Morgan Lewis

newsletter

russian law update

Introducing Our Russian Law Practice

Our offices in Moscow, Russia, and Almaty, Kazakhstan, opened in 2012 with the addition of a team of 45 lawyers from another prominent international firm. We represent international and domestic clients in the region encompassing the Russian Federation, the Republic of Kazakhstan, and the Commonwealth of Independent States (CIS), including Central Asia and the Caspian.

This newsletter summarizes recent legal developments in the Russian Federation that we hope will be of interest to you.

Reform of the Russian Civil Code: Changes in Legal Entities

The ongoing process of Russian corporate reform continues in an effort to streamline the operations of companies and bolster protections for investors. Russia is currently considering important changes to the Civil Code that will affect the types and forms of legal entities available for business activity. These are currently being considered by the Russian parliament and could be enacted later this year, although the exact timing is unclear as of this writing.

Public and Private Companies

Currently, Russian law distinguishes between different forms of stock companies, namely a closed stock company (*zakritoe aktsionernoye obschestvo*, or ZAO) and an open stock company (*otkritoe aktsionernoye obschestvo*, or OAO). The shares of an OAO may be freely bought and sold, and this form of entity is typically used for companies listed on a stock exchange. In a ZAO, existing shareholders have a "right of first refusal" to purchase shares being sold by a fellow shareholder to a third party. There are additional differences between a ZAO and an OAO, mainly relating to corporate governance rules.

Under the proposed amendments, there will be three principal forms of commercial companies: the public stock company (*publichnoye aktsionernoye obschestvo*, or PAO), the nonpublic stock company (*nepublichnoye aktsionernoye obschestvo*, or NAO), and the limited liability company (*obschestvo s ogranichenii otvestvenosstiu*, or OOO). The PAO and NAO are brand new forms of companies; the OOO is not new, but will be subject to certain new rules.

Stock Companies

In brief, a PAO will have shares or securities convertible into shares that are offered to the public or listed on a stock exchange. The proposed Civil Code provisions will establish certain new requirements for PAOs, including a prohibition on limiting the number of shares that may be owned by a single shareholder, the appointment of a board of directors with at least five members, and arrangements for a professional registrar to maintain a shareholder register and verify compliance with procedural and voting rules at shareholder meetings. These changes are clearly intended to address past complaints about corporate governance in Russian public companies.

All stock companies not meeting the requirements for a PAO will be NAOs. The NAO is relatively flexible with respect to internal corporate governance rules. For example, the company charter of a NAO may specify that certain key decisions have been delegated to the board of directors, such as approval of annual reports and financial statements, incorporation of and participation in subsidiaries, determination of priority areas of business, and certain other matters. In a PAO, only shareholders may decide these matters. However, other rules remain mandatory for all stock companies.

Interestingly, new NAOs will not have one key feature of ZAOs: there is no required "right of first refusal" on shares sold by fellow shareholders. Presumably, this feature can be included, if desired, by agreement of the shareholders.

Both PAOs and NAOs will be required to engage an independent auditor to audit and confirm the accuracy of their annual financial statements. This may substantially raise the costs of operating a stock company and may lead many private companies to use the OOO form instead.

OOOs

The new Civil Code provisions do not change the fundamental aspects of OOOs under Russian law, but will implement certain changes to management and operating rules. For

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example, a person appointed as the "sole executive body" (e.g., the general director or president) or a member of a "collegial executive body" (e.g., a management board that operates the company) may not also serve on the board of directors. However, OOOs will be subject to relatively few such mandatory rules and will likely remain the most popular and cost-effective option for private companies.

Transition

Once the new Civil Code provisions become effective, new companies will be required to utilize only the new forms of legal entities. Existing companies will not be required to convert to the new forms or "reregister" immediately. Instead, a transition period until July 1, 2013, will be established for existing ZAOs to convert to OOOs or production cooperatives. Other existing companies will be required to reregister their charters and company names to bring them into compliance with the amended Civil Code only when they make further amendments to their charters. However, even before such reregistration occurs, in case of any conflict, existing charter provisions will be superseded by the provisions of the amended Civil Code.

Russia's Accession to the WTO

In December 2011, the protocol on Russia's accession to the World Trade Organization (WTO) was signed at the Eighth Ministerial Conference in Geneva, ending 18 years of negotiations. Ratification by the Russian parliament and the signature of President Vladimir Putin followed in July 2012, which means Russia will become a full member of the WTO as of August 23, 2012.

Reduced Tariffs. WTO membership may require substantial adjustments in the Russian domestic economy, as local producers will face increasing competition from abroad. According to the Russian Ministry of Economic Development, import tariffs will be reduced on average by 3% for most goods and services and 4.4% for agricultural goods. Implementation periods ranging from two to eight years will be applied to import tariffs on certain groups of goods and services. Russia has also committed to eliminating a broad range of subsidies for domestic producers. However, annual state subsidies in the agricultural sector will be allowed — up to US$9 billion upon accession and up to US$4.4 billion by 2018.

Foreign Investment. As part of its WTO commitments, Russia has negotiated a number of special provisions relating to foreign investment in the banking, insurance, and telecommunications sectors. Russia has reserved the right to limit foreign investment to no more than 50% of the aggregate charter capital of all banks, although at present no such quota has been imposed. No restrictions will be allowed on foreign equity investment in individual banks. Foreign banks will still not be allowed to establish their own branches in Russia, although the Russian authorities have proposed to review this position in the future.

Different rules will apply for the insurance sector. The quota on foreign investment in Russian insurance companies will be increased from 25% to 50% of the aggregate charter capital of all insurers. A separate 49% cap on foreign ownership of Russian companies that provide life insurance and mandatory insurance (such as vehicle liability insurance) will be raised to 51% upon accession and eliminated after five years; but in any case, the cap does not apply to investors from the European Union. In an even more dramatic step, foreign insurance companies will be allowed to establish their own branches in Russia nine years after accession.

As for the telecommunications sector, Russia has reserved the right to limit aggregate foreign investment in the charter capital of certain domestic operators to 49% until four years after accession. However, no such limit has been imposed so far. This rule does not apply to television or radio broadcasters (although they remain subject to other restrictions under the existing Law on Mass Media).

Many other sectors will be affected by the accession to the WTO, and further developments are expected as the Russian government and local businesses implement and adapt to the new changes. Look for future articles about this subject as Russia continues its transition.

Arbitration of Disputes in Russia: Recent Developments

Submission of Corporate Disputes to Arbitration

It is increasingly common in Russia for contracts to require arbitration rather than litigation as a binding means of dispute resolution. The Russian legal system recognizes both domestic and foreign private arbitration.[1] However, the scope of matters subject to arbitration remains controversial because the Russian courts assert exclusive jurisdiction over certain types of disputes. Some recent cases have tested the boundaries of this exclusivity.

Particular attention has focused on Articles 33 and 225.1 of the Russian Commercial Procedure Code (the Code), which provide that commercial courts have jurisdiction over:

> [D]isputes related to the creation of a legal entity, its management or participation in a . . . commercial organization[,] . . . including the following corporate disputes:
>
> 1) disputes relating to the establishment, reorganization and liquidation of a legal entity;
>
> 2) disputes relating to the ownership of shares or equity interests in the charter capital of business entities[,] . . . [and] creation of encumbrances [over such shares or interests] and enforcement thereof . . . ;
>
> 3) disputes regarding claims of the founders [or] members of a legal entity . . . for damages caused by a legal person, invalidating transactions conducted by a legal entity, [and/or] the application of consequences of [such] invalidity . . . .[2]

This language has been subject to varying interpretations and has provoked some interesting litigation.

One prominent dispute involved a large Russian metals company, OJSC Novolipetsky Metallurgichesky Kombinat (NLMK), which was sued by Mr. Nikolai Maximov. The plaintiff claimed that NLMK owed him 9.5 billion rubles (approximately US$311 million) as payment for certain shares sold to NLMK under a sale-purchase agreement. The agreement provided for arbitration in Russia under the rules of the International Commercial Arbitration Court (ICAC), a well-known local arbitration body. Proceedings were held, and the arbitration tribunal found for Mr. Maximov, awarding him 8.9 billion rubles (approximately US$292 million) plus interest.

At that point, NLMK appealed to the Russian courts, which is allowed under local procedural rules.[3] The Moscow City Commercial Court overturned the ICAC award on a number of grounds, including the rule that "corporate disputes" may not be resolved by arbitration. Mr. Maximov then appealed unsuccessfully to a higher court, the Federal Commercial Court for the Moscow Circuit, and to the Supreme Commercial Court. Both courts declined to grant relief and left in place the original lower court decision not to recognize the ICAC arbitration award.[4]

However, at the same time, the same parties were engaged in separate proceedings in the same Moscow City Commercial Court in which NLMK sought a ruling that the sale-purchase agreement was invalid and the purchase price should be returned to NLMK. In these proceedings, the court dismissed the complaint on the grounds that the parties had agreed to binding arbitration of their disputes. NLMK then appealed to the Ninth Commercial Court of Appeals, which reversed the lower court ruling primarily on the basis of Articles 33 and 225.1 of the Code. Mr. Maximov further appealed to the Federal Commercial Court for the Moscow Circuit. This court reversed the rulings of both the Moscow City Commercial Court and the Ninth Commercial Court of Appeals and sent the case to the Moscow City Commercial Court for reexamination of the issues, based on the limitations imposed by Russian law on the submission of certain disputes to arbitration. The case is ongoing.

In view of such inconsistent judicial practice, it is difficult to maintain full confidence that the Russian courts will respect the voluntary agreement of contract parties to submit certain types of disputes to arbitration. Such disputes include the amorphous category of "corporate disputes," which in practice is being interpreted to include conflicts concerning sales and purchases of shares. Some prior authority suggests that the Russian courts are only intended to have exclusive jurisdiction over disputes that have a "public element," such as real property disputes where the decision of a state agency to register title is at issue.[5] However, the practical consequences and limitations remain unclear.

Nonexclusive Arbitration Clauses

In current Russian business practice, parties to a contract sometimes agree to so-called alternative or optional jurisdiction clauses, which provide that (1) *either* party may refer a dispute to the state courts or private arbitration (a "symmetrical" nonexclusive dispute resolution clause) or (2) *only one* of the parties may select the state courts and/or private arbitration in its discretion (a "unilateral" clause). Unilateral clauses most often appear in cross-border loan agreements, where the lenders require that they be given the exclusive right to choose the forum. Such provisions are controversial in Russia. It has been argued that because it grants sole decision rights only to one party, a unilateral clause violates the rights of the other party to obtain equal access to justice and the courts.

Such discussions were largely hypothetical until late 2009, when the Federal Commercial Court for the Moscow Circuit considered a clause in a loan agreement that provided for arbitration to settle any disputes, but also gave the lender the option of bringing proceedings in English courts and any other courts that may have jurisdiction. The court upheld the clause since it complied with the governing law chosen by the parties (English law) and was not contrary to Russian law. However, although interesting, this decision was not binding precedent on other courts.

More recently, the Supreme Commercial Court, whose decisions are likely to be given substantial weight by lower courts, has considered the same issue in relation to another case. The relevant dispute arose between JSC Russian Telephone Company (Russian Telephone) as plaintiff and a Russian subsidiary of Sony Ericsson Mobile Communications AB (Sony Ericsson) as defendant, regarding claims for replacement of defective mobile phones under a supply contract. The dispute resolution clause gave Sony Ericsson the unilateral right to bring proceedings in any competent court or to arbitrate. The Moscow City Commercial Court upheld the clause and declined to hear the claim. Instead, it ruled that Russian Telephone needed to commence arbitration proceedings as per the agreement of the parties.

On appeal, both the Ninth Commercial Court of Appeals and the Federal Commercial Court for the Moscow Circuit upheld the lower court ruling. However, Russian Telephone then appealed to the Supreme Commercial Court, arguing *inter alia* that a nonexclusive arbitration clause violates the basic principle of equality of the rights of both parties before the law, and thus is contrary to the fundamental principles of Russian law.

On June 19, 2012, the Supreme Commercial Court reversed all previous court rulings and remanded the case for further consideration by the Moscow City Commercial Court. As the full text of the decision has not been published yet, the ramifications are unclear. We will be watching further developments closely, as this case could significantly affect future practice concerning dispute resolution clauses.

endnotes

1. Such private arbitration should not be confused with litigation in the Russian state commercial courts, which are known in Russia as *arbitrazhniye* (literally "arbitration") courts.
2. Similarly, Article 248 of the Code grants the courts sole jurisdiction over disputes relating to (1) property owned by the Russian Federation and privatization-related matters; (2) real property located in Russia and related rights; (3) registration of patents and patent rights; (4) invalidation of entries in state registers; and (5) the incorporation and registration of legal entities in Russia and challenges to decisions of the governing bodies of legal entities.
3. Article 230 of the Code.
4. Interestingly, Mr. Maximov managed to have the award recognized in France in June 2012, despite the adverse rulings of the Russian courts. As of this writing, enforcement efforts appear to be ongoing. Mr. Maximov has also submitted a petition to the Russian Constitutional Court.
5. There is a substantial body of such authority, including Supreme Commercial Court (SCC) Informational Letter No. 96 of 2005 and decisions of the SCC and the Constitutional Court in 2010 and 2011. Notably, the Constitutional Court criticized the attempts of lower courts to restrict the arbitrability of real property disputes.

Shareholders' Agreements: Proposed Amendments

The "shareholders' agreement" is a relatively new concept in the Russian legal system. In the past, joint ventures in Russia have typically been organized through offshore holding companies, with agreements between shareholders and other legal documentation governed by foreign law. Investors argued that such arrangements were necessary to provide legal certainty and stability.

In response to such concerns, Russia adopted changes to its laws on joint stock companies and limited liability companies in 2008 and 2009. The amendments provided an express legal basis for agreements between shareholders, thus encouraging investors to choose Russian law and offering guidance to Russian courts and other authorities.

However, a number of important aspects of shareholders' agreements under Russian law remained unclear, such as the scope of rights that may be governed by such an agreement. Recent court practice on such matters has not been encouraging. For example, in one recent case, the court found many provisions in a shareholders' agreement to be invalid. These included the obligation to vote unanimously on certain matters, the right of a particular participant to nominate the general director, certain share transfer restrictions, and a call option in case of deadlock.

New proposed amendments. To further promote the use of Russian law–governed shareholders' agreements, draft amendments to the Russian Civil Code were submitted to the Russian parliament in April 2012. The new legislation would clarify the rules governing shareholders' agreements for Russian companies and provide additional flexibility on certain issues. Key changes would include:

- The decision of a company's management body that breaches the shareholders' agreement may be challenged in court, *provided* that (1) all shareholders were parties to the agreement when the decision was adopted and (2) revoking the decision would not violate the rights of third parties.
- Shareholders will be required to inform the company that they have entered into a shareholders' agreement. For public companies, details of the agreement must be disclosed.
- Shareholders will be free to choose the governing law of the shareholders' agreement, whether Russian or foreign law. However, the choice of law will not affect the mandatory rules of the country with jurisdiction over corporate governance. Accordingly, if English law is selected to govern a shareholders' agreement with respect to a Russian company, this will not override the mandatory rules of Russian corporate law with respect to such matters as shareholder voting and minority rights. Still, this change may facilitate the use of familiar concepts from Western practice such as put and call options upon exit or termination of the agreement.

It is expected that the new amendments may lead to an increase in Russian law–governed shareholders' agreements, especially in joint ventures with state-owned companies that may have a strong preference for transaction documents governed by Russian law.

Copyright Infringement: Liability of Internet Service Providers and Website Owners

The main body of Russian intellectual property (IP) legislation is contained in Part IV of the Civil Code and generally corresponds to international standards. Russia is a party to the major international IP treaties, such as the Berne Convention, the Madrid Agreement Concerning International Registration of Trademarks, and other agreements administered by the World Intellectual Property Organization, as well as the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) (which Russia joined as a prerequisite to its accession to the World Trade Organization (WTO)).

Nonetheless, in practice, substantial piracy of IP continues to occur in the Russian market, prompting complaints from the international business community. In response, and particularly as part of the steps required to join the WTO, the Russian authorities have undertaken substantial efforts to adopt reforms and enhance enforcement of IP rights.

Particular attention is now being paid to piracy on the Internet, with a focus on copyright infringement. This is especially relevant given the popularity of the Internet in Russia; 70 million Russians have Internet access, and the market continues to grow impressively.

In the latest proposed reform, Part IV of the Civil Code would be amended to impose "contributory liability" on Internet service providers (ISPs) and other online service providers, such as website owners, "torrent trackers," and operators of social networks (collectively, Operators), in connection with piracy involving their platforms, such as the distribution of films, television programs, or videos without the permission of the copyright owners.

In the past, Russian law generally has not recognized the notion of contributory liability for ISPs or Operators. Persons uploading unauthorized content onto the Internet could certainly be found liable for copyright infringement;[1] however, they were often hard to identify or catch. In contrast, ISPs and Operators were relatively easy to identify, but were not considered to be liable for infringing content being transmitted and/or received by their customers.

Following developments in some other countries, Russia will now seek to impose liability on ISPs and Operators. The policy argument is that while they are not "primary" infringers, ISPs and Operators offer web space, file storage, and other technical support for uploaders and profit from the use of infringing material. Further, ISPs and Operators are in a position to block infringing content upon notice from copyright owners.

Accordingly, the draft legislation introduces the concept of "information intermediaries" (i.e., ISPs and Operators) and establishes criteria to determine when they are liable for copyright infringement. In brief summary:

- ISPs will not be liable provided that (1) they do not change the information being transmitted and (2) they do not and could not know that the use of such information by the user is unlawful.
- Operators will not be liable provided that (1) they do not and could not know that the use of information by the user is unlawful, and (2) upon receipt of written notice from the copyright owner, they undertake all necessary measures to stop the infringement in a timely manner.

These rules are largely based on Russian court practice that has developed in recent years. In fact, certain Russian courts have taken a progressive approach to these issues and have interpreted the existing provisions of the Civil Code to expand potential liability for ISPs and Operators.[2] (Operators have generally responded by employing standard agreements with website users that seek to shift liability for infringement to the users.)

With the proposed new amendments, these recent trends will become formalized as statutory law. Once adopted, the amendments will allow copyright owners to pursue not only individual uploaders but also ISPs and Operators for copyright infringement on the Internet. In response, ISPs and Operators will need to consider making corresponding changes to their technical and business models, as well as to the legal documentation that they sign with users, to protect their legal position.

endnotes

1 Under Articles 1229.1 and 1270.11 of the Civil Code.

2 A recent prominent case was *First Music Publishing v. Rambler* in 2010. The Russian Internet portal Rambler was accused of uploading an infringing video to its website. After a series of appeals, the Russian courts concluded that, by not taking steps to locate the infringing uploader, Rambler did nothing to prevent the dissemination of the work. Further, Rambler did not provide any evidence that would lead to direct claims against the uploader. Accordingly, it was appropriate to hold Rambler liable.