RUSSIAN M&A LEGAL AND TAX DIGEST

GOLTSBLAT BLP

Goltsblat BLP is the Russian practice of **Berwin Leighton Paisner (BLP)**, an award-winning international law firm

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I. KEY RECENT LEGAL AND TAX DEVELOPMENTS IN THE M&A AREA

1. Russian antimonopoly law can now explicitly capture transactions that do not involve Russian assets

In January 2012 the so called Third Antimonopoly Package has come into force. One of the important premises of the new law is that it applies to agreements made outside Russia if such agreements or actions impact competition in Russia.

In particular, clearance of the Russian antimonopoly service is now required if the buyer acquires more than 50% control in any foreign company that has supplied goods or services to Russian customers worth over RUR 1 bln (or approx USD 35 mln) during the pervious year.

2. Compliance with thin capitalization rules becomes critical

Historically, Russian thin capitalization rules have been largely irrelevant, since, as you are aware, most taxpayers avoided them either through the 'sister-company' loophole (a loan from an affiliated 'sister' company is technically not subject to thin capitalisation) and/or under non-discrimination or special deductibility provisions in the protocols to double tax treaties.

The recent *Severny Kuzbass (*ArcelorMittal subsidiary) and *BMZ* (Transmashholding subsidiary) case, both the non-discrimination and the protocols based defences are largely no longer available. The "sister-company" defence has recently also been successfully challenged in the Naryanmarneftegaz (ConocoPhillips / LUKOIL JV) case based on the "conduit" (artificial) company concept.

In this context it is important to revisit the historical financing structures you have been using for your Russian transactions / businesses, and the potential need to comply to the 3 to 1 debt to equity ratio for debt-financed acquisitions going forward.

3. Maintaining proper substance in Russia-related cross-border structures becomes important

Recently the Russian tax authorities attempted to challenge double tax treaty benefits in several Eurobond structures on the basis that the specific company in the structure had allegedly not been a "beneficial owner" of the interest paid to it.

Although the tax authorities eventually agreed not to attack Eurobond structures for Eurobonds that have been issued prior to 01 January 2013, proving that a foreign company receiving the income is the "beneficial owner" of such income for Russian tax purposes will likely become important in any cross-border structures used for Russian acquisitions.

This means that if you intend to rely on any double tax treaty benefits (eg lower withholding tax rate for dividends or exemption for interest etc) you need to make sure that the foreign company receiving income from Russia has proper business substance.

4. International structuring through Cyprus now requires more care

The State Duma (the Russian Parliament) has eventually ratified the Protocol Amending the Agreement between the Government of the Republic of Cyprus and the Government of the Russian Federation for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital dated 5 December 1998 on 28 February 2012.

The Protocol will constitute an integral part of the Agreement. Technically, it will come into effect on the date of the last of the notifications on completion of relevant intra-state procedures and will apply from the beginning of the subsequent calendar year. On completion of the procedures (which we expect to be completed this year), the Protocol is expected to become effective on 1 January 2013.

The Protocol introduces some important changes to the Agreement which reduces its effectiveness in protection against Russian taxes, as well as gives additional powers to the Russian authorities in information collection and rights to deny treaty benefits (for more details please refer to our detailed legal update).

5. Supreme Arbitration Court provides clarifications on the use of penalties

Russian Supreme Arbitration court has recently issued additional guidance on the use of penalties under Article 333 of the Russian Civil Code (which are sometimes used as a compensatory mechanism in transactions structured under Russian law), significantly reducing the courts' discretion in reducing the amount of penalty agreed by the parties.

This should allow wider use of compensatory penalties in transactions that have to be structured under Russian law (eg in Russian law shareholder agreements).

6. Rules for Foreign Investments into Strategic Enterprises Revised

Early 2012 long time expected new amendments to law on foreign investments into strategic enterprises have been adopted. They improve the environment in general and in particular include the following key updates:

1. Transactions involving international financial institutions (including EBRD, IFC, and some others) will not be subject to prior approval under the Federal Law.

2. The Law will not apply to transactions between organizations under the control of the Russian Federation or citizens of the Russian Federation that are, under the Russian legislation, tax residents of the Russian Federation (apart from Russian citizens with dual citizenship).

3. In relation to a Russian strategic company using subsoil sectors of federal significance, control by a non-government foreign investor or group of persons and prior approval of their transactions will start not from 10 but 25 per cent of the total votes on the shares or the governance bodies of such a company.

4. Some types of strategic activity are specified in more detail and now exclude: (i) operation of radiation sources by companies in the civil sector of the economy for which this does not constitute their core business; (ii) licensable distribution and technical maintenance of encryption (cryptographic) means, provision of services in the sphere of information encryption by banks with no state participation.

II. TAX TIP: FACTOR IN INCREASED TAX BURDEN IF PURCHASING A BUSINESS THAT CURRENTLY USES SIMPLIFIED TAX REGIME

Russian small and medium sized business have often different tolerance of tax risks as compared to foreign investors. They also often use simplified tax regime, which provides significant tax benefits as compared to a regular tax regime. This regime, however, is available only to companies at least 75% owned by individuals.

As a result, purchasing such business by a corporate entity will result in additional taxes going forward with resulting reduced cash flow and lower valuation.

III. LEGAL TIP: TREATMENT OF REPRESENTATION, WARRANTIES AND INDEMNITIES IN ENGLISH AND RUSSIAN LAW

(an extract from Use of English Law in Russian Transactions by Ian Ivory and Anton Rogoza)

English law position

Representations under English law are statements by one party which induce another party to enter into a contract. If the statement is untrue or incorrect the other party may be entitled to 'rescind' the contract, effectively unwinding it, and / or to claim damages. The aim of the damages is to put the innocent party in the position it would have been in had the false statement not been made, in other words, as if it had not entered into the contract.

Warranties are terms of a contract which, if breached, will entitle the innocent party to claim damages (but not generally to rescind or terminate the contract). The aim of these damages is different to those that may be awarded for misrepresentation: the contractual measure of damages aim to put the innocent party in the position it would have been in had the breach not occurred.

Warranties are used by a buyer or bank to obtain contractual statements and reassurances from the seller / borrower about the status of the target company and its business, assets, liabilities and financial position.

English law contracts offer a lot of flexibility when dealing with warranties. A warranty can relate to any event or possible future event (such as the reasonableness of a profit forecast), whether or not that event is within the control of a party to the contract.

Typically a buyer or bank lender will try to get both representations and warranties from a seller / borrower in the contract, in order to give itself maximum fl exibility with its remedies if it needs to bring a legal claim.

Some examples of warranties:

- "the Shares constitute the whole of the issued and allotted share capital of the Company";
- "the Accounts give a true and fair view of the assets

and liabilities of the Company as at the Accounts Date and its profits for the financial period ending on that date";

- "the Company has no bank or loan facilities outstanding";
- "the Company has no outstanding liability to tax".

In certain situations, English law may imply terms into a contract, based on usage or custom, a previous course of dealing or the intention of the parties. In addition, certain statutes provide for terms to be implied into specific types of contract, such as contracts for the sale of goods.

Indemnities are agreements to compensate for loss arising from a particular liability and tend to be used where there is a known or potential, clearly identifiable liability, such as a tax liability, a potential environmental claim, or a specific issue arising from due diligence.

Unlike the usual position for warranties, indemnities under English law are not usually qualified or reduced by disclosures or by the knowledge of the buyer and there is usually no duty on the part of the indemnified party to mitigate loss.

English law clearly recognises representations, warranties and indemnities. These are often essential on international finance and M&A transactions and many deals would be difficult to structure without them.

Russian law position

Russian law does not currently recognise indemnities as a legal concept.

With regards to warranties, there are some implied warranties under the Russian Civil Code in relation to the sale of assets (which could include the sale of shares) relating to title and unencumbered ownership and some basic assumptions about the quantity and the quality of the asset. However, these principles were aimed more at consumer transactions and are fairly limited in the context of an international finance or M&A deal. They cannot be altered or extended (or reduced) by contractual agreement between the parties. Under Russian law, a seller cannot be held liable for any false statements.

Fundamental issues such as protection for liabilities cannot currently be dealt with under Russian law warranties. Also, on a sale of shares in a company, the implied warranties under Russian law will only relate to the shares themselves and not to the title, ownership, condition, etc. of the underlying business and assets of the company to which the shares relate.

Professionals, however, have great hopes for the new Civil Code, which is currently being widely discussed. A draft of the new Civil Code provides specifically for such a new legal institution as warranties. They are defined as statements of fact that are important for the signing and fulfilment of a contract. The draft also introduces a new category of a creditor's losses incurred in connection with fulfilment, change or termination of an obligation. The key feature of such losses is that they do not need to be related to any breach by the debtor. Potentially, this new category of losses can be used in practice as an equivalent to indemnities.

IV. RECENT DEAL HANDLED BY BERWIN LEIGHTON PAISNER IN RUSSIA

Our team have recently helped North Caucasus Development Corporation (VEB's subsidiary) to structure its investment into the first stage of construction of the Arkhyz All-Season Mountain Resort. This included developing a legal structure for the investment (that included developing proper protection of investor's position under Russian law), performing due diligence, drafting and negotiating shareholder agreements, as well as handling subsequent successful closing of the transaction.

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