on the economic activity of a business entity, which influence is exercised by the following:

- the right to possess or use all assets and a significant part thereof;
- the right which will ensure a deciding influence on the formation of the composition, voting results and resolutions of a business entity’s governing bodies;
- the conclusion of agreements which makes it possible (i) to determine the terms and conditions of economic activity; (ii) to give mandatory instructions; or (iii) to fulfill the functions of a business entity’s governing body;
- the occupation of the position of chairman or deputy chairman of the supervisory council or the management board, or any other surveillance or executive body of a business entity by a person, who already occupies one or more of the above positions in other business entities; and
- the occupation of more than half of the positions of members of the supervisory council, management board or other supervisory or executive bodies of a business entity by persons, who already occupy one or more of the above positions in another business entity.”

### **Agency Has Wide Discretion**

Moreover, Law No. 2132/92 defines “monopoly position” as “a dominating position of a business entity,

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## Antimonopoly *(from page 16)*

which makes it possible to independently or together with other business entities restrict competition on a specific product market. A business entity is deemed a monopoly if its share on a specific product market exceeds 35 percent. The AMC may, at its discretion, determine a monopoly position of a business entity whose market share is less than 35 percent." The last statement in this definition encourages all foreign investors and Ukrainian businessmen to run their transactions by the AMC, even if there is only a remote possibility that the transaction will lead to a 35 percent concentration on a market.

The AMC also analyzes all transactions in terms of their "economic concentration," which includes: (i) the creation, reorganization (merger, consolidation) of business entities, such as limited liability companies, joint stock companies, additional liability companies, general or limited partnerships, associations, concerns, corporations, consortiums, other associations of enterprises and industrial-financial groups; (ii) the expansion of an association by the joining of one or more business entities thereto; (iii) the direct or indirect acquisition of shares, assets or control in any manner in a business entity; and (iv) the lease of integrated property complexes of business entities or any structural subdivision thereof.<sup>7</sup>

As a matter of procedure, the AMC compares the documents submitted by the requesting party with the above-listed thresholds.

### Reply by AMC Required within 30 Days

Once an application has been filed and the AMC has completed its review, the AMC's final consent to a transaction is due within 30 days after acceptance of the application, provided that no grounds exist to prohibit an intended transaction (i.e., the applicant has provided all required documents and information, and the AMC has determined that there will be no market concentration). If the AMC discovers grounds for the possible prohibition of a transaction, or in cases when further investigation is necessary to examine an intended transaction, the AMC's decisions are due within three months from the initiation of additional investigations. This second stage, three-month period is extendible up to a further three months by the Chairman of the AMC if he deems it necessary under the circumstances.

<sup>1</sup>Articles 4.5, 4.6 and 4.7 of Order No. 134-r "On the Regulations on the Control Over Economic Concentration," dated May 25, 1998.

<sup>2</sup>*Id.*, Articles 4.10 and 4.11.

<sup>3</sup>*Id.*, Article 4.11.

<sup>4</sup>*Id.*, Article 4.

<sup>5</sup>*Id.*, Article 4.4.

<sup>6</sup>*Id.*, Articles 4.1, 4.2 and 4.3.

<sup>7</sup>Article 2 of Order No. 134-r "On the Regulations on the Control Over Economic Concentration," dated May 25, 1998, registered with the Ministry of Justice of Ukraine under No. 409/2849. □

## Czech Code *(from page 2)*

price thereof for the purposes of making a public offer of new shares (s. 216c).

### Mergers and Acquisitions

Most notably, the useful squeeze-out procedure introduced in 2001 by section 220p, whereby a shareholder holding more than 90 percent of the registered capital of a stock corporation was able to approve (via a special shareholders' resolution) the transfer to itself of all the assets and liabilities of the company, and compensate the minority in cash on reasonable terms, has been amended. Under the amendments, the required threshold has been raised from 90 to 95 percent of the registered capital and, more important, the majority shareholder may not vote on approval of the transaction (s. 220p (1)). The latter amendment clearly defeats the purpose of the provision.

Where, in a control agreement, the controlling person has undertaken to purchase the shares of the outside shareholders and such undertaking is not limited in time, the controlling person will not need to make the mandatory tender offer for the shares of the controlled company under section 183b and 183c (s. 183b (3)(e)).

Notably, the passing of the amendments was surrounded by controversy in the Lower House of the Parliament. As a result, a constitutional complaint has been filed in the Constitutional Court requiring the repeal of section 183b (3)(a). That section currently contains exemptions from the duty to make a mandatory tender offer, including an exemption for persons who acquired their shares in connection with privatization of state assets. Unfortunately, the scope of the constitutional complaint and its possible outcome are unclear, as are the potential effects that the complaint may have on investors acquiring shares in privatized Czech companies.

### Disclosure Alert

As most companies will have noticed, reports on relations within corporate groups (where control agreements have not been entered into) will have to be disclosed for the first time this year. Under the amendments, the report will have to be filed with the Commercial Register. Pursuant to section 66a (9) of the Commercial Code, the report must be drawn up within three months from the end of the previous financial year. For companies whose financial year is identical to the calendar year, this will be the end of March, 2002. □

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## Tax Changes *(from page 6)*

The accelerated depreciation is not available for the following:

- entities directly engaged in production activities prohibited by law;
- capital investment made out of non-refundable financial aid and grants.

### Withholding Taxes

Withholding tax rates applicable to “other income” from Azeri sources has been decreased from 15 percent to 10 percent.<sup>10</sup> This amendment results from a contradiction between two original provisions of the Tax Code, 2000, one stating that income from the lease of moveable and immovable property and royalties was subject to withholding tax at 10 percent,<sup>11</sup> and the other suggesting such income was subject to withholding tax at 15 percent.<sup>12</sup> This has now

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***Under the new provisions, depreciation on investments of capital goods may now be accelerated to four times the standard rate.***

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been resolved, with effect from January 1, 2002, by an amendment to the Code reducing the second rate to 10 percent.<sup>13</sup> This eliminates confusion arising, in particular, in relation to withholding tax on lease rentals.

### Value Added Tax

*Registration threshold.* The monetary threshold for value added tax (VAT) registration has been lowered and VAT registration is now obligatory for all persons whose taxable supplies for the last three months exceed 300 times (previously, 1,000 times) the non-taxable band of monthly salary (AZM 30,000,000).<sup>14</sup>

*Zero-rate VAT.* VAT at the zero-rate in relation to diplomatic missions and international cargo and passenger carriage will only be applied on the basis of reciprocity.<sup>15</sup>

*Credit for input VAT.* Credit for input VAT (i.e., VAT on payables) may now only be taken once it has been paid.<sup>16</sup> Previously, credit was available on an accruals basis, i.e., when an invoice was received.

*VAT—rules for alternative VAT calculation determined.* Alternative methods for calculating VAT have now been defined for certain particular types of transactions (e.g., sale of goods and services through agents, lotteries, etc.).<sup>17</sup> Transactions carried out by an agent are to be considered as performed by the principal (unless the principal is a non-resident and not registered for VAT purposes in Azerbaijan, in which case the transaction will be treated as being one carried out by the agent). A VAT-payer who conducts business both through an agent and directly must separately identify such transactions in his records.

*VAT recovery procedures for diplomats.* The tax authorities have introduced new rules for diplomatic missions and

diplomatic agents to assist them in the recovery of VAT. The new procedure does not constitute a normative legal act and, therefore, does not have the force of law.<sup>18</sup> Where a diplomatic mission or diplomatic agent wishes to recover VAT incurred in a transaction, the new rules require the mission to obtain a tax identification number and to submit quarterly reports appending, *inter alia*, tax invoices and receipts. Repayments of VAT will be made within 45 days or interest of 0.05 percent per day of delay will be paid. The procedures have an effective date of January 1, 2001, but were only made known to diplomatic missions in November, 2001.

### Social Security

The Tax Code 2000, in its early drafts, embraced both social security contributions as well as payments more generally accepted as taxes. However, the promulgated version of the Code did not encompass social security contributions though the draftsman failed to amend the definition of “tax” to accord with the omission. The definition of a “tax” has now been changed so that it no longer embraces contributions to State funds. One of the difficulties created by the previous definition was that the 1 percent levy on corporate profits payable to the Invalid Fund was fully within the definition of “tax” yet the Code did not authorize the levy. This anomaly has now been removed, although, in this particular instance, it has lost its importance in any event as the obligatory contributions to the Invalid Fund have effectively been repealed.<sup>19</sup>

*Social security contribution rate changes:* A new law amending the law On Social Insurance, 1997, became effective as of January 1, 2002. It has introduced important changes by, among others, effectively amending the rates of social insurance contributions. Most important, social insurance contributions payable by employers has been reduced to 29 percent (previously 30 percent), whereas employees’ contributions have been increased to 1.5 percent (previously 1 percent).

*Compulsory registration for social insurance.* The law On Individual Registration in the State Social Insurance System, 2001, was signed by the president on February 27, 2001, and published on December 29, 2001. It sets out rules and procedures for the collection and registration of information on each insured individual for the protection of their pension and social rights.

The State Social Protection Fund has been designated as the relevant executive authority responsible for carrying out the registration of individuals. Additionally, the law defines, among others, the form and content of individual registration, and the rights and obligations of insured individuals, employers and the State Social Protection Fund. The State Social Protection Fund is required to issue a State Social Insurance Certificate, which should be shown to a new employer upon hiring.

*Employment Fund contributions abolished.* Employers’ compulsory contributions to the Employment Fund of 2

*Continued on page 19*

## Tax Changes *(from page 18)*

percent of gross salaries have been abolished. The law On Employment, 2001, reduced employers' contributions to the Employment Fund from 2 percent to 1 percent. The law was published on August 15, 2001, and was intended to become effective on January 1, 2002. However, Article XXVII(3) of the law On Making Amendments and Additions to Various Laws of the Azerbaijan Republic published on December 29, 2001, has the effect of amending Article 18 of the law On Employment, 2001 so as to completely eliminate employers' contributions to the Employment Fund.

A further amendment affecting social security is that the control function of the tax authorities over payments to special purpose state funds has been formally abolished. In practice, this had already ceased following the introduction of the Tax Code, 2000.

The definition in the Tax Code, 2000, of "entrepreneurial activity" has been changed.<sup>20</sup> This previously referred to economic activity being carried out on a "regular" basis. The new definition is wide enough to encompass single transactions.

### Administration; Penalties; Interest

*Penalties for excise duty default.* All financial sanctions applicable to VAT now apply to excise tax.<sup>21</sup> Previously, the penalty for an excise tax understatement was 20 percent of the understated amount. The penalty for understatement has, consequently, been increased to 40 percent.

*New penalty for wrong accounting.* A new financial sanction of 20 percent of the unpaid tax has been introduced for not recording stock in accounting records.

Interest on overdue tax has been reduced to 0.05 percent per day (from 0.1 percent).

*Disclosure of information.* Certain provisions concerning the disclosure of customer-related information by banks to the tax authorities have been extended to include the accounts of entrepreneurs as well as legal entities.<sup>22</sup>

*Tax exemption for interest from securities and bank deposits.* Tax exemptions for bank interest and interest and dividends on securities have been extended until January 1, 2004, by a new law dated November 15, 2001. Ironically, although the law granting exemption for three years enters into force on January 1, 2002, the exemption commences on January 1, 2001. It appears, therefore, that the tax authorities have somewhat belatedly accepted arguments that the previous exemption, established under an amendment to the old law on income tax, was made invalid by virtue of the Tax Code, 2000.

### Registration; Accounting; Miscellaneous

*Tax-only registrations.* A new provision enables foreign companies with activities in Azerbaijan, which do not give rise to the creation of a permanent establishment, to register for tax purposes only.<sup>23</sup> However, in practice, meeting the requirements for such registration is likely to be problematic. Implementing regulations are awaited.

*Transfer-pricing* provisions have been expanded by applying market pricing standards to import-export transactions as well as barter, related-party and deeply discounted transactions.<sup>24</sup>

*New reporting requirements:* A quarterly report on withheld taxes should be filed within 20 days of end of the quarter.

The *simplified tax regime* is no longer simple.<sup>25</sup> It previously applied to all persons whose taxable supplies for the prior three months did not exceed 1,000 times the non-taxable band of monthly salary (i.e., equal to AZM 100,000,000). Such taxpayers did not have to register for VAT or pay taxes other than 2 percent of turnover. The threshold has been reduced to 300 times the non-taxable band of monthly salary (i.e., equal to AZM 30,000,000) and legal entities are also made payers of land and assets taxes.

*New law on State duties enters into force.* A new law On State Duties has been signed into law and became effective as of January 1, 2002 (thus effectively repealing the law On State Duties, 1995). In a departure from former procedure, the law itself establishes a list of specific activities subject to State duty and sets out the specific rates of duty applicable. Previously, the Cabinet of Ministers was in charge of determining the specific rates of State duty. The most important change relates to duty for the State registration of representative offices of foreign legal entities. This was previously \$2000 but is now the same as for branches of foreign legal entities and local banks, exchanges, insurance companies, etc. (around \$230).

<sup>1</sup>Law On Making Amendments and Additions to the Tax Code, 2001, made on November 16, 2001, and entering into force January 1, 2002 (Amendments, 2001).

<sup>2</sup>Amendments, 2001, Article 37, 38, amending Article 101 of the Tax Code, 2000.

<sup>3</sup>Amendments, 2001, Article 40, amending Article 102.1.4 of the Tax Code, 2000.

<sup>4</sup>Amendments, 2001, Article 45, repealing Tax Code, 2000, Article 106.3.

<sup>5</sup>Amendments, 2001, Article 46, amending Tax Code, 2000, Article 114. The new provision is somewhat ambiguously worded—it seems to intend to limit the application of accelerated depreciation to assets used in the production process (including buildings, structures, assets used in the expansion of an enterprise and in technological development, and motor vehicles used in production). However, it then adds "other assets" as also qualifying assets which appears to negate the earlier limitation.

<sup>6</sup>Intangible assets are included as a class of fixed assets although the definition of fixed assets given in Tax Code, 2000, Article 13.2.17 would seem to preclude this.

<sup>7</sup>Tax Code, 2000, Article 117.

<sup>8</sup>See Tax Code, 2000, Article 118.1.

<sup>9</sup>Land, fine art and other assets that do not deteriorate are not depreciable for tax purposes—Tax Code, 2000, Article 114.2. See also Cabinet of Ministers' resolution No. 5, January 4, 2001.

<sup>10</sup>Amendments, 2001, Article 47, amending Tax Code, 2000, Article 125.1.5.

<sup>11</sup>Tax Code, 2000, Article 124.

<sup>12</sup>Tax Code, 2000, Article 125.1.5 which refers, *inter alia*, to Tax Code, 2000, Article 13.2.16.10, 13.2.16.11, 13.2.16.12.

<sup>13</sup>Cf. the law On Making Amendments and Additions to the Tax Code, 2001, Art. 47.

<sup>14</sup>Amendments, 2001, Article 55, amending Tax Code, Article 155.1.

<sup>15</sup>Amendments, 2001, Article 63, amending Tax Code, Article 165.2.

<sup>16</sup>Amendments, 2001, Article 64, amending Tax Code, Article 175.

<sup>17</sup>See Cabinet of Ministers' resolution No. 135, 8 August 2001.

<sup>18</sup>Procedural Rules for Zero-rate Taxation of Value Added Tax in respect of Official Use by Foreign Diplomatic Missions and Similar Representations, etc., July 13, 2001.

<sup>19</sup>Law On Making Amendments and Additions to Various Laws of the Azerbaijan Republic published on December 29, 2001, Article 1, amending the law On Preventing Disability, and the Social Insurance and Rehabilitation of Invalids, 1992, Article 5.

<sup>20</sup>Amendments, 2001, Article 7, amending Tax Code, 2000, Article 13.2.37.

<sup>21</sup>Amendments, 2001, Article 21, 22, amending Tax Code, 2000, Article 58.3.

<sup>22</sup>Amendments, 2001, Article 30-33, amending Tax Code, 2000, Article 76.

<sup>23</sup>Amendments, 2001, Article 15, adding new Article 33.8 to the Tax Code, 2000.

<sup>24</sup>Amendments, 2001, Article 8, amending Tax Code, 2000, Article 14.3.1.

<sup>25</sup>Amendments, 2001, Article 55, 78, amending Tax Code, 2000, Article 155.1, 219.2. □

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