

Russia

BAKER & MCKENZIE

Doing Business in Russia

May 2007

A photograph of a Russian Orthodox church, likely the Spasskaya Tower of the Moscow Kremlin. The image shows several white stone towers with dark, onion-shaped domes. The architecture is traditional Russian Orthodox. The sky is a clear, bright blue. The image is positioned at the bottom of the page, partially overlapping the blue background of the title.

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PREFACE

Baker & McKenzie provides sophisticated legal advice to the world's most dynamic global enterprises, and has done so for more than 50 years.

With a network of more than 3,400 locally qualified, internationally experienced lawyers in 70 offices across 38 countries, we have the knowledge and resources to deliver the broad scope of quality services required to respond effectively to both international and local needs – consistently, with confidence and with sensitivity to cultural, social and legal differences.

Active in the USSR and the Commonwealth of Independent States for over 40 years, with offices in Almaty, Kyiv, Moscow and St. Petersburg, we now have one of the largest legal practices in the region, offering expertise (in close cooperation with our offices worldwide) on all aspects of investment in the region including corporate law, banking and finance, securities and capital markets, venture capital, competition law, tax and customs, real estate and construction, labor and migration, intellectual property, and dispute resolution.

The first western law firm to be registered with the then Soviet authorities, our Moscow office was opened in 1989, followed by the opening of our St. Petersburg office in 1992.

Since the dissolution of the Soviet Union in 1991, the Russian Federation has adopted new legislation at a rapid pace. It remains a country in transition and its legal system in continued development. *Doing Business in Russia* has been prepared as a general guide for companies operating in or considering investment into the Russian Federation. It is intended to present an overview of the key aspects of the Russian legal system and regulation of business activities in this country.

The information contained in this guide is current as of the date below. We will be happy to provide you with updates on the material contained in this guide, or to provide you with further information regarding a specific industry or area of Russian law in which you may have a particular interest.

1. RUSSIA – AN OVERVIEW

1.1 Geography

The Russian Federation stretches across Eurasia from Eastern Europe to the Pacific coast. Even after the collapse of the Soviet Union, Russia remains the largest country in the world in terms of territory.

1.2 Population

The population of the Russian Federation numbers approximately 143 million. Although approximately 80% of the country's population are ethnically Russian, the Russian Federation is a multinational state and is home to numerous ethnic minority groups, including sizeable Tatar (3.8%) and Ukrainian (2%) populations. About 73% of the population live in urban areas and 13 cities have a population of over 1 million. The largest city in the Russian Federation is Moscow, with a population of approximately 10.4 million, followed by St. Petersburg, with a population of approximately 4.5 million.

1.3 Political System and International Relations

The Russian Federation is a federal republic consisting of 86 constituent entities. There are six categories of federal constituent entities which, while subtly different in classification, are constitutionally defined as equal members of the federation. The 21 republics (corresponding with the homelands of various ethnic groups) enjoy certain degrees of regional autonomy. The federation is further divided into 48 oblasts (regions), one autonomous oblast (autonomous region) and seven krais (territories) in which nine autonomous okrugs (autonomous districts, also delineated for various ethnic groups) are located. Moscow and St. Petersburg are classified as Cities of Federal Significance. In 2000, Russia was further delimited into seven federal super-districts (circuits) with the aim of ensuring federal supervision over regional affairs.

As constituent entities of a federal state, each constituent entity of the federation possesses its own foundation laws, political institutions and local legislation. Approximately half of the constituent entities have signed bilateral treaties that regulate the relationship between regional and federal governments. While significant progress has been made towards greater consistency between regional and federal legal systems,

when conducting business transactions at the regional level, treaty stipulations should be carefully reviewed as they may assign slightly different rights and privileges to the constituent entity in question.

Constitutionally, the President of the Russian Federation is elected for a four year term (limited to two terms) and is vested with extensive powers, serving as the head of state, the commander-in-chief, and the highest executive authority of the federation. The office of the President also includes the powers of decree, legislative veto, and the ability to appoint and dissolve the Government. The President is primarily responsible for domestic and foreign policy and represents Russia in international relations. Since the election of Vladimir Putin to the Russian Presidency in May 2000, the country has undergone a number of sweeping political reforms aimed at centralizing power within the federal executive. Mr. Putin was re-elected in March 2004. In September 2000, the President was given the power to dismiss both regional governors and legislatures if their acts are found to be in violation of federal law. A court decision must support such an order. Furthermore, as of December 2004, the President was granted the authority to directly appoint Russia's regional leaders, subject to confirmation from the regional legislature. Russia's next presidential election is scheduled for 2008.

The Prime Minister oversees the activities of the government and serves as the acting President if the President becomes ill and is unable to carry out the functions of that office. The Prime Minister's authority as the acting President ceases upon the election of the new President, which would normally be three months after the former President's authority extinguished.

The legislative branch of the Russian Federation is comprised of a bicameral Federal Assembly which consists of the Federation Council (upper house) and the State Duma (lower house). The composition of both houses underwent extensive reform in the 2000-2004 period. Since January 2002, the Federation Council has been comprised of two representatives from each federal constituent entity, one from the executive branch (appointed by the regional governor) and one from the legislature (nominated by the Speaker of the regional assembly), amending the previous system by which leaders of the regional legislative and executive branches served on the council *ex officio*. Additionally, in December 2004, the 225 single mandate seats in the State Duma (out of a total of 450) were abolished, confirming that in the next election (March 2008) all seats will be decided by proportional representation through national party lists. In addition, new rules were introduced governing national political parties,

increasing both the minimum number of party members required for registration (from 10,000 to 50,000) and the threshold to secure Duma seats (from 5% to 7% of the national vote).

At the top of the Russian judicial system are three high courts: the Constitutional Court, Supreme Court and Supreme Arbitrazh (Commercial) Court. The 19 justices of the Constitutional Court review all constitutional disputes. The Supreme Court reviews civil, criminal, and administrative disputes involving private individuals, while the Supreme Arbitrazh Court reviews commercial disputes and administrative disputes involving legal entities and individual entrepreneurs. Judges for all of these courts are appointed for life by the Federation Council on the recommendation of the President.

The lowest governmental level in the Russian Federation is local self-government. Reformed in September 2003, bodies at this level remain relatively new and untested. The current law distinguishes between community-level government and the governments of cities and counties, reforming the roles and responsibilities at each level. However, the overall influence of local self-government depends on how much authority has been delegated to local authorities by the regional government. Foreign investors should be aware of the position of local bodies in regions where business is conducted, since they may possess limited powers of taxation.

1.4 Economy

Since the dissolution of the Soviet Union in 1991, Russia has implemented a series of well-publicized economic reforms directed at dismantling the planned economy. In addition to an extensive privatization program in the early 1990s, the reforms were implemented through the removal of price controls, a decrease in state subsidies, a reduction of the public-sector role in the economy, active support of the industrial and service sectors, the liberalization of foreign trade, promotion of export growth, reduced regulation of capital transfers and exchange controls, and encouragement of foreign investment.

While the remnants of the planned economy have now all but disappeared, it is still too early to categorize Russia as a full-fledged free-market economy, although both the United States and the European Union have conferred this status upon it. Since the first five years of the reform period severely diminished both the size and industrial capacity of the Russian economy, with perhaps inevitable mistakes at both the federal and regional levels in the implementation of these reforms, increased prosperity has thus far continued to elude the majority of the Russian population. Only recently have

economic indicators began to point in a positive direction, with GDP increasing by an average 6.8% annually between 1999-2004, by 6 % in 2005 and 6.6% in 2006. This rapid economic expansion can be attributed to high oil prices, a weaker ruble and increasing service production and industrial output. Russia's continued economic difficulties are derived largely from the Soviet inheritance of artificial resource allocation, which, when removed in the early 1990's, quickly exposed an economy with endemic, high levels of mismanagement and corruption. In the 1990's the economy was plagued by a pattern of growing income inequality, an expanding shadow economy, shrinking Government revenues and expenditures, and poor macroeconomic policy. In combination with weakened central government authority, Russia's early experiment with the transition to a market economy was seriously compromised.

Russia's economic problems were further compounded by the financial crash of August 1998, inducing a major economic crisis. On 17 August 1998, the Russian Government announced a 90-day moratorium on certain foreign debt repayments, together with the planned restructuring of the Government's debt owed on treasury bills ("GKO's"). The subsequent combination of default and devaluation led to the near collapse of the Russian private banking sector, causing a panic on world markets. The results of the 1998 crisis included a sharp deterioration in living standards for much of the population, economic recession, and intense capital flight.

Since 1998 Russia successfully weathered the results of this financial crisis. With rising oil prices, several years ago, Russia no longer needed international financial assistance and has successfully paid down substantial portions of its foreign debt. In 2004, Russia created a stabilization fund which now has over USD 100 billion. In addition, real fixed capital investments have, on average, increased by 10% annually since 2000 while real personal incomes have increased on average by 12% annually. These achievements, in conjunction with renewed Government efforts to advance structural reforms, have raised business and investor confidence, with new business opportunities emerging in such sectors as telecommunications and electric power in particular.

1.5 Foreign Relations

Russia remains in the process of defining its position in the post-Cold War world. One of the primary accomplishments of Russian foreign policy has been an improved relationship with Western Europe and the United States, although this bond has been severely tested on several occasions. In the past few years Russia has been re-evaluating its foreign policy agenda in response to increased Western involvement in both Eastern

Europe and Central Asia. One of the key pillars of Russian foreign policy has been the Commonwealth of Independent States (CIS), whose membership is comprised of 11 former Soviet republics. While the CIS has struggled to establish itself as an effective and integrated body, its existence has had a significant impact upon transactions between its member-states. Currently, the most significant issue facing the CIS is the establishment of a “Common Economic Space” between Russia, Ukraine, Belarus, and Kazakhstan. Agreement in principle was announced in 2003, mandating the creation of a self-governing supranational commission on trade and tariffs. The ultimate goal is the creation of a regional organization with the ability to expand its membership and forge a currency union, the first stage of which was scheduled to begin in 2005. Another issue of central concern for the CIS is the Collective Security Treaty Organization (CSTO) of 2002, in which Armenia, Belarus, Kazakhstan, Kyrgyzstan, Russia and Tajikistan have agreed to abstain from the use or threat of force, and relinquish their right to join other military alliances based upon a mutual guarantee of collective security. Recently Russia has been very active in various Western programs, including the strengthening of the International Non-proliferation Initiative as well the formation of a joint Russia-NATO action plan on international terrorism, which envisages the exchange of confidential information as well as joint exercises and anti-terrorism training. Internationally, Russia continues to be an active member of all bodies of the United Nations, and retains a permanent seat on the Security Council with veto rights.

2. PROMOTING FOREIGN INVESTMENT IN THE RUSSIAN FEDERATION

2.1 The Foreign Investment Law

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

The *Law on Foreign Investments* guarantees foreign investors the right to invest and to receive revenues and profits from such investments, and sets forth the terms for foreign investors' business activity on the territory of the Russian Federation.

The objective of the *Law on Foreign Investments* is to attract foreign materials, financial resources, technology and management skills to improve the Russian economy, while providing stability for foreign investors. The *Law on Foreign Investments* aims for the Government of the Russian Federation to conform to standards of international law and to international standards of investment cooperation.

The *Law on Foreign Investments* emphasizes the role of both federal and regional legislation, and stipulates that foreign investors and investments must be treated no less favorably than domestic investments, with some exceptions. Such exceptions may be introduced to protect the Russian constitutional system, the morality, health and rights of persons, or in order to ensure state security and defense.

The *Law on Foreign Investments* permits foreign investment in most sectors of the Russian economy: portfolios of government securities, stocks and bonds, direct investment in new businesses, the acquisition of existing Russian-owned enterprises, joint ventures, etc. Foreign investors are protected against nationalization or expropriation unless such action is mandated by a federal law. In such cases, foreign investors are entitled to receive compensation for any investment and other losses.

One of the most important features of the *Law on Foreign Investments* is the tax stabilization clause set forth in Article 9. Under Article 9.1, the Law's tax stabilization clause, also known as "the Grandfather Clause", applies to i) foreign investors that are implementing "priority investment projects", ii) Russian companies with more than 25% foreign equity ownership, or iii) Russian companies with any foreign participation that are implementing "priority investment projects."

Article 2 defines a priority investment project as a project with foreign investment of at least 1 billion rubles (about USD 38 million at current exchange rates), or where a foreign investor has purchased an equity interest of at least 100 million rubles (about USD 3.8 million at current exchange rates); in either case, the investment project must also be included in a list of projects approved by the Russian Government.

For qualifying companies and projects, the Grandfather Clause prohibits increases in the rates of certain import duties and federal taxes until initial investments have been recouped (up to a maximum of seven years, unless this period is extended by the Russian Government under certain conditions). Key exceptions to the Grandfather

Clause are established for protective customs tariffs on commodities, excise tax, VAT on domestic goods, and Pension Fund payments. Article 9.4 provides a further and potentially broad exception for laws protecting certain public or state interests. Article 9.5 contemplates the adoption of regulations to implement the Grandfather Clause. Given all of these exceptions and qualifications, it remains arguable whether the tax stabilization clause is a real benefit for foreign investors.

2.2 Production Sharing Agreements

In the Russian Federation Production Sharing Agreements (PSAs) are used to provide a particular legal framework for foreign investors in mining, oil, gas, and other extraction sectors. The main legislation governing PSAs in Russia is the PSA Law. PSAs govern relations between federal and local government bodies and foreign investors, and have been vital in attracting foreign investments into Russia's natural resources sectors.

The main objective of the PSA legislation is to provide investors in these sectors with greater stability in fiscal and regulatory issues in the longer term. However, in June 2003, amendments to the PSA Law were enacted which significantly reduced the benefits to foreign investors, by limiting the circumstances in which subsoil plots were eligible for the application of the hitherto favorable PSA policies. Since then, subsoil plot development under the PSA Law has been available only in cases where subsoil plots are unfit for exploration and development under general subsoil legislation. Such ineligibility for general development must be confirmed by an unsuccessful auction of subsurface rights on the terms and conditions specified by the Subsoil Law. The amendments provided that an auction is the only means of selecting an investor(s), specified more detailed and stricter Russian content requirements for equipment used, established the maximum amount of extracted natural resources that may be awarded to investors as compensation for reimbursable expenses, and removed certain other advantages previously enjoyed by investors.

Due to the restrictions imposed by the amendments to the PSA Law and to the PSA tax regime established at the same time (see section 6.9 below), PSAs have, in practice, become largely ineffective in terms of attracting foreign investment into Russia.

2.3 Special Economic Zones

In 2005, the Federal Law On Special Economic Zones in the Russian Federation No. 116-FZ dated 22 July, 2005 (the Law on Special Economic Zones) was passed, which introduced new methods for the provision of investment benefits. Under the Law on

Special Economic Zones, a special economic zone (“SEZ”) is a territory in Russia selected by the government on a tender basis from proposals submitted by regional authorities. A special preferential regime for conducting business activities is to be provided in an SEZ for twenty years to encourage industrial development based on innovations as well as the development of transport infrastructure and health resorts.

In December, 2005 six geographic locations in various parts of Russia were selected by the government for the creation of SEZs of two types - High Technology Incubation Zones (“TIZs”) and Industrial Production Zones (“IPZs”).

TIZs will be located in the Moscow Region (Dubna and Zelenograd), St. Petersburg, and Tomsk - four in total. Each zone will have its own specialization: The TIZ in Dubna will specialize in nuclear technology, energy saving, aerospace and civil engineering; the TIZ in Zelenograd will specialize in microelectronics; St. Petersburg will specialize in the development and testing of computer programs, databases, and complex equipment; while Tomsk will specialize in the development and production of new types of materials.

Two selected territories have been chosen to accommodate IPZs - in the Lipetsk Region and in Yelabuga (Tatarstan). The IPZ in Lipetsk will produce consumer appliances, electronics and machinery, while the IPZ in Yelabuga will specialize in components for the automotive industry and petrochemicals.

Another type of SEZ, introduced in late 2006/early 2007 is the Zone of Tourism and Recreation (“ZTR”), which will provide for the development of tourism, and health and recreational resorts. Currently seven projects have been selected for ZTRs, to be located in Altay, Buriatia, the Krasnodarskiy, Stavropolskiy and Altaiskiy Territories, and the Kaliningrad and Irkutsk Regions. The introduction of the Port Zone (“PZ”) type of SEZ is also expected during 2007.

It is also of note that all gambling businesses will be transferred to four territories (zones) in the Primorskiy, Altaiskiy, and Krasnodarskiy Territories, and Kaliningrad Region, by July 1, 2009; however, these zones will not come with any special benefits.

The Federal SEZ Management Agency was created by the Russian Government within the Ministry of Economic Development and Trade (more information on SEZ development is available at <http://www.rosez.ru>). Russian legal entities interested in participating in an SEZ (note - benefits apply to foreign investors only upon the creation of a Russian subsidiary) should obtain the status of an SEZ resident by entering into an agreement on technology implementation activities with an SEZ

Administration. The application should be supported by a business plan. A Special SEZ Expert Council (including the SEZ Management Agency, regional and local administration officials, other SEZ residents and experts) decides on whether the applicant qualifies as an SEZ resident based on a score evaluation system, taking into account the prior expertise of the applicant (or the founder of the applicant) in the selected industry, calculation of the investment recoupment period, the markets for the developed products, competition and other business risk analysis, intellectual property rights issues, etc. Residents of an IPZ have to invest at least 1 million Euros during the first year of their project and at least 10 million Euros overall during the project.

Residents of SEZs will be provided with the following major tax benefits:

- exemption from Corporate Property Tax, Transport Tax and Land Tax (the latter applicable only to the owners of land plots) for the first five years after a property is acquired;
- a reduced regional portion (13.5%) of the Corporate Profits Tax rate upon the introduction of that benefit in the corresponding Regional Law, resulting in a total Corporate Profits Tax rate of 20% down from the usual 24%; also, the amended provisions of the Russian Tax Code now allow residents of TIZs, IPZs and even ZTRs to immediately write-off expenditure on scientific research and development works; in addition to that IPZ and ZTR residents will be able to use accelerated amortization for its fixed assets, and be able to write-off any losses without limitations, otherwise resulting in a need to carry-forward.
- a Unified Social Tax (UST) on employees' salaries on a regressive scale ranging from 14% down to 2% (usually 26% down to 2%) for TIZs;
- a special customs regime for residents of TIZs and IPZs incorporating the ability to import goods and equipment for the resident company's use with neither import customs duties nor VAT, and the possibility to acquire Russian goods under a 0% export rate of VAT.

According to Russian government officials, the first residents of the special economic zones will be able to start their business there no earlier than in 2008. It is expected that the construction of new roads, infrastructure, and office and production buildings partly financed by the state will be finished by that time.

In addition to Special Economic Zones discussed above, ad-hoc legislation on specific free economic zones ("FEZ") has been adopted for several regions and is currently still

active. One example of such legislation is the Federal Law On the Special Economic Zone in the Kaliningrad Region of 10 January, 2006 (which recently replaced previous legislation of 22 January 1996) and the Federal Law On the Special Economic Zone in the Magadan Region of 31 May, 1999.

2.4 Regional Legislation

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

One of the most progressive regional investment laws was approved in the Leningrad Oblast (region) in 1997. The goal of this law was to develop investment activity in the Leningrad Region. To achieve this goal, the law created the “most favorable treatment regime” and provided additional guarantees of state support to investors who are involved in investment projects which have major economic and social importance for the Region. Further to this, the city of St. Petersburg has recently adopted a number of tax incentives aimed at attracting investment into the production sphere.

Other pro-investment regions include the Samara, Saratov, Nizhnii Novgorod, Sverdlovsk, and Novgorod Oblasts (regions) and the Khabarovsk Krai (territory), all of which have attracted significant amounts of foreign capital.

In addition to what has been mentioned above, the creation of Special Economic Zones in the Russian Federation may become a new means of attracting investors. The regulatory framework for these territories is established on both federal and regional levels. Laws providing for tax incentives for residents of Special Economic Zones have already been adopted in the Lipetsk, Moscow and Tomsk Oblasts (regions), in the Republic of Tatarstan and in St. Petersburg.

2.5 International Treaties

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

3. ESTABLISHING A LEGAL PRESENCE

In Russia, foreign investors may:

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

3.1 Representative Office and Branch of a Foreign Legal Entity

3.1.1 Legal Status

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

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

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

The obligations imposed on a branch may include the same obligations as those imposed on a representative office. However, a branch has less flexibility in selecting an accrediting authority in Russia compared to a representative office. This can sometimes affect certain areas such as the effectiveness of visa support.

3.1.2 Registration

An appropriate accrediting body must approve representative offices. There are numerous accrediting bodies authorized to grant such accreditation, including those responsible for the accreditation of representative offices in a particular industry – representative offices of foreign banks, for example, are accredited by the Central Bank of the Russian Federation. The bodies most frequently charged with the accreditation of foreign entities are the Chamber of Commerce and Industry of the Russian Federation (the “CCI”) and the State Registration Chamber at the Ministry of Justice of the Russian Federation (the “SRC”).

All documents from a foreign legal entity must be notarized and apostilled/legalized in the country of execution, and any document supplied in a language other than Russian must be accompanied by a translation which has a notarized certification. Accreditation is usually granted for a period of up to three years, with the right to extension. An application letter for the accreditation of a representative office should be submitted to the appropriate accrediting body and must be accompanied by the following documents:

- The Charter or Articles of Incorporation (articles of association, or equivalent) of the foreign legal entity;
- The registration certificate, Certificate of Incorporation, or extract from the trade register of the foreign legal entity certifying that the parent is a validly existing legal entity under the legislation of its home country;
- The resolution of the foreign legal entity resolving to establish the representative office in the Russian Federation and to appoint the chief representative(s);
- The regulations which will govern the operation of the representative office;

- A bank letter confirming the good credit standing of the foreign legal entity;
- A document confirming coordination with the regional authorities of the Russian Federation on the establishment of a representative office (not required for representative offices to be located in Moscow);
- General Power of Attorney issued to the chief representative(s);
- Power of Attorney for filing the application for accreditation on behalf of the foreign legal entity;
- The Accreditation Card containing information on the representative office, filled out in accordance with a sample form of a particular accrediting body and signed by an authorized representative of the foreign legal entity;
- Certification from the tax authorities in the country of the foreign legal entity's incorporation confirming that the foreign legal entity is registered as a taxpayer and specifying the taxpayer identification code;
- Two letters of recommendation from Russian trading partners (preferably Government bodies, social organizations, or 100% Russian-owned entities) on the official letterhead of the recommending organization; and
- A copy of a lease agreement or landlord guarantee letter, together with confirmation of the landlord's right to the property to be leased by the representative office.

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

- The Charter or Articles of Incorporation (articles of association, or equivalent) of the foreign legal entity;
- The registration certificate, Certificate of Incorporation, or excerpt from the trade register of the foreign legal entity certifying that the parent is a validly existing legal entity under the legislation of its home country;
- The resolution of the foreign legal entity to establish the branch office in the Russian Federation;
- The regulation which will govern the operation of the branch office;
- A bank letter confirming the good credit standing of the foreign legal entity;

- A document confirming coordination with the regional authorities of the Russian Federation on establishment of a branch office (not required for branches to be located in Moscow);
- A General Power of Attorney issued to the Director of a branch office;
- A Power of Attorney for filing the application for accreditation on behalf of the foreign legal entity;
- The Accreditation Card containing information on the branch office filled out in accordance with a sample form of a particular accrediting body and signed by a representative of the foreign legal entity;
- Certification from the tax authorities in the country of the foreign legal entity's incorporation confirming that the foreign legal entity is registered as a taxpayer and specifying the taxpayer identification code;
- Expert opinions from the respective ministries of the Russian Federation (the Ministry of Energy, the Ministry of Natural Resources *etc.*) as required by the statutes of the Russian Federation for certain types of activities; and
- Documentation of payment of the registration fee.

All documents from a foreign legal entity must be notarized and apostilled/legalized in the country of execution. Any document supplied in a language other than Russian must be accompanied by a translation which has a notarized certification.

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

3.2 Forming a Russian Legal Entity

The *Civil Code of the Russian Federation* recognizes, among others, the following types of commercial legal entities:

- General partnerships;
- Limited partnerships;
- Limited liability companies;
- Additional liability companies; and
- Joint stock companies.

Moreover, additional legislation has been passed governing the establishment of limited liability companies (“LLC”) and joint stock companies (“JSC”), notably the Federal Law No. 14-FZ *On Limited Liability Companies* dated 8 February 1998 (as amended), (the LLC Law) and the Federal Law No. 208-FZ *On Joint Stock Companies* dated 26 December 1995 (as amended), (the JSC Law). Since these two forms of corporate structure are the most popular with the foreign investors, the provisions of the LLC Law and the JSC Law are examined below.

3.2.1 Choosing between an LLC and a JSC

In choosing between an LLC and a JSC in establishing a wholly-owned subsidiary, LLCs appear to be more popular than JSCs, due to the various establishment considerations discussed below. Generally speaking, the main general corporate benefit of an LLC in comparison with a JSC is that the procedure for the establishment and the operation of an LLC is significantly less burdensome and time-consuming, since there is no legal requirement that an LLC must issue shares or perform the procedural steps required in connection with its issuance (*e.g.* the establishment and maintenance of a securities register, *etc.*). The absence of necessity to issue shares in an LLC makes this form of legal entity more mobile and flexible when it is necessary for participants of the LLC to change (increase or decrease) the charter capital of the company.

Still, a JSC may be preferable for a joint venture in Russia between unrelated parties. This is mainly due to the following reasons. In an LLC, each participant is entitled to leave the company at any time and for no reason, irrespective of the consent of the other participants. This right entitles the participant to receive from the LLC an amount corresponding to its proportionate share of the value of the LLC’s property, determined by reference to its proportionate share in the charter capital of the LLC.

Also, participants in an LLC who either individually or collectively hold at least a 10% interest in the company’s charter capital can apply to a court seeking the expulsion of another participant. In order to actually exclude a participant from the LLC, the other participant(s) must prove that the participant substantially hindered the company’s operations or materially breached its obligations.

Further, in contrast to the JSC law, the LLC Law contemplates a large number of issues which require a unanimous voting decision of all of the LLC participants, what may be unfavorable for a joint venture partner which is a majority participant in the LLC.

3.3 Limited Liability Companies

3.3.1 Number of Participants

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

3.3.2 Rights of Participants

The participants in an LLC have the right to:

- Participate in the management of the LLC in accordance with procedures established by the *LLC Law* and the LLC foundation documents;
- Obtain information concerning the activities of the LLC and have access to its accounting and other documents in accordance with the procedures established by the LLC foundation documents;
- Participate in the distribution of profits;
- Sell or otherwise assign their participation interests in the LLC charter capital, or a part thereof, to one or more of the participants in the LLC in accordance with the procedure established by the *LLC Law* and LLC charter;
- Withdraw from the LLC without first seeking the approval of the other participants; and
- Receive a portion of the assets left after settlement with creditors in the case of the liquidation of the LLC.

The participants in an LLC also have other rights as provided by the *LLC Law*, and may have additional rights set forth in the LLC charter or foundation documents during the establishment of the LLC, or which are granted at a later date by a decision of the LLC’s General Participants’ Meeting. The following points should be noted with regard to granting of additional rights to LLC participants:

- Where additional rights are granted by the decision of the LLC's General Participants' Meeting, this decision must be unanimous; and
- Additional rights granted to a particular participant in the LLC do not transfer to any party acquiring all (or a part) of such participant's ownership interest if it is transferred.

3.3.3 Obligations of Participants

The participants in an LLC are required to:

- Make contributions to the charter capital as specified in the *LLC Law* and the LLC foundation documents (or in the decision on the establishment of the LLC, if there is only one participant in the LLC) and within the time periods specified in the *LLC Law*; and
- Keep confidential all information concerning the activities of the LLC.

Participants in an LLC also have other obligations as provided for by the *LLC Law*, and may have additional obligations set forth during the establishment of the LLC in the LLC charter, or which are imposed on them at a later time by a decision of the LLC's General Participants' Meeting.

The following issues should be considered when imposing additional obligations on participants of an LLC:

- When additional obligations are imposed by the decision of the LLC's General Participants' Meeting on all LLC participants, this decision must be made unanimously;
- If additional obligations are imposed by the decision of the LLC General Participants' Meeting on a particular LLC participant, such decision must be made by a two-thirds majority vote of the total number of votes held by the LLC participants, provided that the LLC participant on whom such additional obligations are imposed voted in favor of such decision or consented to them in writing; and
- Additional obligations imposed on a particular participant(s) in the LLC do not pass to any party acquiring all (or part) of such participant's ownership interest in case it is transferred.

3.3.4 Charter Capital

The charter capital of an LLC consists of contributions made by its participants. The initial charter capital may not be less than an amount equal to 100 times the statutory monthly minimum wage, currently 100 RUR. As at the date of publication, the minimum required charter capital for an LLC is approximately USD 380.

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

3.3.5 Participation Interests

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

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

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

3.3.6 Management Structure

The General Participants' Meeting is the highest governing body of the LLC, and almost all matters fall within its exclusive competence. Should the LLC participants choose to create a Board of Directors, for example, the General Participants' Meeting may nonetheless only delegate a limited number of matters to the Board.

The General Participants' Meeting has the exclusive right to:

- Amend the charter;
- Amend the foundation agreement;
- Define the basic goals and directions of the LLC;

- Delegate to a commercial organization or to an individual entrepreneur the authority reserved to the LLC executive and approve the conditions of the agreements with such organizations or persons;
- Assign supplemental rights and duties to the participants in the LLC;
- Approve the annual financial report and the distribution of profits;
- Alter the amount of the charter capital of the LLC;
- Approve regulations governing the internal activities of the LLC; and
- Reorganize or liquidate the LLC, appoint a liquidation commission, and approve the liquidation balance sheet of the LLC.

The daily management of the LLC is the responsibility of the Executive Body, which may be comprised of one person (the General Director) or may consist of both the General Director and the Management Council. The Executive Body is responsible for all matters which do not fall within the authority of either the Board of Directors or the General Participants' Meeting. The General Participants' Meeting may choose to delegate the powers of the Executive Body to an external commercial organization or to an individual manager on a contractual basis.

3.3.7 Registration

With effect from 1 July 2002, the new Federal Law *On State Registration of Legal Entities* (the *Registration Law*) entered into force, transferring authority for registration of legal entities in Russia to the local bodies of the Federal Tax Service of the Russian Federation. As a result, activities connected with the state registration of legal entities and with their registration as taxpayers are now under the auspices of the local tax inspectorates.

The following documents are required for registration purposes:

- An application;
- The foundation agreement of the LLC (if the LLC has more than one founder/participant);
- The protocol of the founders' meeting or, if the LLC has only one founder, the resolution of the founder on the establishment of the LLC;
- The Charter of the LLC;

- A copy of the passport of the proposed General Director of the LLC;
- Power(s) of Attorney issued by the founder(s) for establishment of the LLC;
- Power(s) of Attorney issued by the founder(s) for filing the application for the state registration of the LLC;
- Confirmation of the legal status of the founder(s) (*e.g.* extract from the trade register or certificate of good standing);
- The Charter (Articles of Association, By-laws) of any foreign legal entities;
- Confirmation of payment of the state registration fee;
- Foreign tax registration certificate of founders (to be provided to a bank);
- Bank letter of good credit standing of a foreign legal entity; and
- Confirmation of the foreign legal entity's contribution to the charter capital of the LLC.

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

3.4 Joint Stock Companies

3.4.1 Types of Joint Stock Companies

A significant number of commercial organizations have been established since the *JSC Law* came into force on 1 January 1996. While the adoption of the *LLC Law* in 1998 introduced another option for investors seeking to establish a corporate entity, the *JSC Law* represented one of the most significant pieces of civil legislation of the post-Soviet era, and JSCs remain among the most important commercial corporate forms and structures for doing business in Russia.

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

Two types of joint stock companies exist in Russia:

- Closed joint stock companies; and
- Open joint stock companies.

An open JSC may have an unlimited number of shareholders. Shareholders in an open JSC are entitled to freely dispose of their shares. The number of shareholders in a closed JSC may not exceed 50, and the JSC must be transformed into an open JSC within one year should the number of shareholders ever exceed this amount. As with participants in an LLC, shareholders in a closed JSC have a right of first refusal to acquire shares sold by other shareholders to third parties, at the price offered to the third parties. Shareholders in both open and closed JSCs have a preemptive right to acquire newly issued shares that are to be privately placed, in proportion to their existing shareholdings.

Shareholders in an open JSC also have a preemptive right to acquire newly issued shares that are to be publicly placed, in proportion to their existing shareholdings, but do not have a right of first refusal to acquire shares sold to third parties.

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

3.4.2 Formation of a Joint Stock Company

Individuals and legal entities may be the founders of a JSC. A company's foundation document, *i.e.* its charter, must include the following information:

- The name, address, and type of the JSC (*i.e.* open or closed);
- The size of the JSC charter capital;
- The quantity, nominal value, and categories (common or preferred) of shares, as well as the classes of preferred shares issued and distributed by the JSC;
- The rights of the holders of shares of each category;
- The structure and competence of the governing bodies of the JSC, and their decision-making procedures;

- The procedure for preparing for and holding the General Shareholders Meetings, including a list of issues requiring either unanimous consent or a resolution adopted by a qualified majority of votes;
- Information on branches and representative offices;
- Information on the existence of any special right of participation in the management of the company (a “golden share”) vested in the Russian Federation, a constituent entity of the Russian Federation, or a municipality of the Russian Federation; and
- Other provisions required by law.

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

3.4.3 Charter Capital

The charter capital of an open JSC may not be less than 1,000 times the Russian statutory monthly minimum wage (the monthly minimum wage used for the purposes of calculating the minimum charter capital of the JSC is currently 100 rubles). Currently, using an exchange rate of approximately 26 rubles/USD, the minimum charter capital for an open JSC is approximately USD 3,800. A closed joint stock company must have a minimum charter capital equivalent to at least 100 times the minimum monthly wage - currently approximately USD 380.

In contrast to LLC founders, the founders of a JSC must pay 50% of the JSC charter capital within three months following its state registration, with the balance payable in full within the first year.

3.4.4 Shares and Other Types of Securities

A JSC can issue securities in the form of shares, bonds, and issuer’s options. In either case, such securities must be registered with the Federal Service for the Financial Markets of the Russian Federation (the “FSFM”), which replaced the former Federal Commission for the Securities Market (the “FCSM”) in March 2004. A JSC can issue common shares and/or several classes of preferred shares. The total value of a JSC’s preferred shares may not exceed 25% of its charter capital.

The concept of a “fractional share” was introduced on 1 January 2002. A fractional share is a share representing a portion of a whole share, which can come into existence when it is not possible to acquire the whole share during the consolidation of shares,

when a shareholder exercises its preemptive right, or in the course of acquiring additional shares. A fractional share grants its owner the same rights that are granted by the whole share of the corresponding category or class, on a pro rata basis.

3.4.5 Management Structure

Both open and closed JSCs must maintain two governing bodies: the General Shareholders Meeting and the Executive Body. An open JSC with more than 50 shareholders must also have a Board of Directors (also called a Supervisory Board). An open JSC with less than 50 shareholders and all closed JSCs may appoint a Board of Directors, although this is not a requirement. The authority of the Board of Directors is defined by the charter of the JSC and, if a Board is not provided for in the charter, the corresponding authority must be vested with the JSC's General Shareholders Meeting.

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

The General Shareholders Meeting is the highest governing body overseeing the activities of a JSC. Its authority is outlined in the *JSC Law* and cannot be altered. Each common share carries one vote at the General Shareholders Meeting (except for cases of cumulative voting where provided for in the *JSC Law*), and most decisions are made by a simple majority vote, although for certain key decisions a supermajority of 75% is required.

The daily management of a JSC is the responsibility of the Executive Body, which may be comprised of one person (the General Director) or may consist of both the General Director and the Management Council. The Executive Body is responsible for all matters which do not fall within the authority of either the Board of Directors or the General Shareholders Meeting. The General Shareholders Meeting may (by a majority vote), choose to delegate the powers of the Executive Body to an external commercial organization or to an individual manager on the contractual basis: however this decision may be taken only pursuant to a proposal from the Board of Directors (if the company has a Board of Directors).

3.4.6 Registration

Effective as of 1 July 2002, the procedure for state registration described in Section 3.3.7 above in respect of LLCs is also applicable to JSCs: the only additional requirement in respect to JSCs is the registration of the issuance of the JSC shares with the FSFM, which is obligatory at the establishment of the company.

4. ISSUANCE AND REGULATION OF SECURITIES

4.1 Introduction

The securities market and securities transactions within the Russian Federation are primarily regulated by Federal Law No. 39-FZ *On the Securities Market* (the *Securities Law*), dated 22 April 1996 (as amended). The offering of corporate securities is regulated by Federal Law No. 208-FZ *On Joint-Stock Companies* (the *JSC Law*), dated 26 December 1995 (as amended), and (with regard to credit institutions) by Law No. 395-1 *On Banks and Banking Activity*, dated 2 December 1990 (as amended). While recent years have seen considerable discussion on changes to the applicable legislation and the structure of the securities markets in general, to date such changes have been limited to the adoption of Federal Law No. 152-FZ *On Mortgage-Backed Securities* (the *MBS Law*), dated 18 November 2003 (as amended). The issuance of securities in the Russian Federation is also subject to a number of regulations issued by the Federal Service for the Financial Markets of the Russian Federation (the FSFM), (previously the Federal Commission for the Securities Market (the FCSM)), and other regulatory agencies, as well as the general provisions of the *Civil Code*.

4.2 Securities in General

Particular instruments will not be considered securities unless they are specifically recognized as such under Article 143 of the *Civil Code* or other relevant securities laws. Such securities include bonds, shares, negotiable promissory notes, checks, deposit and saving certificates, bills of lading, securities issued in the process of privatization, options on shares, Russian depository receipts and exchange bonds.

The *Securities Law* outlines the procedure for the registration of securities issuances and stipulates when a prospectus is required as follows:

- When securities are to be distributed to an unlimited number of holders;
- When the number of holders is known and exceeds 500; or
- When securities are intended to be listed or otherwise publicly traded.

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

4.3 Equity Securities

Russian joint-stock companies (JSCs) may issue shares, options on shares, corporate bonds, and other securities. Open joint-stock companies may raise capital either by issuing shares to the public or by private placement. Shares of closed joint-stock companies may not be offered to the general public. Shares in a limited liability company are not deemed to be securities and cannot be used for raising capital from the general public.

4.4 Debt Securities

The issuance of corporate bonds is regulated by the *Civil Code*, the *JSC Law*, and, in respect of limited liability companies, by Federal Law No. 14-FZ *On Limited Liability Companies*, dated 8 February 1998 (as amended), (the *LLC Law*). The public issuance and trading of bonds is governed by the *Securities Law*. This legislation introduced the concept of secured and unsecured bonds. Secured bonds must be fully secured with a third-party guarantee or suretyship, or with a pledge (or a mortgage) over the issuer’s and/or third party’s securities or immovable property. Only companies (including credit institutions) which have existed for a minimum of two years may issue unsecured bonds. The above legislation provides that the par value of all unsecured bonds issued by a company must not exceed the charter capital of the company or the amount of a guarantee provided by a third party. The issuance of mortgage backed bonds and exchange bonds may be exempt from this restriction. Russian JSC’s may also issue bonds convertible into shares.

Two specific types of securities were introduced in 2003 to facilitate mortgage securitizations. Pursuant to the *MBS Law*, Russian banks and certain other entities may issue mortgage-backed bonds and mortgage-participation certificates. Such securities must be backed by loan receivables secured by mortgages over real estate.

Besides bonds, Russian companies commonly use promissory notes and bills of exchange for debt financing. Under Russian law, promissory notes and bills of exchange are treated as securities. The legal regime for promissory notes and bills of exchange is prescribed in Federal Law No. 48-FZ, *On Promissory Notes and Bills of Exchange*, dated 11 March 1997. In addition, the Russian Federation is a party to the *Convention Providing a Uniform Law for Bills of Exchange and Promissory Notes* (Geneva, 7 June 1930).

4.5 Russian Depository Receipts (RDRs) and Exchange Bonds

RDRs

Recent amendments to the *Securities Law* introduced a new type of derivative security – the Russian Depository Receipt (*RDR*).

An RDR is a registered issuable security without a nominal amount which certifies the right to a specified amount of shares or bonds of a foreign or Russian issuer of RDRs and the provision of services in connection with the realization of rights by a Russian holder of an RDR.

Only a Russian depository which has been in business for 3 or more years and is a professional participant in the securities market can issue RDRs. RDRs are documented bearer securities and are stored centrally by the issuer. In the event that the issuer performs services relating to the acquisition of income on shares or bonds certified by the RDRs, it must open separate depository accounts for the benefit of the holders of the RDRs. According to the issuer's obligations, funds in such accounts may not be executed.

A foreign issuer assumes obligations to Russian RDR holders by entering into an agreement governed by Russian law with a depository. Such agreement must specify the order of voting under such securities, the obligation of the foreign issuer to disclose information in Russian, and other information. This agreement cannot be terminated without the consent of the RDR holders. Where a foreign issuer does

not assume obligations to Russian RDR holders, public circulation of RDRs will only be allowed if the securities of such foreign issuer are listed on the foreign stock exchanges which feature on a list drawn up by the FSFR.

Exchange Bonds

Other amendments to the *Securities Law* introduced another new type of security – exchange bonds, which are defined as short-term documented bearer bonds which certify the right of the holder to receive par value and fixed interest not later than 12 months after the date of issue. The amendments establish simplified rules for the issuance of such securities. The issuance, prospectus and placement report do not need to be registered. However, the amendments set out the following conditions, inter alia: (i) the placement must be made through a public offering; (ii) the issuer must be an OJSC whose shares are listed on a stock exchange permitting the trading of exchange bonds; (iii) the issuer must have existed for 3 years and have annual accounts for the two closed financial years; (iv) exchange bonds may not be issued with pledge collateral; (v) the FSFM must be notified of the admittance to trading and placement on the stock exchange; (vi) such bonds may only be placed on one stock exchange although they may subsequently be circulated on other exchanges provided certain procedural rules are complied with.

4.6 Infrastructure of the Securities Market

The *Securities Law* regulates the status of professional participants of the securities market and provides the legal requirements for their operations. The activities of professional participants of the securities market are subject to licensing by the FSFM, and the procedures for obtaining a license and the requirements for professional participants of the securities market are prescribed in various regulations adopted by the FSFM. A summary of the types of professional participants of the securities market that are subject to FSFM licensing and regulation is set forth below.

4.6.1 Brokers, Dealers, and Trust Managers of Securities

Under the *Securities Law*, brokers are professional participants of the securities market who perform transactions with securities on behalf of and at the expense of their clients (investors or issuers) or on their own behalf and at the expense of a client.

Dealers are defined as professional participants of the securities market who perform transactions with securities on their own behalf and for their own account by declaring in public the bid/ask prices with the obligation to buy and/or sell securities at such prices.

Trust managers of securities are professional participants of the securities market who manage the securities of their clients under a trust management agreement. Trust management may be exercised over securities, money for investment in securities, and also assets and securities derived from such management activities.

4.6.2 Registrars, Depositories

Under the *Securities Law*, registrars are professional participants of the securities market who are charged with maintaining the register of securities owners. If a joint-stock company has over 50 shareholders, it must appoint a professional licensed registrar to maintain its shareholders' register. (A joint-stock company with 50 or less shareholders may maintain its own shareholders' register.)

Under the *Securities Law*, depositories are professional participants of the securities market who hold certificates of securities and/or record the transfer of rights to the securities. The conclusion of a depositary contract does not involve the transfer to the depositary of the right of ownership of the depositor's securities. The depositary has no right to dispose of the depositor's securities, to manage them, or to perform any actions with securities on behalf of the depositor, except for those performed on the depositor's order in cases provided for by the depositary contract.

4.7 Organizers of Trade, Stock Exchanges, and Clearing Organizations

Under the *Securities Law*, "organizers of trades" are professional participants of the securities market who render services which directly facilitate the conclusion of transactions with securities among the participants of the securities market. The *Securities Law* requires organizers of trades to disclose information on the rules for trading, rules for the circulation of securities, rules for the conclusion and registration of transactions with securities and other information related to trade to any interested party.

The Russian Federation has several well-established stock exchanges in Moscow and throughout the country, including MICEX (Moscow Interbank Currency Exchange),

RTS (Russian Trading System Stock Exchange), and certain others. A legal entity may exercise the activity of a stock exchange as a non-profit partnership or as a joint-stock company.

Under the *Securities Law*, clearing organizations are professional participants of the securities market that clear settlements under transactions with securities. Typically, a clearing organization will work closely with a stock exchange (e.g. MICEX Clearing House, RTS Clearing Center, etc.).

4.8 Regulation of the Securities Market

4.8.1 The Federal Service for the Financial Markets

Pursuant to Presidential Decree No. 314 dated 9 March 2004, the FSFM has replaced the FCSM as the primary regulator of the Russian securities market. The main functions of the FSFM, which it carries out either directly or through its authorized territorial agencies, include: the licensing and supervision of professional securities-market participants; the authorization of self-regulatory organizations; the registration of securities issuances and prospectuses and the approval of standards for them; and the classification and definition of different types of securities. The FSFM has the authority to take certain actions against professional participants of the securities market who have breached securities market regulations. Such measures include the suspension and revocation of licenses, enforcement actions, and petitions for criminal prosecution. In addition, the FSFM has the power to fine legal entities or individual entrepreneurs for various securities law violations. Any action pursued against issuers, such as the invalidation of an issuance, must be effected through the courts. Consequently, the ultimate jurisdiction over breaches of securities laws remains with the courts.

As for banks, certain regulatory functions (including registration of securities, etc.) have been transferred from the FSFM to the Central Bank of the Russian Federation. Issuance of securities by state and municipal authorities also falls outside the domain of FSFM regulation and is regulated by the Ministry of Finance.

The *Securities Law* requires that notification be provided to the FSFM of transactions by which foreign parties acquire shares in Russian companies, foreign ownership of which is restricted by law (e.g. the gas and electricity monopolies and insurance entities). Notably, Russian issuers must receive an approval from the FSFM for issuing of securities outside of the Russian Federation.

4.8.2 Self-regulating Organizations (“SROs”)

Under the *Securities Law*, an SRO is a voluntary association of professional participants in the securities market functioning on the principles of a non-profit organization established for the provision of their professional activity, the observance of standards of professional ethics, the protection of the interests of owners of securities and the implementation of regulations and standards to ensure the effective functioning of the securities market. Membership in a SRO is not mandatory.

5. COMPETITION PROTECTION LAW

The basic law for antimonopoly regulation in the Russian Federation is the *Federal Law on Protection of Competition* (the “*Competition Law*”), adopted on 26 July, 2006, effective as of 26 October, 2006. Antimonopoly issues in the Russian Federation are under the auspices of the Federal Antimonopoly Service (the “FAS”).

The *Competition Law* regulates competition in both the commodities market and the financial services market and includes seven areas of particular interest to foreign investors:

- Abuse of a dominant position;
- Agreements limiting competition;
- State aid;
- Establishment of companies;
- Mergers and acquisitions;
- Unfair competition; and
- Selection of a financial organization by subjects of natural monopolies and various states and municipal bodies.

5.1 Abuse of a Dominant Position

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

For entities with a market share of 55% or greater, there is a presumption of market dominance.

Entities with a market share of between 35% and 55% are deemed dominant, provided their dominant position has been established by the FAS.

For entities with a market share of 35% or less, there is a conclusive presumption of non-dominance, with a few exceptions provided by the *Competition Law*.

The FAS deems a financial organization to be a dominant entity according to the criteria/thresholds set down by the Russian Government together with the Russian Central Bank. A financial organization whose share in any single market in the Russian Federation does not exceed 10%, or whose share does not exceed 20% in a commodity market where the commodity also circulates in other commodity markets in the Russian Federation, may not be deemed dominant.

When determining market share, the FAS may take into account not merely one company in isolation but also the group of companies to which it belongs. The “group” will include all persons/legal entities related by a common controlling share ownership, contractual or other de facto management control.

In addition to the term “dominant position” the *Competition Law* introduced a new concept of “collective dominant position”, i.e. the collective domination of the market by between two and five independent companies. According to the *Competition Law*, a participant in this collective domination can occupy only 8% of the market and will be viewed as a violator in case two or three other participants jointly have more than 50% of the commodities’ market share, or, four or five other participants jointly hold more than 70% of the commodities’ market share, and such entities meet certain criteria specified in the *Competition Law*.

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

- Setting and/or support of monopoly high or low prices;
- Withdrawal of goods from circulation if the result of such a withdrawal is a rise of the price of the goods;
- Creation of conditions that place one or more business entities in an unequal position as compared to other entities in their ability to access the market for particular goods (discriminatory conditions);

- Imposition of contractual terms that are disadvantageous to the other party or do not relate to the subject matter of the contract on a contracting party;
- Discontinuance or reduction of production of goods for which there is a consumer demand if it is possible to produce them on a profitable basis;
- Unjustified refusal to enter into a contract with particular customers if it is possible to produce or deliver the relevant goods to such customers;
- Setting different prices on the same goods where it is not economically or technologically substantiated;
- Creation of discriminatory conditions;
- Creation of barriers to market entry or market exit for other business entities; or
- Violation of pricing rules established by normative acts.

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

5.2 Agreements Limiting Competition

The *Competition Law* prohibits agreements, transactions, or other business activities of business entities that lead or may lead to the following:

- Control or fixing of prices, discounts, bonus payments, or surcharges;
- Increase or reduction of prices or the manipulation of prices at tenders;
- Division of the market by reference to territories or according to the volume of sales/purchases, the range of marketable goods, or the range of sellers or buyers;
- refusal to enter into a contract with particular sellers or customers without economic or technological justification;
- Imposition of contractual terms that are disadvantageous to the other party or do not relate to the subject matter of the contract;
- Setting different prices on the same goods without economic or technological justification;

- Discontinuance or reduction of production of goods for which there is a consumer demand if it is possible to produce them on a profitable basis;
- Restriction of access to the market or the removal from the market of other entities that sell or purchase particular products; etc.

The *Competition Law* further prohibits other agreements if such agreements lead or may lead to limitation of competition, with the exception of “Vertical Agreements” (agreements between economic entities not competing with each other, one of which acquires goods or is the potential acquirer, while the other supplies goods or is the potential seller) which are permitted by the *Competition Law* (“Vertical Agreements” between economic entities where the market share of each one is less than 20% or “Vertical Agreements” in written form which are commercial concession agreements).

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

The *Competition Law* also lists cases under which agreements, transactions, or other business activities of business entities, including concerted actions, may be permitted.

The *Competition Law* prohibits the so-called “*coordination of economic activities*” by economic entities, if such coordination may lead to restriction of competition. “Coordination of economic activities” is understood as coordination of the actions of economic entities by a third person who does not belong to the “group of persons” at such economic entities.

5.3 State Aid

State aid is new to Russian competition legislation and was introduced by the *Competition Law* of 2006.

In accordance with the *Competition Law*, state (or municipal) aid consists in granting an economic entity certain privileges over other market participants, ensuring more favorable conditions for their activity in the relevant market by transferring property and (or) civil rights or providing priority access to information.

The *Competition Law* regulates the procedure of providing state (or municipal) aid for the following purposes:

- ensuring life activity of the population in Arctic regions and equivalent areas;
- carrying out fundamental scientific research;
- environmental protection;
- cultural development and conservation of the cultural heritage;
- agricultural production;
- support of small businesses engaged in high priority activities;
- rendering social services to the population; and
- rendering social support to unemployed citizens and facilitating employment of the population.

State (or municipal) aid shall be granted with the preliminary written approval of the FAS unless such aid is directly granted by a federal law, a law of a Russian Federation constituent entity or a regulatory act of the local government on the budget for the following year, or is granted from the reserve funds of the executive body of a constituent entity of the Russian Federation or the reserve funds of the local government.

In order to provide state (or municipal) aid, the authority intending to grant the aid submits an application to the FAS for approval to grant such state (or municipal) aid together with (a) a draft act which provides for the granting of the state (or municipal) aid with an indication of the goals and amounts of the aid; (b) a list of the beneficiary entity's activities over the two years preceding the date of the FAS application; and other information as provided for by the *Competition Law*.

The FAS shall make a decision on the application within two (2) months from the moment it is submitted together with all necessary documents. The FAS may extend the period for its review of the application for a term of up to two (2) months. If the FAS approves the granting of state (or municipal) aid, the authority granting the aid must submit documents confirming observance of the restrictions as indicated in the FAS approval within one (1) month after the aid has been granted.

5.4 Establishment of Companies

The founders of a new company must notify the FAS prior to the establishment of a company only if the charter capital of the company being established is paid by shares and/or property of another legal entity and the company acquires more than 25%/50%/75% of such shares or more than $1/3$ / 50% / $2/3$ of such participatory shares, or where the company acquires more 20% of the main production facilities and (or) intangible assets of another legal entity, and where the thresholds provided in the *Competition Law* are met.

According to specific conditions provided by the *Competition Law* the establishment of a company whose charter capital is paid by shares and/or property of a financial organization may be subject to a mandatory pre-establishment FAS notification. Such conditions are similar to those described above with respect to entities acting in the commodities market but contain certain differences that should be considered separately.

5.5 Mergers and Acquisitions

5.5.1 Mergers

Entities involved in a consolidation or a merger must obtain the prior approval of the FAS if the aggregate asset value of the entities exceeds 3 billion rubles or the aggregate revenue earned by the entities and their “group of persons” from sale of goods during the past calendar year exceeds 6 billion rubles or if either of the entities is included in the FAS Register of Entities with a market share exceeding 35% in the relevant market. The procedures for obtaining such approval are similar to the procedures used for acquisitions.

5.5.2 Acquisition of an Interest, Assets and Rights in a Russian Company

Acquisition of Shares/Participatory Interest in a Russian Company

When an individual, legal entity or group of persons acquires more than 25%/50%/75% of voting shares or more than $1/3$ / 50% / $2/3$ of participatory shares in an entity, such persons, entities or group of entities must receive prior approval from the FAS if:

- the aggregate book value of the assets of the acquirer and its “group of persons” plus the target and its “group of persons” exceeds 3 billion rubles and the balance sheet value of the total assets of the target and its group exceeds 150 million rubles; or
- the aggregate revenue earned by the acquirer and its “group of persons” plus the target and its “group of persons” from sale of goods over the past calendar year exceeds 6 billion rubles and the balance sheet value of the total assets of the target and its group exceeds 150 million rubles; or
- either the acquirer, or any of its “group of persons”, or the target, or any of its “group of persons”, is included in the FAS Register of Entities with a market share exceeding 35% in the relevant market.

Acquisition of Assets in a Russian Company

When an individual, legal entity or group of persons acquires the right of ownership or the right to use the main production (fixed) assets or intangible assets of an entity, if the acquired assets account for more than 20% of the book value of the main production (fixed) assets and intangible assets of the selling entity, such persons, entities or a group of entities involved in the acquisition must receive prior approval from the FAS if:

- the aggregate book value of the assets of the acquirer and its “group of persons” plus the target and its “group of persons” exceeds 3 billion rubles and the balance sheet value of the total assets of the target and its group exceeds 150 million rubles; or
- the aggregate revenue earned by the acquirer and its “group of persons” plus the target and its “group of persons” from sale of goods during the past calendar year exceeds 6 billion rubles and the balance sheet value of the total assets of the target and its group exceeds 150 million rubles; or
- either the acquirer, or any of its “group of persons”, or the target, or any of its “group of persons”, is included in the FAS Register of Entities with a market share exceeding 35% in the relevant market.

Acquisition of Rights in a Russian Company

When an individual, legal entity or group of persons acquires rights conferring the ability to determine the commercial behavior of the target company (including as

a result of change of indirect control over a Russian target company) or of the right to perform the functions of its executive bodies, such persons, entities or group of entities involved in the acquisition must receive prior approval from the FAS if:

- the aggregate book value of the assets of the acquirer and its “group of persons” plus the target and its “group of persons” exceeds 3 billion rubles and the balance sheet value of the total assets of the target and its group exceeds 150 million rubles; or
- the aggregate revenue earned by the acquirer and its “group of persons” plus the target and its “group of persons” from sale of goods over the past calendar year exceeds 6 billion rubles and the balance sheet value of the total assets of the target and its group exceeds 150 million rubles; or
- either the acquirer, or any of its “group of persons”, or the target, or any of its “group of persons”, is included in the FAS Register of Entities with a market share exceeding 35% in the relevant market.

In practice, the FAS supervises those offshore mergers or other transactions involving the acquisition of shares, as a result of which indirect control over a Russian entity changes. It is presumed by the FAS that as a result of an indirect change of control of a Russian legal entity, the foreign entity acquiring the shares would obtain rights over the Russian entity which would allow it to determine the conditions of this Russian entity’s business activity.

Depending on the asset value threshold, the acquisitions described above need to be either preliminarily approved by FAS or only notified to the FAS post-closing.

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

Where a merger or acquisition takes place between entities in the same “group of persons”, and where preliminary approval by the FAS is required by law, the *Competition Law* permits the application for preliminary approval to make a post transaction notification to the FAS within 45 days after the transaction is completed. In this case the group structure must be submitted to the FAS one (1) month prior to the transaction, and may not change until the transaction is completed.

The *Competition Law* contains separate articles for the acquisitions of interest, assets and/or rights in *financial organizations* which are subject to a pre-acquisition FAS notification, and the articles contain specific conditions and thresholds applicable to such acquisitions concerning financial organizations that should be considered separately.

5.5.3 Procedures and Timing

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

After all documents have been submitted, the FAS has thirty (30) days to review the application or notification. If the FAS believes that the transaction may lead to restriction of competition, the review period may be prolonged for an additional two (2) months, during which the FAS places information about the transaction on its official web-site and invites all interested parties to send their opinions to the transaction.

5.6 Unfair Competition

Unfair competition, namely any actions of commercial entities aimed at acquiring competitive advantages in commercial activity which contradict the *Competition Law*, business customs, the requirements of good-faith, reasonableness and fairness, which may or have caused losses to other competing legal entities, or damage their business reputation, is prohibited in Russia.

Types of activities, which constitute unfair competition, include:

- distribution of false, inaccurate or distorted information, which may cause losses to a commercial entity or damage this entity's business reputation;
- misleading consumers about the nature, methods and place of production, as well as consumer properties and quality of goods;
- incorrect comparison by a commercial entity of goods produced or sold by this entity with the goods of other commercial entities;
- sale of goods with illegal use of the results of intellectual activity (i.e., intellectual property) and of the means of individualization of a commercial entity, products, or services, such as trademarks, logotypes and other objects of intellectual property;

- receipt, use and disclosure of scientific and technical, production or trade information, including commercial secrets, without the consent of the commercial entity to which this information belongs, etc.

5.7 Selection of a Financial Organization by Subjects of Natural Monopolies and Various States and Municipal Bodies

All federal and municipal bodies, bodies of Russian Federation constituent entities and subjects of natural monopolies shall select a financial organization by holding a public tender or public auction (in the procedures set down by other federal laws) to render certain number of financial services for them, a full list of which is set down by the *Competition Law*, and which includes granting credits, rendering services on the securities market and under leasing contracts, attraction of monetary funds of legal entities for deposits, opening and maintaining bank accounts of legal entities, and making settlements with these accounts, etc.

Violation of the above provision shall serve as grounds for the court to declare the relevant transactions or auctions invalid, including on the basis of a claim made by the FAS.

6. TAXATION

6.1 Introduction

Starting in 1999, Russia began a significant reform of its tax system, which has been implemented phase-by-phase. This reform has improved procedural rules and made them more favorable to taxpayers, has reduced the overall number of taxes, and has begun to reduce the overall tax burden in the country.

Part I of the new *Tax Code of the Russian Federation* (the *Tax Code*) came into effect in 1999, dealing largely with administrative and procedural rules. The latest amendments to the Part I that would take effect starting from January 1, 2007 have clarified certain administrative and procedural issues raised by seven years of practice of the application of the Part I of the *Tax Code*. The provisions of Part II of the *Tax Code* regarding excise taxes, VAT, individual income tax, and the unified social tax came

into force in 2001, followed by the new profits tax and new mineral extraction tax provisions of the *Tax Code* in 2002. In 2003, further amendments introduced a simplified system of taxation, a single tax on imputed income, a new Chapter on transport tax, and established a special tax regime for production sharing agreements in Russia. A new Chapter on corporate property tax came into effect as of 1 January 2004, replacing the former 1991 *Corporate Property Tax Law*. As of 1 January 2005, the new water tax, land tax, and state duty Chapters came into effect. The remaining Chapters of the *Tax Code* still under review cover the property tax on individuals, which is currently governed by the corresponding 1991 legislation. Starting from 1 January 2006, the inheritance and gift tax that was in existence since 1991 was repealed. In addition, over the last several years, various amendments to these new Tax code provisions have been amended. Thus, tax reform continues to be an ongoing process.

6.2 Types of Tax

The *Tax Code* sets forth three levels of taxation: federal, regional and local. Currently, federal taxes include VAT, excise taxes, profits tax, unified social tax, personal income tax, mineral extraction tax, state duty, special tax regimes, and several other taxes. Regional taxes include corporate property tax, transport tax, and gambling tax, while local taxes include land tax and individual property tax.

There are four types of special tax regimes that may be applicable to certain activities and/or categories of taxpayers: single agriculture tax, simplified system of taxation, single tax on imputed income from certain kinds of activity, and taxation of production sharing agreements. These special tax regimes have the status of a federal tax and may provide exemptions from certain federal, regional, and local taxes.

6.3 Tax Audits

Russian tax authorities may conduct off-site or on-site tax audits of taxpayers. Amendments that came into affect starting from January 1, 2007 introduced more detailed regulation for both types of tax audits. Tax authorities may audit several different taxes simultaneously as part of on-site tax audits. However, except in cases of liquidation or reorganization, when a higher tax authority inspects the activities of a lower tax authority that conducted an on-site audit, or when a taxpayer files adjustment tax return claiming reduced taxation, a tax for a given period may only be audited once. The taxpayer may also be repeatedly inspected in the same tax

period upon the decision of the Head of the Federal Tax Service of Russia. In case during repeat tax audit the tax authority would find underpayment that was not found during previous tax audit, the fine for such underpayment would not be applied to the taxpayer, except for the case when undetected violation resulted from conspiracy between the taxpayer and the tax authority. In exceptional cases provided by the Tax Code the Russian tax authorities may suspend on-site tax audit, however the overall term of suspension in any case may not exceed nine months. The results of a tax audit relating to reviewed taxes may only be reconsidered by supervising tax authorities. In any case, however, tax authorities may only audit the three calendar years preceding the year of the tax audit. As a general rule, a three-year statute of limitations applies to imposition of fines for tax violations, although according to the position taken in Constitutional Court Ruling No. 9-P, dated 14 July 2005, this type of defense could be rejected by the court if the taxpayer impeded execution of the tax audit by the tax authorities. Also, tax authorities may collect outstanding taxes and interest on late tax payments in an out-of-court procedure, while collection of fines larger than 5,000 rubles in case of individuals and 50,000 rubles in case of legal entities for a given tax period requires a corresponding court decision. Starting from January 1, 2007 the amount of tax that was not duly paid during the three months period may be collected from companies affiliated with the taxpayer if such affiliated companies receive payments for goods, works or services provided by the taxpayer.

6.4 Corporate Profits Tax

Prior to 2002, the maximum profits tax rate for most businesses was 35%, while a slightly higher maximum tax rate of 38% applied to banks and insurance and intermediary companies. Pursuant to the profits tax provisions of Chapter 25 of the *Tax Code*, as of 1 January 2002, the maximum tax rate for all companies was reduced to 24%, which is currently payable at a rate of 6.5% to the federal budget and 17.5% to regional budgets. The regional authorities may, at their discretion, reduce their regional profits tax rate to as low as 13.5%. Thus, the overall tax rate can vary from 20% to 24%.

Under Chapter 25, the following tax rates apply to dividends:

- 9% on dividends payable by Russian companies to Russian shareholders; and
- 15% on dividends payable by Russian companies to foreign legal entities and on dividends received by Russian companies from foreign legal entities.

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

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

6.4.1 Interest Deductibility and Thin Capitalization Rules

Generally, under the *Tax Code*, interest is deductible as long as it does not deviate by more than 20% from market interest rates paid on comparable loans in the same calendar quarter. Any excessive part of the interest will not be deductible. If no such comparable loans exist, interest is deducted within certain limits; for ruble loans, the deductible interest may not exceed 110% of the Central Bank refinancing rate, and for loans denominated in a foreign currency, the deduction is limited to 15% per annum.

In addition, there is a specific provision with respect to “thin capitalization.” The *Tax Code* introduces a 12.5/1 debt-to-equity ratio limit for banks and leasing companies, and a 3/1 ratio limit for all other companies. If the ratio of the Russian borrower company’s internal capital to its outstanding debt owed to a foreign shareholder holding more than a 20% interest in the Russian borrower company (including debt owed to a Russian affiliate of the foreign shareholder and debt guaranteed by the foreign shareholder or its Russian affiliate) exceeds these limits, the Tax Code restricts the deductibility of interest paid on the excess debt. Non-deductible interest is also considered to be a dividend payment to the foreign shareholder and hence is subject to a 15% withholding tax, unless the latter is reduced or eliminated by an applicable tax treaty.

6.4.2 Asset Depreciation and Carrying Forward Losses

Chapter 25 allows taxpayers to split assets into ten groups, depending on the type of asset and its useful life, and to apply accelerated depreciation rates; for example, the useful life for buildings under the new rules is 30 years, whereas under the old rules (before 1 January 2002) the period was 80-90 years. Under Chapter 25,

taxpayers are able to choose between a straight-line method (somewhat similar to the old method of asset depreciation) and a new accelerated method. Land, subsoil, and natural resource assets are not subject to depreciation and hence do not reduce the tax base of the profits tax.

Starting from 1 January 2006, a lump-sum deduction in the amount of 10% of the initial book value of newly acquired fixed assets is allowed to be made for profits tax purposes in the period when the fixed assets are acquired.

Pre-tax losses may be carried forward for ten years. Also, there is no requirement to spread the loss over the entire carry-forward term. Starting from January 1, 2007 the taxpayer may reduce taxable base of the current tax period by the losses of the previous periods without limitation, i.e. may reduce the taxable base of the current period to zero.

In addition, capital losses may be offset against operating income; this deduction, however, must be evenly spread over the residual useful life of the capital asset for which the loss was incurred.

6.4.3 Investment Benefits

Russian companies enjoyed various regional and local tax concessions under the 1991 *Corporate Profits Tax Law*, and under the relevant regional and/or local laws of several territories (particularly Chukotka, Kalmykia, Mordovia, and Evenkia). Chapter 25 of the *Tax Code* abolished all tax incentives, including the capital investment allowance. Some types of tax benefits (including investment benefits) were grandfathered, although they ceased to be effective as of 1 January 2004. Presently, regional and local legislative bodies are no longer authorized to provide tax concessions, except for regional authorities, which may reduce their regional profits tax rate by 4% and thus reduce the overall tax rate to 20%. However, the effective tax rate could be even lower under the special tax regimes referred to under section 6.2 above or under the special economic zone regime.

In 2005, the Federal Law No. 116-FZ *On Special Economic Zones in the Russian Federation* dated 22 July 2005 was passed. It introduced a new concept for provision of investment benefits. Please refer to section 2.3 above for more information on this topic.

6.4.4 Transfer Pricing Rules

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

- A transaction between affiliated parties;
- A barter transaction;
- A foreign trade transaction; or
- A transaction involving significant variations in prices (*i.e.* a fluctuation of more than 20%) for identical goods or services within a short period of time (in practice, this term is interpreted as 30 days immediately preceding the date in question).

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

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

6.5 Taxation of Foreign Companies

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

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

Unless an applicable double taxation treaty provides for a lower rate, dividends payable by Russian companies to foreign shareholders are subject to a 15% withholding tax. Other listed income received by foreign legal entities from Russian sources is subject to either a 20% withholding tax (for most categories of income, including royalties and most types of interest) or a 10% withholding tax (for income from freight and lease of transportation vehicles), subject to any reduction available under a double taxation treaty.

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

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

The profits tax is payable on a quarterly basis. The annual tax return and a report on the foreign legal entity's activity in the Russian Federation must be submitted to the tax authorities by 28 March of the year following the close of the taxable year.

6.6 Double Taxation Treaties

Russia has entered into the following bilateral treaties for the avoidance of double taxation which are currently in force:

No.	Country	Dividends		Interest ¹	Royalties
		Individuals, Companies	Qualifying Companies		
1.	Albania	10	10	10	10
2.	Armenia	10	5 ²	0	0
3.	Australia	15	5 ³	10	10
4.	Austria	15	5 ⁴	0	0
5.	Azerbaijan	10	10	10	10
6.	Belarus	15	15	10	10
7.	Belgium	10	10	10	0
8.	Bulgaria	15	15	15	15
9.	Canada	15	10 ⁵	10	0/10 ⁶
10.	China	10	10	10	10
11.	Croatia	10	5 ⁷	10	10

¹ Many treaties provide for an exemption for certain types of interest *e.g.* interest paid to the state local authorities, the central bank export credit institutions or in relation to sales on credit. Such exemptions are not considered in this column.

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

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

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

⁵ The rate applies if the recipient company owns at least 10% of the capital or voting power in the Russian company, as the case may be.

⁶ The lower rate applies to computer software, patents and know-how.

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

No.	Country	Dividends		Interest	Royalties
		Individuals, Companies	Qualifying Companies		
12.	Cyprus	10	5 ⁸	0	0
13.	Czech Republic	10	10	0	10
14.	Denmark	10	10	0	0
15.	Egypt	10	10	15	15
16.	Finland	12	5 ⁹	0	0
17.	France	15	5/10 ¹⁰	0	0
18.	Germany	15	5 ¹¹	0	0
19.	Hungary	10	10	0	0
20.	Iceland	15	5 ¹²	0	0
21.	India	10	10	10	10
22.	Indonesia	15	15	15	15
23.	Iran	10	5 ¹³	7.5	5
24.	Ireland	10	10	0	0
25.	Israel	10	10	10	10

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

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

¹⁰ The 5% rate applies if the French company: (1) has directly invested at least EUR 76,225 in the Russian company; and (2) is subject to tax in France, but is exempt with respect to the dividends (*i.e.* participation exemption). The 10% rate applies if only one of the requirements is fulfilled.

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

¹² The rate applies if the recipient company directly owns at least 25% of the capital in the paying dividends and the value of the holding is at least USD 100,000.

¹³ The rate applies if the recipient company directly owns at least 25% of the capital in the Russian company.

No.	Country	Dividends		Interest	Royalties
		Individuals, Companies	Qualifying Companies		
26.	Italy	10	5 ¹⁴	10	0
27.	Japan	15	15	10	0/10 ¹⁵
28.	Kazakhstan	10	10	10	10
29.	North Korea	10	10	0	0
30.	Korea (Rep.)	10	5 ¹⁶	0	5
31.	Kuwait	5	5	0	10
32.	Kyrgyzstan	10	10	10	10
33.	Lebanon	10	10	5	5
34.	Lithuanian Republic	10	5 ¹⁷	10	5/10 ¹⁸
35.	Luxembourg	15	10 ¹⁹	0	0
36.	Macedonia	10	10	10	10

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

¹⁵ The lower rate applies to copyright royalties.

¹⁶ The rate applies if the recipient company (other than a partnership) directly owns at least 30% of the capital in the company paying the dividends and the value of the holding is at least USD 100,000.

¹⁷ The rate applies if the recipient company (other than a partnership) directly owns at least 25% of the capital in the company paying the dividends and the value of the holding exceeds USD 100,000.

¹⁸ The lower rate applies to the royalties for the use of industrial, commercial, and scientific equipment.

¹⁹ The 10% rate applies if the Luxembourg recipient directly owns at least 30% of the capital in the Russian company and the value of the holding is at least EUR 75,000.

No.	Country	Dividends		Interest	Royalties
		Individuals, Companies	Qualifying Companies		
37.	Malaysia	-/15 ²⁰	-/15 ²¹	15	10/15 ²²
38.	Mali	15	10 ²³	15	0
39.	Morocco	10	5 ²⁴	0/10 ²⁵	10
40.	Moldova	10	10	0	10
41.	Mongolia	10	10	10	_ ²⁶
42.	Namibia	10	5 ²⁷	10	5
43.	Netherlands	15	5 ²⁸	0	0
44.	New Zealand	15	15	10	10
45.	Norway	10	10	10	0
46.	Philippines	15	15	15	15
47.	Poland	10	10	10	10

²⁰ The 15% rate applies to profits of joint ventures. Otherwise, the domestic rate applies; there is no reduction under the treaty.

²¹ The 15% rate applies to profits of joint ventures. Otherwise, the domestic rate applies; there is no reduction under the treaty.

²² The lower rate applies to industrial royalties.

²³ The rate applies if the value of the holding is at least FRF 1 million.

²⁴ The 5% rate applies if the value of the holding is at least USD 500,000.

²⁵ The lower rate applies to interest on foreign currency deposit.

²⁶ The domestic rate applies, there is no reduction under the treaty.

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

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

No.	Country	Dividends		Interest	Royalties
		Individuals, Companies	Qualifying Companies		
48.	Portugal	15	10 ²⁹	10	10
49.	Qatar	5	5	5	0
50.	Romania	15	15	15	10
51.	Serbia and Montenegro	15	5 ³⁰	10	10
52.	Slovakia	10	10	0	10
53.	Slovenia	10	10	10	10
54.	South Africa	15	10 ³¹	10	0
55.	Spain	15	5/10 ³²	0/5 ³³	5
56.	Sri Lanka	15	10 ³⁴	10	10
57.	Sweden	15	5 ³⁵	0	0

²⁹ The rate applies if the Portuguese company has owned directly at least 25% of the capital in the Russian company during an uninterrupted period of at least 2 years prior to the payment.

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

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

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

³³ The lower rate applies to long term loans (minimum seven years) granted by credit institutions resident in a contracting state.

³⁴ The rate applies if the Swedish company owns 100% of the capital in the Russian company (or in the case of a joint venture, at least 30% of the capital in such a joint venture) and the foreign capital invested exceeds USD 100,000.

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

No.	Country	Dividends		Interest	Royalties
		Individuals, Companies	Qualifying Companies		
58.	Switzerland	15	5 ³⁶	5/10 ³⁷	0
59.	Syria	15	15	10	4.5/13.5/18 ³⁸
60.	Tajikistan	10	5 ³⁹	10	0
61.	Turkey	10	10	10	10
62.	Turkmenistan	10	10	5	5
63.	Ukraine	15	5 ⁴⁰	10	10
64.	United Kingdom of Great Britain and Northern Ireland	10	10	0	0
65.	United States of America	10	5 ⁴¹	0	0
66.	Uzbekistan	10	10	10	0
67.	Vietnam	15	10 ⁴²	10	15

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

³⁷ The lower rate applies to loans of any kind granted by a bank.

³⁸ The 4.5% rate applies to cinema movies and TV and radio broadcasting programs, the 13.5% rate applies to literature, art, and science products, and the 18% rate applies to computer software, patents, trademarks, and know-how.

³⁹ The rate applies if the recipient company owns at least 25% of the capital in the company paying the dividends.

⁴⁰ The rate applies if the value of the holding is at least USD 50,000.

⁴¹ The rate applies if the recipient company owns at least 10% of the capital or voting power in the Russian company as the case may be.

⁴² The rate applies if the Vietnamese company has invested directly in the capital of the Russian company at least USD 10 million.

In addition to the above, Russia has entered into the following tax treaties for the avoidance of double taxation which have not yet been ratified:

No.	Country	Dividends		Interest ⁴³	Royalties
		Individuals, Companies	Qualifying Companies		
1.	Algeria	15	5 ⁴⁴	15	15
2.	Argentina	15	10 ⁴⁵	15	15
3.	Botswana	10	5 ⁴⁶	10	10
4.	Brazil	15	10 ⁴⁷	15	15
5.	Chile	10	5 ⁴⁸	15	5/10 ⁴⁹
6.	Cuba	15	5 ⁵⁰	10	0/5 ⁵¹
7.	Estonia	10	5 ⁵²	10	10

⁴³ Many treaties provide for an exemption for certain types of interest e.g. interest paid to the state local authorities, the central bank, export credit institutions or in relation to sales on credit. Such exemptions are not considered in this column.

⁴⁴ The rate applies if the recipient company (other than a partnership) directly owns at least 25% of the capital in the company paying the dividends.

⁴⁵ The rate applies if the recipient company owns at least 25% of the capital in the company paying the dividends.

⁴⁶ The rate applies if the recipient company owns at least 25% of the capital in the company paying the dividends.

⁴⁷ The rate applies if the recipient company directly owns at least 20% of the capital in the company paying the dividends.

⁴⁸ The rate applies if the recipient company directly owns at least 25% of the capital in the company paying the dividends.

⁴⁹ The lower rate applies to the royalties for the use of, or the right to use, any industrial, commercial, or scientific equipment.

⁵⁰ The rate applies if the recipient company (other than a partnership) owns at least 25% of the capital in the company paying the dividends.

⁵¹ The lower rate applies to copyright royalties.

⁵² The rate applies if the recipient company (other than a partnership) owns at least 25% of the capital in the company paying the dividends and the value of the holding exceeds USD 75,000.

No.	Country	Dividends		Interest	Royalties
		Individuals, Companies	Qualifying Companies		
8.	Ethiopia	5	5	5	15
9.	Georgia	10	10	10	5
10.	Greece	10	5 ⁵³	7	7
11.	Laos	10	10	10	0
12.	Malta	10/ ⁵⁴	5 ⁵⁵	0	0
13.	Mauritius	10	5 ⁵⁶	0	0
14.	Mexico	10	10	10	10
15.	Oman	10	5 ⁵⁷	0	5
16.	Singapore	10	5 ⁵⁸	7.5	7.5
17.	Thailand	15	15	10	15
18.	Venezuela	15	10 ⁵⁹	5/10 ⁶⁰	10/15 ⁶¹

⁵³ The rate applies if the recipient company (other than a partnership) owns at least 25% of the capital in the company paying the dividends.

⁵⁴ The rate shall not exceed the rate established for Maltese income tax purposes if the recipient company is a Russian resident.

⁵⁵ The rate applies if the recipient company (Maltese resident) directly owns 20% in the capital of the Russian company and the foreign capital invested exceeds USD 100,000.

⁵⁶ The 5% rate applies if the value of the recipient company's holding is at least USD 500,000.

⁵⁷ The rate applies if the value of the recipient company's holding exceeds USD 500,000.

⁵⁸ The rate applies if the recipient company owns at least 15% of the capital in the company paying the dividends and the value of the holding exceeds USD 100,000.

⁵⁹ The rate applies if the recipient company (other than a partnership) directly owns at least 10% of the capital in the company paying the dividends and the value of the holding is at least USD 100,000.

⁶⁰ The 5% rate applies to bank loans.

⁶¹ The lower rate applies to the fees for technical assistance.

6.7 Value Added Tax (“VAT”)

VAT is imposed on all goods imported into Russia and is also applied to the sale of goods, work, and services. Current legislation imposes a VAT rate of 18% on the sale of most goods. A fixed 10% rate is applied to limited types of goods, such as pharmaceuticals, medical equipment, and certain food products and periodicals. Export of goods is subject to 0% VAT. In addition, certain types of goods, work, and services are exempt from VAT (for example, land plots, dwelling houses and apartments, lease of office space to accredited representative offices and branches of foreign legal entities, certain medical goods and services, *etc.*).

Generally, VAT paid on acquired goods, work, and services may be offset against VAT collected from customers. In order to claim a refund of input VAT paid in relation to goods that subsequently were exported and subject to 0% VAT, the company is required to file various supporting documents with the Russian tax authorities. In capital construction, the input VAT paid to suppliers of goods, work, and services may be offset under a general procedure as the construction progresses (prior to 2006, such input VAT could be offset only when the constructed assets are recorded on the taxpayer’s balance sheet).

An enterprise ends up transferring to the state only the difference between VAT paid and VAT collected. As a general rule, however, a taxpayer may not offset input VAT if such VAT is incurred on the goods, work or services used by the taxpayer for the sale of goods or provision of services that are exempt from VAT. In this case, the taxpayer will be required to include such input VAT into its production costs and will effectively lose this input VAT for future recovery. In those cases where only a portion of certain input costs was used for the production of goods or provision of services subject to VAT, the corresponding input VAT may be offset only on a pro-rata basis. Careful planning will therefore be required to maintain full recovery if part of a newly constructed building is to be directly leased to representative offices or branches of foreign legal entities accredited in Russia.

Starting from 2006, foreign legal entities having more than one representative office and/or branch registered in various locations in Russia may consolidate all VAT accruals and offsets on a company level (prior to 2006, each representative office and/or branch was regarded as a separate VAT payer). For that purpose a foreign legal entity must choose a particular representative office or branch that would be responsible for VAT reporting on a company level and notify the local tax authorities responsible for each representative office and branch registered in Russia of its decision

A Russian customer of a foreign company that is not registered with the tax authorities and is active (making sales or rendering services) in Russia must withhold either 9.09% or 15.25% reverse charge VAT (depending on the applicable underlying VAT rate of 10% or 18%, respectively) from the amounts transferred to the foreign company and must itself remit such VAT directly to the state budget.

6.8 Mineral Extraction Tax

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

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

The mineral extraction tax is generally calculated as the value of the mineral resources extracted from the subsoil based on the prices (excluding VAT and excise taxes) at which the extracted minerals were sold, subject to the transfer pricing provisions of the *Tax Code*, and effectively not lower than the market price. Taxpayers are required to calculate the tax base separately for each type of mineral resource extracted and pay it on a monthly basis. In particular, Chapter 26 sets out a tax rate of 6% for gold, 6.5% for silver, 16.5% for oil, 17.5% for gas condensate, and 147 rubles (approximately USD 3.69) per 1,000 cubic meters of gas. Subsoil users having prospected and explored an oilfield at their own expense are required to pay 70% of the tax normally due for the natural resources extracted from the respective licensed oilfield. Subsoil users include the mineral extraction tax paid to the state budget in their deductible expenses, decreasing the taxable base of the corporate profits tax due. Chapter 26 does not provide for any special concessions for subsoil users.

Until 31 December 2006, the mineral extraction tax with respect to oil is determined as the quantity of extracted oil multiplied by the tax rate. The basic tax rate is 419 rubles, which is adjusted quarterly by a multiplier reflecting changes in world prices for Urals crude. This multiplier is determined under the following formula:

$$M = (P - 9) \times E / 261$$

where P is the average price for Urals crude in US dollars per barrel and E is the average RUR/USD exchange rate of the Central Bank of Russia for a given calendar quarter.

6.9 Taxation under Production Sharing Agreements

Pursuant to Chapter 26.4 of the *Tax Code*, effective as of 10 June 2003, companies extracting minerals under production sharing agreements (“Investors”) are subject to a special (and, in comparison with the mineral extraction tax, entirely different) tax regime. For instance, an Investor pays 50% of the mineral extraction rate for oil and gas condensate until it reaches a certain limit of commercial production, specified in the Production Sharing Agreement (“PSA”). Once an Investor has reached such limit, however, it pays the full mineral extraction rate for oil and gas condensate.

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

The PSA taxation regime introduced by Chapter 26.4 of the *Tax Code* has increased the number of tax law requirements for, and taxes payable by, Investors. These amendments (together with other legislative amendments described in Section 2.2 above) are unlikely to make PSAs an attractive proposition to Investors.

6.10 Corporate Property Tax

As of 1 January 2004, Chapter 30 of the *Tax Code* (covering the corporate property tax) came into effect, replacing the former 1991 *Corporate Property Tax Law*. The property tax is a regional tax, i.e. its imposition is regulated by the legislation of the relevant

region, to a maximum rate of 2.2%. The tax base includes movable and/or immovable fixed assets owned by the taxpayer in Russia, and is calculated based on the depreciated book value of those assets. Taxable assets no longer include any costs or intangible assets recorded on the taxpayer's balance sheet, nor land and water objects, and such are not subject to the property tax either.

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

6.11 Unified Social Tax

Effective 1 January 2001, one unified social tax replaced employers' contributions to four separate social benefit funds (the Pension Fund, the Social Security Fund, the Mandatory Medical Insurance Fund, and the Employment Fund). The unified social tax is paid centrally and is afterwards distributed among these three funds (the Employment Fund having been abolished). The unified social tax has a regressive tax scale from 26% to 2% of an employee's salary, with the lowest rate applicable to the portion of an employee's annual salary in excess of 600,000 rubles (approximately USD 21,430). The tax period is one year, and the tax is paid on a monthly basis.

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

6.12 Personal Income Tax

Individuals who are defined as "Russian tax residents," *i.e.* those who have been in the country for 183 days or more during any 12 consecutive months, are subject to personal income tax on all their income, both that earned in Russia and that earned

elsewhere. Individuals who do not meet this criterion are subject to tax on any income received from Russian sources. From 1 January 2001, Russia has enacted various income tax rates, including: a 13% flat rate applicable to most types of income; a 9% rate applicable to dividend income; a 35% rate applicable to income from gambling, lottery prizes, deemed income from low-interest or interest-free loans (except loans directed at new construction or dwelling acquisition), certain insurance payments and excessive bank interest; and a 30% rate applicable to Russian-source income received by non-residents.

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

6.13 Regional and Local Taxes

Regional and local legislative bodies may, at their discretion, introduce various tax incentives and credits with regard to regional and local taxes. Regional taxes currently include corporate property tax, transport tax, and gambling tax. Local taxes currently include property tax on individuals and land tax. Although these taxes are set regionally and locally, the federal legislature has enacted limits on their overall rates.

7. CURRENCY REGULATIONS

7.1 Introduction

The *Civil Code* states that the ruble is the national currency of the Russian Federation. Although agreements may refer to the ruble value equivalent of foreign currency, all transactions conducted inside the Russian Federation must, as a general rule, be settled in rubles. The *Civil Code*, however, permits the use of foreign currency in cases provided for by law. Federal Law No. 173-FZ *On Currency Regulations and Currency Control*, dated 10 December 2003, as amended, (the *Currency Law*) establishes the basic rules of currency regulation and control.

7.2 Currency Operations

The *Currency Law* regulates a broad range of currency operations including:

- Payments made in a foreign currency;
- Transfer of foreign securities;
- Ruble transfers between a Russian resident and a non-resident or between two non-residents;
- Transfer of domestic securities between a resident and a non-resident or between two non-residents;
- The import and export of rubles and securities;
- Transfer of funds and securities from the overseas account of a resident into a domestic account, and *vice versa*; and
- Transfer of rubles and securities between the domestic accounts of a non-resident.

7.3 Resident vs. Non-resident Status

The *Currency Law* divides individuals and legal entities into two classes: residents and non-residents. Residents include: Russian citizens and other individuals whose permanent place of residence is the Russian Federation; legal entities established in accordance with Russian legislation; representative offices (branches) of Russian legal entities outside of Russia; and the governments of the Russian Federation, constituent entities of the Russian Federation, and municipal units. Non-residents are defined as individuals whose permanent place of residence is located outside of Russia; legal entities incorporated outside Russia; enterprises/organizations that are not legal entities, organized and located outside the Russian Federation; and representative offices (branches) of foreign legal entities in Russia.

7.4 Special Currency Control Rules

As of January 1, 2007 most currency control limitations have been eliminated. However certain requirements still apply to Russian residents:

- Russian companies must hold all foreign currency export proceeds in their Russian bank account(s) (“repatriation of currency proceeds”);

- “transaction passports” are required for certain transactions (external trade, loans) at Russian banks;
- most Russian residents are prohibited from performing foreign currency transactions (the Currency Law provides some exceptions);
- the purchase and sale of foreign currency may only be performed at authorized Russian banks;
- cash exports are subject to restrictions;
- when a Russian company or individual opens an overseas bank account in OECD/FATF member countries they must notify the tax authorities and present regular reports on the cash flow in such accounts; and
- the operation of an overseas bank account by a Russian resident is subject to certain restrictions.

7.5 Liability for Violation

The *Currency Law* has reproduced the system of state agencies which are responsible for the execution of currency control. This includes: the CBR, the Government, and the federal agencies authorized by the Government. Currency control is executed through agents of the currency control regime, including: authorized banks, professional participants of the securities market, and governmental agencies.

Violation of Russian currency control requirements may entail civil, administrative, or criminal liability. Administrative penalties for violation of Russia’s currency control requirements include various fines, which may be imposed on individuals, legal entities, and company executives. The amount of a fine may be as high as the entire value of a transaction performed in violation of the currency control requirements. Other sanctions include the revocation of licenses (primarily applicable to banks), and imprisonment.

8. EMPLOYMENT

8.1 Introduction

The principal legislation governing labor relationships in the Russian Federation is the *Labor Code of the Russian Federation* (the *Labor Code*), effective 1 February 2002, as amended. A large number of important amendments to the *Labor Code* have been enacted by Federal Law No.90-FZ dated 30 June 2006, effective 6 October 2006. In addition to this core legislation, labor relationships are regulated by the 1996 Federal Law *On Trade Unions, Their Rights and Guarantees of Activities*, as amended (currently through 2005), as well as Russian legislation on minimum wages, labor safety and other related laws and numerous regulations.

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

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

Under Russian labor legislation, relevant employment duties and obligations must be defined in the employment contract. It is important that these duties and obligations are broadly defined, since an employee cannot be required to perform tasks outside of the scope of duties described in his/her employment contract. Similarly, an employer cannot make unilateral changes to an employer's obligations. In general employment terms and conditions which have been agreed upon by employer and employee can only be amended by agreement of both parties. In the limited cases where an employer is allowed to unilaterally amend the employment

terms and conditions agreed upon by the parties, the employer must notify the employee two months in advance of any changes and follow other formalities prescribed by law. .

8.2 Employment-related Orders

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

8.3 Labor Books

A labor book is a document containing information on a person's employment history, and certain other information. An employee must make sure that a record of employment is made in his/her labor book by an employer in respect of any employment of longer than five days. The labor book is vital because it confirms an employee's right to a state-provided pension and other social benefits. Employers are responsible for keeping their employees' labor books and making all records in them in a timely manner and in strict conformity with the required format. The employer must return the labor book duly completed and stamped to the employee on the last day of employment. If this is not done, the employer may be penalized.

8.4 Probationary Period

An employer has the right to establish a three-month probationary period for a newly hired employee. As an exception to the above rule, an employer may establish a six-month probationary period for employees hired for certain top executive positions (*e.g.* head of an organization, chief accountant and their deputies, head of a branch office, representative office, or other separate structural subdivision of an organization). The imposition of a probationary period must be specifically stated in the employment contract, as well as in the order on hiring. If, during the probationary period, the employer determines that the employee does not meet the criteria established for the role for which he/she was hired, the employee can be dismissed by the employer without payment of severance and with only three days' written notice. Importantly, such

notice to the employee must provide the reasons for the employee's failure to pass the probationary period. However, the employee is also entitled to resign during the probationary period without stating any reason with three days' written notice to the employer.

8.5 Minimum Wage

Wages may not be lower than the minimum monthly wage established by the applicable Russian legislation. The amount of the minimum monthly wage is subject to frequent indexation. The federal statutory minimum monthly wage is currently 1,100 rubles per month (as of the date of this publication approximately USD 42).

8.6 Work Time

Employers are required to keep a record of all the time worked by each employee, including any overtime. The regular work week is 40 hours. Any time worked over 40 hours is classified as overtime and may only be demanded by employers in extraordinary circumstances, as specified in Article 99 of the *Labor Code*, and in most cases upon an employee's prior written consent. The *Labor Code* limits the total amount of overtime for each employee to 120 hours a year, and an employee cannot be required to work more than four hours of overtime in two consecutive days. Overtime must be paid at a rate of 150% of the regular hourly rate for the first two hours of overtime worked during one day, and at a rate of 200% of the regular hourly rate thereafter. Upon an employee's written request, an employer must compensate overtime work by granting the employee additional time off in lieu of payment; the time off should be no less than the time worked as overtime.

It should be noted that certain limitations regarding overtime work apply to protected categories of employees, including employees under the age of 18, pregnant women, women with children under the age of three, disabled employees, and certain other categories as defined by federal laws.

8.7 Holidays and Non-working Days

There are currently 12 public holidays in the Russian Federation.

Uninterrupted weekly time off during weekends must not be less than 42 hours. As a rule, employees may only be required to work on a non-working day or on a public holiday in extraordinary circumstances, as specified in the *Labor Code*, and only upon

the employees' prior written consent. As a general rule, employees must receive payment at no less than twice the regular rate for any work performed on a non-working day or on a public holiday, or be given time off in lieu of payment.

Certain limitations regarding work requirements on public holidays and non-working days apply to certain protected categories of employees, including employees under the age of 18, pregnant women, women with children under the age of three, disabled employees, and other categories as defined by federal laws.

8.8 Vacations

Employees in Russia are entitled to annual paid vacation of at least 28 calendar days per year of employment. An employee is entitled to use his/her vacation time (in full) once he/she has worked for an employer for at least six months. The *Labor Code* requires that the dates of the annual vacation of each employee should be indicated in the schedule of vacations for the calendar year, which the employer must approve by mid-December of the preceding year. The *Labor Code* further requires that employers notify their employees in writing at least two weeks before the commencement of any vacation. An employee's vacation allowance should be paid to the employee at least three days before such a vacation is due to start.

8.9 Sick Leave

Employees are required to submit a medical certificate for any absence only after their recovery and return to work. Generally, employees cannot be terminated by their employer while absent on sick leave, and are entitled to receive sick leave compensation. Sick leave compensation is covered by the Russian State Social Insurance Fund, which is funded by the employer's mandatory contributions paid as a percentage of its employees' salaries in the form of the Unified Social Tax.

As of 1 January 2007, sick leave compensation and maternity leave compensation are regulated by Federal Law No. 255-FZ dated 29 December 2006 *On the Provision of Sick Leave and Maternity Leave Compensation to Citizens Eligible for Mandatory Social Insurance*. Pursuant to this law, sick leave compensation must be paid to an employee in the event of his/her illness, injury (labor-related or other), and in cases when an employee is caring for a sick family member, as well as in some other instances. The duration and amount of sick leave compensation will vary according to the grounds for the sick leave. In cases of a labor-related injury or occupational disease, the amount of sick leave compensation is 100% of the employee's average earnings. In other cases sick

leave or maternity leave compensation may not exceed the statutory maximum, which in 2007 is 16,125 rubles per month (approximately USD 613). If the employee has more than one place of employment he/she is entitled to sick leave compensation at each place of employment. If the employee's total work history is less than 6 months, the maximum sick leave compensation cannot exceed the minimum wage for a full month.

8.10 Maternity Leave

Paid maternity leave starts to accrue no later than 70 calendar days prior to a birth, and continues to accrue for an additional 70 calendar days thereafter. Paid maternity leave is provided for a longer period in the event of complications while giving birth or in cases of multiple births. Maternity leave compensation is covered by the Russian State Social Insurance Fund, which is funded by the employer's contributions retained as a percentage of its employees' salaries in the form of the Unified Social Tax. A child's care-giver (the employee who has given birth, the father, grandmother, grandfather, or another relative who is actually taking care of the child) may request partially paid childcare leave until the child is three years old. The employee retains the right to return to his/her job during the entire period of paid/unpaid leave, and the full leave period is included when calculating the employee's length of service.

8.11 Dismissal

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

8.12 Compensation

Salaries must be paid to employees at least once every half-month. Employers are obliged to pay salary and other employment-related payments on the dates set by their internal labor regulations or by the individual employment contract. An employer will be obliged to pay compensation (*i.e.* interest) for any delay in the payment of salary and other employment-related payments in accordance with the rules established under Article 236 of the *Labor Code*. In addition, employees have the right to stop working, with a prior written notice to their employer, if their employer has delayed payment of their salary for more than 15 days. Employees must be compensated in the currency of the Russian Federation (rubles). As a general rule, employment-related payments in a foreign currency (both in cash and by bank transfer) are prohibited.

8.13 Foreigners Working in Russia

Foreign nationals must obtain the relevant documents (work permit, work visa, etc.) before starting work in Russia. The procedure and documents vary according to whether or not the foreign national requires a Russian visa. The same rule applies to foreign nationals working in Russia under civil-law contracts for the performance of works or the provision of services (*e.g.* sales representatives). In Moscow, the procedure for obtaining permission to hire foreign nationals and individual work permits may take four to five months to complete, although this may be significantly shorter in other regions of the Russian Federation.

Foreign nationals working at accredited representative offices or branch offices of foreign firms also need to obtain a personal accreditation card from the accrediting body of the representative or branch office.

8.14 Trade Secrets

Trade secrets may form an important element of an employment relationship. In particular, Federal law No. 98-FZ *On Trade Secrets* that was enacted on 29 July 2004, provides for regulation of trade secrets in an employment relationship context. Under this law, if an employer desires to protect its trade secrets from unauthorized disclosure by employees, it should implement certain statutory procedures comprehensively named the “trade secrets regime.”

In order to implement a trade secrets regime, an employer should determine a list of trade secrets, restrict access to them, and include in the employment contracts

with employees provisions regulating trade secrets. Also, the law expressly lists the information that may not constitute trade secrets and therefore is not protected under the trade secrets regime.

Employees should be notified, against their signed receipt, of the trade secrets directly related to their job functions and of their liability for violation of the trade secrets regime. Also, an employer is required to provide the conditions necessary for the employees to observe the trade secrets regime.

The participating employees, on their part, must observe the trade secrets regime, must not disclose trade secrets, and must pay the damages arising out of a culpable disclosure of the protected trade secrets, if all the statutory procedures were properly implemented by the employer. The statute extends the protection of trade secrets beyond the termination of the employment relationship, forbidding employees from disclosing trade secrets for 3 years after employment was terminated. An employer may extend (or reduce) this term by agreement with the employees.

8.15 Personal Data

Pursuant to Federal Law No. 152-FZ *On Personal Data*, enacted on 27 July 2006 and effective as of 26 January, 2007, employers are required to obtain prior written consent from employees and other individuals in order to process their personal data. In particular, an employer must obtain consent when transferring personal data to any third parties or abroad. These requirements are of importance to transnational companies with subsidiaries, representative offices or branch offices in Russia which generally process the personal data of their Russian employees and individual contractors at a central location abroad. They are also important for all employers who transfer the personal data of their employees to law firms, audit and accounting firms, and other providers of professional services.

9. PROPERTY RIGHTS

9.1 Introduction

Both the *Constitution of the Russian Federation* and the *Civil Code of the Russian Federation* uphold the right to own private property. The *Land Code* of October 2001, and other legislation adopted as a follow-up to the *Land Code*, represent significant measures ensuring that this policy becomes a reality.

President Vladimir Putin and the Government of the Russian Federation have always recognized the importance of statutory regulation of the status of land. As a result, the *Land Code* was adopted by the State Duma, approved by the Federation Council, and signed by the President on 25 October 2001. As provided in Federal Law No. 137-FZ *On Implementation of the Land Code* of 25 October 2001 as amended (the *Implementing Law*), the *Land Code* came into force on the date of its publication, 30 October 2001. The *Land Code* has since been amended several times to meet the requirements of the Russian market economy and to comply with amendments made to other Codes (Forestry Code, Water Code, Town-Planning Code) and other legal acts of the Russian Federation.

The *Land Code*, together with Federal Law No. 101-FZ *On Circulation of Agricultural Lands* of 24 July 2002 as amended (the *Circulation Law*), which entered into force in January 2003, put an end to the political debate as to whether land ownership in Russia is possible. The new Federal Law No. 172-FZ *On Transfer of Lands and Land Plots from One Category to Another Category* of 28 December 2004 as amended (the *Land Category Law*), came into force on 5 January 2005. A follow-up on the *Land Code* and the *Implementing Law*, it finalizes procedures for the transfer of lands and land plots among different categories at the federal level. The *Land Category Law* defines the respective powers of federal authorities, authorities of the constituent entities of the Russian Federation (see p. 1.3), and local authorities in the procedure of changing the category of land plots. The uniform mechanism installed at the federal level to move land plots from one category to another marks a significant development in making the land market in Russia more transparent.

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

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

9.2 Ownership of Land

The general principles of land ownership are set forth in the *Constitution of the Russian Federation*, adopted in December 1993. Article 9 of the *Constitution* establishes the principle of private ownership of land but does not, however, stipulate the procedure for the transfer of land (which had historically been owned by the state) into private ownership. This legislative vacuum has prompted a rise in the number of regional laws and regulations, as well as Presidential Decrees, adopted in an attempt to regulate various land issues. Such regional initiatives, however, have raised a more serious concern with respect to the overall validity of all of the regional laws on land ownership. According to Article 72 of the *Constitution*, decisions on issues regarding the possession, use, and disposal of land are the joint responsibility of the federation and its constituent entities. Article 76 of the *Constitution* further provides that a federal law must govern such issues of joint responsibility. Such federal law may be supplemented by laws and other regulations which the constituent entities of the federation may issue in compliance with the federal law in question. In addition, Article 36 of the *Constitution* provides that a federal law must determine the "terms and procedures of land use."

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

The possession, use, and disposal of land plots designated for agricultural use are regulated by the *Circulation Law*. Not all agricultural land, however, is subject to the *Circulation Law*. It does not extend, for example, to those land plots which were provided to individuals for the construction of individual homes or garages, or for carrying on a smallholding or dacha garden; such land plots being covered by the provisions of the *Land Code*. Agricultural land plots may be held by right of ownership, perpetual (indefinite) use, lifelong inheritable possession, or free fixed-term use, and such plots may also be

leased. Ownership of land plots in state or municipal ownership is to be awarded to individuals and legal entities, as a rule, through bidding by tender or auction. Such bidding may also be held during such land plots' lease when they are claimed by two or more potential lessees – the organization of such tenders or auctions being described in Article 38 of the *Land Code*. However, an important exception to this general rule exists until 1 January 2008: owners of existing buildings, facilities or structures located on land owned by a third party now enjoy the pre-emptive right to purchase or lease the land plot beneath such buildings.

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

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

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

New rights of perpetual or indefinite use may only be granted to state and municipal institutions, federal treasury-owned enterprises, and state and local authorities. Legal entities (other than those listed above) with existing rights of perpetual use will no longer be able to transfer these rights. Under the terms of the *Implementing Law*, these entities had until 1 January 2004 to convert and re-register their rights as (at their option) either lease or ownership rights. This term has been extended twice: until 1 January 2006, in accordance with Federal Law No. 160-FZ of 8 December 2003, and subsequently until 1 January 2008 in accordance with Federal Law No. 192-FZ of 27 December 2005. Presently, any legal entity looking to transfer its land rights to another legal entity, such as a joint venture, will first need to upgrade its rights accordingly before contributions can be made.

The *Land Code* sets out detailed procedures for acquiring rights over federally or municipally owned land which is intended for new construction. In particular, the *Land Code* distinguishes two scenarios. Under the first, a land plot must first have been “prepared” for sale or lease: its boundaries defined, a cadastral number (a special number assigned to land plots indicating their area, location, type category, etc.) assigned, and technical conditions for connection to utilities determined. In such cases, the *Land Code* provides either for acquisition of land directly into private ownership, or for lease.

The second scenario for the allocation of land for construction purposes is to be used when a new project will require a thorough investigation of ecological, sanitary, architectural and other issues, and a specific request for land rights from an investor. This may also involve the investigation of public opinion regarding construction in the area. The land will be given to legal entities and individuals on lease only. For construction of religious buildings and structures, religious organizations are granted with free-fixed term use for the period of such construction.

Of particular interest to owners of existing buildings and structures is the option to privatize or to obtain land lease rights over the land plots on which their buildings are located when such land plots are owned by the state or a municipality. Owners of existing buildings, facilities or structures located on land owned by a third party now enjoy the pre-emptive right to purchase or lease the land plot beneath such buildings until 1 January 2008.

9.3 Ownership of Buildings

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

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

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

9.4 Leases

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

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

The level of rent payments for the majority of land leases granted by the state or municipalities is set by a general local decree. In Moscow, where the demand for land remains relatively high, a lessee must pay rent calculated on the basis of a formula. In addition, a Moscow lessee must pay for the right to lease any land in excess of the area of the existing buildings on that land. In St. Petersburg, the level of rent is determined by a decree of the Governor; the levels differ depending on the location of the site and the type of activity of the lessee. The basis for granting a lease for a municipal or state-owned building, as well as the rental payments, is normally established by a local decree. The parties themselves may negotiate leases for part of a privately-owned building. To date, few office and retail-sector leases have exceeded a ten-year term; with five-year terms being the most common. Longer leases of 15 years or more have been executed in the industrial sector. All three markets, however, are changing rapidly. Sub-leases are also permitted, and are subject to any contractual restrictions in the primary lease.

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

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

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

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

Most leases must be state-registered to be valid, the only exception being leases of buildings, premises, and land plots for a period of less than one year.

9.5 State Registration of Rights to Immovable Property

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

According to the *Registration Law*, transactions involving immovable property (buildings, land, *etc.*) are also subject to state registration, and become effective and enforceable only upon such registration. The registration process is carried out by the registration authorities in the location of the immovable property. State registration of an immovable property right or an immovable property transaction takes one month. The *Registration Law* specifies the grounds for refusal or suspension of state registration. Refusal in state registration can be contested only through a court.

The registration authorities maintain the Unified State Register of Rights to and Transactions With Immovable Property (the “Register”), which indicates the history and the current status of the immovable property in question. This Register also records various encumbrances over immovable property, including leases and claims submitted to a court. The registration authorities issue a certificate in a prescribed form that certifies the rights to the immovable property. Information on state-registered transactions with immovable property is also included in the Register. Basic information on the right holder(s) and restrictions (encumbrances) of such rights is open to the public, and can be provided for a fee to any person submitting a written request within five business days after submission of an application to the registration authority.

Land plots are also required to undergo cadastral registration. The procedures and rules for the state cadastral registration of land are outlined in Federal Law No. 28-FZ *On the State Land Cadastre*, dated 2 January 2000 (the *Land Cadastre Law*), which came into force in July 2000. The state cadastral registration applies to all land plots located in the Russian Federation, regardless of the form of ownership, the designation, or the authorized use of the land plots. Under the *Land Code*, only land plots that have state cadastral registration can be the subject matter of a sale-purchase transaction. In practice, particularly in Moscow, this applies to all transactions with land plots. The State Cadastre of Land (the “*Land Cadastre*”) is established pursuant to the Land Cadastre Law and contains detailed information on land plots, including their cadastral number, location, land

category and authorized use, borders, registered proprietary rights and encumbrances, and information on any immovable property located thereon. Information contained in the Land Cadastre is available to the public. The *Land Cadastre Law* states that such information will also be provided in the form of extracts and copied documents from cadastral files. Additional regulations and rules will define the procedures for filing the relevant applications to obtain such information.

9.6 Classifications of Real Estate

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

It should be noted that all real estate construction requires state permits and approvals. The new *Town Planning Code* of 29 December 2004 as amended (the *Town Planning Code*), prescribes at the federal level those documents to be prepared for construction, procedures for their approval, and the grounds for refusal of such construction.

9.7 Payments for Real Estate

Previously, when a foreign investor purchased or simply leased real estate from Russian residents, payments for the real estate purchased and, usually, lease payments effected in foreign currency, were classified as “capital transfer transactions,” requiring a specific license from the Central Bank of the Russian Federation. This licensing requirement has now been abolished. Furthermore, under Federal Law No. 173-FZ *On Currency Regulation and Currency Control* dated 10 December 2003 (the greater part of which came into effect on 17 June 2004), foreign currency payments made by foreign investors to Russian residents in consideration of purchased or leased immovable property are no longer deemed “capital transfer transactions.” Additionally, where both the seller and the buyer (or the lessor and the lessee), are foreign legal entities, a payment in foreign currency to an offshore bank account is also possible. Such transactions, however, may have tax consequences, particularly with regard to withholding tax.

9.8 Residential Real Estate

Until the early 1990s, most apartments in the Russian Federation were state or municipally owned. However, many apartments have since been privatized or constructed by investors, and are in private ownership. The new *Housing Code* of 29 December 2004 (the *Housing Code*), which came into effect from 1 March 2005, reflects such changes in the housing sector. Unlike the previous *Housing Code*, which regulated relations of lessees of state or municipally owned apartments, the new *Housing Code* focuses largely on relations between the owners of residential property. The *Housing Code* defines categories of residential property, which include a residential house (cottage), an apartment in a multi-storey building or a room in such an apartment, as well as various forms of housing ownership. Residential property may be used only for residence by individuals. Following adoption of the *Housing Code*, Federal Law No. 72 *On Partnerships of Home Owners* dated 15 June 1996 (the Condominium Law), is no longer in effect.

9.9 Mortgage of Real Estate

Federal Law No. 102-FZ *On Mortgage of Real Property* of 16 July 1998 (the *Mortgage Law*), has been amended on many occasions following its coming into effect on 22 July 1998, most recently on 18 December 2006. The *Mortgage Law* significantly improves the potential of mortgages as an instrument for investments. It is important to note that buildings and structures can only be mortgaged together with the land plots on which such buildings and structures are located.

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

Until recently, in order to be valid, a mortgage agreement was required to be certified by a Russian notary and registered with the relevant state real property registration authority. At present, certification of a mortgage agreement by a Russian notary is no longer required, but state registration is mandatory, and in the absence of such state

registration a mortgage agreement is null and void. A mortgage agreement enters into force from the date of its state registration. The *Mortgage Law* requires that in addition to the right by virtue of which the property is mortgaged, the mortgage agreement must include the name of the registration authority that registers the mortgage. The local office of the state real property registration authority can provide information on the absence or presence of a valid mortgage over immovable property in the form of an extract from the Register.

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

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

The terms and conditions of a mortgage may restrict the owner's or user's capability to dispose of the property, including its contribution to charter capital and/or lease to third parties. Therefore, confirmation of the absence or existence of a valid mortgage over the property is important. If there is a valid mortgage, the purchase can be effected only with the consent of the mortgagee. Even then, notwithstanding such consent, the mortgage will follow the immovable property unless and until the primary obligation secured by the mortgage is performed and the property is released from it.

The *Mortgage Law* as amended includes some significant changes: the revised Article 77 of the *Mortgage Law* provides that, unless otherwise provided in the mortgage agreement or by federal law, a house or an apartment which was purchased or constructed with loans from banks or other credit companies is deemed to be mortgaged from the date of state registration of the ownership right of the purchaser/investor of the house or the apartment. Article 78 of the *Mortgage Law* further provides that foreclosure by the

mortgagee on a mortgaged residential house or apartment and disposal of such property constitutes grounds for termination of occupancy rights of a mortgagor and the family members residing together in such residential house or apartment, provided that this residential house or apartment was mortgaged under a mortgage agreement to secure the return of a loan granted for the purchase or construction of such residential house or apartment.

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

The *Mortgage Law* as amended also introduced changes with respect to the extension of an existing mortgage on a newly constructed building. The previous version of Article 65 of the *Mortgage Law* provided that a mortgage did not extend to buildings and structures constructed on a mortgaged land plot unless otherwise stipulated by the mortgage agreement. Based on this provision of the *Mortgage Law*, the real property registration authorities demanded that an addendum to the existing mortgage be signed each time the existing mortgage was to be extended to cover a newly constructed building or structure. This had inevitable consequences in terms of delays and cost, particularly in view of the applicable notary fee of 1.5% of the mortgaged property value, payable each time such an addendum was executed. Currently, according to Article 65 as amended, the existing mortgage of a land plot is automatically extended to cover a building or a structure erected on a land plot by the mortgagor, unless otherwise provided by the mortgage agreement. The revised Article 65 of the *Mortgage Law* allows a mortgagee to extend the mortgage over a land plot to all buildings and structures that may be constructed on the plot, without the need for a subsequent addendum.

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

10. PRIVATIZATION

10.1 History of Privatization

In general, the privatization process in Russia can be roughly summarized as occurring in three progressive stages. The first stage of “voucher-assisted privatization” lasted from 1992 to 1994, and included the privatization of state property on a massive scale. This first privatization scheme allocated vouchers to state employees, with these vouchers later transformed into shares in the capital structures of newly established (privatized) joint stock companies.

Although at this early stage the country lacked experience in all privatization matters, and the first *Privatization Law* of 3 July 1991 was perhaps inevitably undeveloped, the Government’s rush to privatize companies through the allocation of vouchers resulted in a very large percentage of state-owned entities being transferred into private hands.

The second stage of the privatization process lasted from 1995 to 1996, and was focused on obtaining large payments for significant enterprise stakes. The principal objective of this scheme was to replenish the state budget and to attract domestic and foreign investment into Russia. Unfortunately, this objective was never achieved because:

- Most of the financially viable and attractive businesses had already been privatized during the first stage of development;
- Domestically, large-scale investors did not yet exist; and
- Foreign investors were still wary of large-scale capital injections into Russian entities (particularly due to the volatile political environment in the Russian Federation at the time).

As a result of the difficulty in attracting investment during this second stage, the “loans for shares” scheme was introduced. The outcome of these auctions was that a limited number of Russian businessmen were able to acquire state property at artificially low prices.

Since that time, there have been very few major developments within the sphere of privatization.

The *Privatization Law* provided for a single fundamental sanction for the failure to abide by the privatization rules, *i.e.* that the corresponding transaction could be declared

void, and the property unlawfully acquired be returned to the state. Furthermore, the privatized entities and the procedures relating to their privatization could be challenged and declared invalid for a period of up to ten years. In this context, returning those companies that had been privatized in gross violation of the applicable legislation to the state would appear to be justifiable from both a legal and political standpoint.

Mindful of the potentially negative effects of any reversal of the privatization process President Putin indicated on several occasions that he would be unlikely to allow any significant reviews of previously held privatization proceedings. Shortly after that the statute of limitations to reconstitute a void transaction (including past privatization deals which it was still possible to reconstitute by 25 July 2005 on the ground of the deals' alleged invalidity) was reduced from ten to three years.

10.2 Current Status

The new *Privatization Law* entered into force on 26 April 2002. In contrast to previous legislation and consistent with Government policy with respect to the sale of land, the new *Privatization Law* allows the privatization of land plots associated with real estate objects. The new *Privatization Law* also established a number of new privatization methods including, for example, the sale of shares in open joint stock companies on stock exchanges, and the sale of such shares outside the Russian Federation. At the same time, some of the previously well-known and widely used methods of privatization (such as the sale of shares in open joint stock companies to their employees, or the buyout of the leased state property by the lessees) are now excluded from the new *Privatization Law*. In doing so, the Government is trying to eliminate the use of "cheap" methods of privatization, which appears to be a reasonable and long-expected change based on the inadequacies of previous privatization attempts.

Current legislation on privatization clearly demonstrates an overall increase in state control over the privatization process, the specific forms of which, in many instances, are yet to be developed. It is unlikely that there will be a great deal of privatization activity in the short run.

11. LANGUAGE POLICY

Under Article 68 of the *Constitution of the Russian Federation*, the state language throughout the territory of the Russian Federation is Russian. All official election materials, legislation, and other legal acts, must be published in the official state language.

In addition, the *Constitution* upholds the rights of each of the individual republics within the Russian Federation to establish its own state language. Thus, regional state bodies and local institutions of self-government within Russia's 21 republics may conduct official state business in two languages: Russian and the republic's national language.

Foreign investors should be aware of some of the restrictions governing the use of the Russian language. For example, the Federal Law *On the State Language of the Russian Federation* requires that all advertising in the Russian Federation must be either in Russian or in the particular state language of the individual republic in which the advertising appears. The exceptions to this rule are trademarks, which may be in the original language of the trademark, and mass media designed for teaching foreign languages. In addition, the use of the word "Russia" or "Russian Federation" in the name of a company (except for the transliterated foreign spelling of the same words) exposes that company to certain tax consequences.

12. CIVIL LEGISLATION

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

Part I of the *Civil Code* upholds such rights as the rights to own and inherit property; to engage in entrepreneurial activity; to establish independent legal entities, and provides for the protection of intellectual property rights. Part I also defines concepts such as securities, transaction, obligation, power of attorney and contract. Part II further expands on the law of obligations, and contains provisions governing certain types of contracts: sale and purchase; barter; donation; annuity; rent; contractor's agreement; provision of services; transportation; forwarding; loan; insurance; agency. In addition, Part II of the *Civil Code* provides for non-contractual obligations such as agency without authority, torts (including product liability), unjust enrichment, public contest, and public promise of a reward.

Although Parts I and II of the *Civil Code* were signed into law, several provisions of the *Civil Code* required the adoption of additional legislation. Such legislation has now, in large part, been adopted including the Federal Law *On Joint Stock Companies*, the Federal Law *On Limited Liability Companies*, and the Federal Law *On State Registration of Legal Entities*. Instances remain, however, where appropriate legislation has not been adopted – the absence of a mutual insurance law being one such example.

Part III of the *Civil Code* entered into force on 1 March 2002, covering the law of succession and choice of law rules. Part III, Chapter V of the *Civil Code* (the *Inheritance Law*) details the rights of citizens to dispose of their property by devise, establishes priority categories of heirs-at-law (*i.e.* those who inherit absent a devise), and provides for other forms of taking the inheritance. Legal entities and the state may act as heirs. In addition to regular wills (which should be executed in writing and notarized), Chapter V provides for confidential wills and wills made in a simple written form. Furthermore, irrespective of the contents of a testator’s will, the testator’s minor or disabled children (as well as their disabled spouse, parents, or dependents) are entitled to a compulsory inheritance of at least one half of the amount they would have been allocated under the *Civil Code* had there been no will.

Part III, Chapter VI (the *International Private Law*) regulates transactions “complicated by a foreign element” *i.e.* transactions with a foreign citizen or with a foreign legal entity, or otherwise when a “foreign element” is involved (for instance, a contract for the sale of real property located abroad). Chapter VI contains a number of essential innovations, including, for instance, the default rule of the closest connection for determining substantive law applicable to a civil-law obligation. The parties to a transaction that is complicated by a foreign element are free to choose any nation’s law (either Russian or foreign) as applicable to their transaction, except for cases where the chosen law contravenes the public policy (public order) of the Russian Federation or preemptory rules of Russian Federation law.

Part III, Chapter VI of the *Civil Code* also provides other conflict-of-law rules, relating to both contractual and non-contractual (*e.g.* torts) obligations. In particular, specific provisions in the *Code* determine law applicable to international consumer transactions; assignment of rights; obligations arising from unilateral transactions; interest accrued on monetary liabilities; product and service liability; liability for unfair competition; unjust enrichment.

Part IV of the Civil Code, adopted on December 18, 2006, will come into effect on January 1, 2008, covering various intellectual property issues that are currently regulated by a number of separate statutes.⁶²

13. BANKING

13.1 Legal Framework

The foundations of the Russian banking system are provided in Federal Law No. 395-1 *On Banks and Banking Activities*, dated 2 December 1990 (the “Banking Law”), and Federal Law No.86-FZ *On the Central Bank of the Russian Federation*, dated 10 July 2002 (the “CBR Law”). Bank insolvency is regulated by Federal Law No. 40-FZ *On Insolvency (Bankruptcy) of Credit Organizations*, dated 25 February 1999. The Central Bank of the Russian Federation (the “CBR”) is responsible for regulating banking activities. Through its instructions, regulations, and other acts, the CBR establishes rules, standards, and obligatory requirements for banks and non-banking credit organizations throughout the territory of the Russian Federation.

13.2 Regulatory Bodies

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

The CBR and the Government share authority over monetary policy. The CBR is responsible for circulating monetary funds and ensuring the stability of the Russian ruble. As part of its general oversight role, the CBR establishes state registration and

⁶² For intellectual property, see Chapter 14.

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

Several self-regulatory banking organizations, among which the Association of Russian Banks (the “ARB”) is the largest, are also important standard-setting bodies.

13.3 Credit Organizations in the Russian Market

Pursuant to the Banking Law, there are two main groups of credit organizations: banks and non-banking credit organizations. A bank is a credit organization which may simultaneously engage in most banking activities, subject to obtaining a general CBR license (see Section 13.5, below). Banks, however, need special licenses to take deposits from individuals and/or to operate with precious metals. Conversely, a non-banking credit organization is an entity which is established to perform a limited number of specified banking operations and obtains a limited CBR license for this purpose. Banks and non-banking credit organizations may participate in banking groups (when the controlling company is a credit organization) and banking holdings (when the controlling company is a non-credit organization).

Currently, foreign banks may not establish branch offices in the Russian Federation but may set up Russian banking subsidiaries. The participation of foreign banks in the Russian market is subject to certain restrictions. However, at the end of 2006 the regulatory regime in this area was significantly liberalized. In particular, non-residents now need the CBR’s prior approval only if they acquire 20% or more of a Russian bank’s shares. When a non-resident acquires more than 1% but less than 20%, the CBR need only be notified. This is similar to the regulation which applies to Russian residents. Also the CBR may not establish additional requirements for the offices and subsidiaries of foreign banks related to mandatory ratios and minimal charter capital. However, such additional requirements in the areas of reporting, governing bodies and permitted operations of such offices and subsidiaries may still be introduced.

13.4 Banking Activities

According to the Banking Law, the list of banking operations includes: raising and investing funds; depositing precious metals; maintaining accounts; providing bank accounts for individuals and legal entities; collecting money; exchanging foreign currency; issuing bank guarantees; and transferring money. Banks are also entitled to perform certain non-banking operations, inter alia: providing financial suretyship;

trust management; performing operations with precious metals and stones; renting safe deposit boxes; participating in financial leasing operations; and providing consultancy and other informational services. Credit organizations are prohibited from engaging in any industrial, trade, or insurance activities.

13.5 Licensing

A credit organization must be licensed by the CBR in order to conduct “banking activities” as defined in the Banking Law, and must be incorporated in the Russian Federation. License applicants must submit a feasibility report, detailed information on senior management and their compliance with qualification requirements, and documents certifying the source of funds contributed to the charter capital of the credit organization, to the CBR. Newly established banks can receive the following licenses:

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

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

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

The CBR may refuse to issue a banking license in the event of: non-compliance of the application documents with Russian legal requirements; the unsatisfactory financial standing of the owners of the credit organization; the inability of the chief executive officer and chief accountant of the credit organization (or their deputies or members of the management board of the credit organization) to meet the qualification requirements; and the unsatisfactory business reputation of members of the board of directors of the credit organization.

13.6 Deposit Insurance

Federal Law No. 177-FZ *On Insurance of Deposits of Individuals in the Banks of the Russian Federation*, dated 23 December 2003 (the “Deposit Insurance Law”), came into effect at the end of December 2003 and established an insurance system for the deposits of individuals. The Deposit Insurance Law is intended to protect the interests of individual depositors. It stipulates that all banks accepting individual deposits become members of the deposit insurance system. The Agency for Deposit Insurance (the “Agency”) is responsible for supervising the bank deposit insurance system. Henceforth, banks that have been issued a retail banking license will be entered into the Agency’s register. Banks that hold a valid retail banking license will need to apply to the CBR to become registered as a participant in the mandatory deposit insurance system. A bank is expected to pass a number of tests before it can be admitted. The CBR must be assured that: the bank’s financial accounts and reports are accurate; the bank is in full compliance with the CBR mandatory ratios (capital adequacy, liquidity, etc.); the bank’s solvency position is sufficient; and that the CBR has not cancelled such bank’s banking license. If a bank fails the above tests or chooses not to participate in the deposits insurance system, it will not be able to attract deposits from, or open accounts for, individuals. Member banks have to make contributions to the special deposit insurance fund. These contributions will be calculated as a percentage of the average daily balance of individual deposits maintained with a particular bank, and are generally subject to an upper limit of 0.15%. All individual depositors with deposits in member banks will be entitled to 100% compensation for aggregate amounts up to RUR 190,000 (approximately USD 7,200).

13.7 Money Laundering

On the basis of recommendations made by the Financial Action Task Force on Money Laundering (the “FATF”), the State Duma adopted Federal Law No. 115-FZ *On Combating Money Laundering and the Financing of Terrorism* (the *Money Laundering Law*), which came into force on 1 February 2002. The *Money Laundering Law* requires banks and a wide range of financial institutions to report any cash or electronic transactions of 600,000 rubles or more (approximately USD 22,700), as well as any suspicious transaction (i.e. that may be related to criminal activity) to the Federal Financial Monitoring Service. The *Money Laundering Law* establishes requirements governing the supervision and reporting of suspicious transactions (including internal record-keeping and customer identification procedures) by financial institutions such as banks and non-banking credit organizations, professional participants of securities markets, insurance

and leasing companies, postal and other non-credit organizations that deal with the transmission of money. The rules governing a financial institution's internal record-keeping and the reporting of suspicious transactions include an obligation to investigate all complex or unusual transaction schemes that have no apparent economic or lawful purpose. Financial institutions are exempt from legal responsibility for breach of any obligatory information disclosure restrictions when such a breach is necessary for compliance with the *Money Laundering Law*. The *Money Laundering Law* requires financial institutions to ascertain the actual identity of their customers and to disallow the creation and maintenance of anonymously held accounts.

Failure to comply with the requirements of the *Money Laundering Law* may serve as the basis for revocation of a bank's license. Administrative penalties for violation of Russia's money laundering requirements include various fines, which may be imposed on officials and legal entities. The fines can be up to 20,000 rubles (approximately USD 760) for officials and up to 500,000 rubles (approximately USD 18,900), for legal entities.

14. NATURAL RESOURCES (OIL AND GAS/MINING)

Today Russia is one of the largest mineral producers in the world. Russian deposits contain approximately 15 to 17 per cent of the world's global mineral deposits and Russian mineral resources are an important component of its wealth.

14.1 Introduction

Russia differs from many other countries, where the private ownership of minerals in the ground exists and where land owners have title to all mineral resources located below their land plots. All Russian subsoil resources in the ground, including oil, gas, gold and other minerals, unless extracted, are owned by the Russian state, irrespective of who has the title to the relevant land plot or holds the relevant subsoil license. Rights to extract subsoil resources can be granted under subsoil licenses which, as a rule, provide that ownership rights to the extracted resources belong to the holder of the relevant license.

14.2 Subsoil Legislation

The Constitution of the Russian Federation stipulates that subsoil-use legislation falls within the joint competence of the federal and regional state authorities. However, in practical terms, the regional authorities have competence over deposits of certain widespread mineral resources and insignificant subsoil deposits.

The core legal act in the mining and oil and gas domain is Russian Federation Law on Subsoil Resources dated 21 February 1992 (the *Subsoil Law*). The *Subsoil Law* provides the general legal framework for the use of subsoil resources in Russia and covers almost all principal issues connected with geological survey, exploration and production/mining of underground resources.

The other principal law governing the use of subsoil resources in Russia is the Federal Law on Production Sharing Agreements dated 30 December 1995, as amended (the *PSA Law*). The PSA Law sets forth the legal framework for Russian and foreign investments in the geological survey, exploration and production of subsoil resources.

14.3 Subsoil Users

Under the *Subsoil Law*, both Russian and foreign companies may hold subsoil licenses in the Russian Federation. However in practice there are only a few cases where a foreign company directly holds subsoil rights in Russia. Usually foreign companies hold subsoil rights to Russian deposits indirectly through their Russian subsidiaries.

14.4 Licenses

Russia, similarly to many other countries, has adopted a licensing system. Subsoil licenses in Russia include: geological survey licenses, exploration and mining/production licenses and combined licenses (geological survey, exploration and mining/production licenses).

A geological survey license may be granted for a maximum period of 5 years and can be extended if needed for completion of the works. Exploration and mining/production licenses and combined licenses can be issued for a term equal to the life of the project, however in practice they are usually granted for 20 or 25 year terms and can generally be extended.

Geological survey licenses are issued without a tender or auction based on an application of the interested party. Unlike geological survey licenses, mining/production licenses

and combined licenses can be granted only through a tender or auction, except when a mining/production or combined license is issued to a holder of geological rights that made a commercial discovery under a geological survey license.

Subsoil licenses are issued by the Federal Agency for Subsoil Use (Rosnedra). Rosnedra is in charge of granting subsoil rights with respect to all onshore deposits, as well as granting rights for the geological survey of offshore deposits. Rights to production of oil and gas on offshore fields may only be granted based on a decision of the Government of the Russian Federation.

14.5 Transfer of Subsoil Rights

As a general rule, subsoil rights in Russia are not freely transferable. This means that they cannot be sold, pledged or otherwise encumbered. However, the *Subsoil Law* permits the transfer of subsoil rights in certain instances, which makes such rights transferable to a limited extent. Such instances include: (i) transfer of subsoil rights from a parent company to its subsidiary and vice versa and transfer between the subsidiaries of the same parent company; (ii) transfer following a merger of the license holder with and into another company; (iii) transfer following a consolidation of the license holder with another company; (iv) transfer following a spin-off or split-off of a new company. Any such transfer of subsoil rights requires a special decision of Rosnedra.

The above options are often used by subsoil users for structuring their business, as well as for the “sale” of licenses, which is only possible through a sale of the licensee’s shares.

15. INTELLECTUAL PROPERTY

15.1 Regulatory Environment

The primary legislation regulating intellectual property in Russia was passed in 1992. This legislation included laws on the protection of trademarks, software programs and databases, patents, as well as topologies of integrated microcircuits. The Federal Law *On Copyright and Neighboring Rights* (the *Copyright Law*) was passed in 1993 and revised in 1995. During 2002 – 2003, significant amendments were made to the Federal Law *On Trademarks, Service Marks, and Appellation of Origin of Goods* (the *Trademark Law*), the

Patent Law, the Federal Law *On Legal Protection of Software Programs and Databases* (the *Software Law*) and the Federal Law *On Legal Protection of Topologies of Integrated Microcircuits*. The Federal Law *On Trade Secrets* (the *Law on Trade Secrets*) was adopted in 2004.

In December 2006, Part IV of the *Civil Code*, which specifically governs intellectual property issues, was passed. This codification will take effect as of January 1, 2008 and will replace all Russian laws which previously regulated intellectual property issues, including the *Copyright Law*, the *Trademark Law*, the *Patent Law*, the *Software Law*. It also cancels or amends a number of related legal acts.

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

Russia is a signatory to major international treaties on intellectual property rights, including the Universal Copyright Convention, the Berne Convention for the Protection of Literary and Artistic Works, the Paris Convention for the Protection of Industrial Property, the Patent Cooperation Treaty, the Madrid Agreement on the International Registration of Trademarks and the Protocol to the Madrid Agreement.

15.2 Patents

An **invention** is a technical solution in any field related to a product (*inter alia*, to a device, substance, microbial strain, cell culture of plants and animals) or a process. Patent protection is given to an invention if it is novel, inventive and industrially applicable. The maximum duration of patent protection for an invention is 20 years from the date of the application, subject to payment of annuities. The term of a patent for an invention related to a medicine, pesticide or agrochemical, the use of which is subject to obtaining special permission, may be extended at the request of the patent owner for a period not exceeding five years. The right to obtain a patent belongs to the inventor, his/her employer (in case of an employee's invention) and their assignees. A patent application is filed with the Federal Service for Intellectual Property, Patents and Trademarks ("Rospatent"), which examines it and grants the patent if the invention meets the above-mentioned criteria.

A **utility model** is a technical solution pertaining to a device. Utility model protection is similar to that of invention with certain limitations and restrictions. A utility model is granted patent protection if it is new and industrially applicable. The term of protection is 5 years from the filing date of the application, and may be extended for an additional three-year period.

An industrial design is an artistic and design solution that determines the external appearance of a product of industrial or handicraft origin. Patent protection is granted for 10 years if the industrial design is new and original. This protection may be extended for additional five years.

Part IV of the *Civil Code* extends the terms of patent protection to 10 years from the filing date of the application for utility models and 15 years for industrial designs. Pursuant to Part IV of the *Civil Code*, the term of a patent for industrial design may be extended for an additional period not exceeding 10 years.

Under Russian law it is possible to assign or license an invention, utility model or industrial design that is protected by a patent to another person. Such assignment and license agreements must be registered with the Rospatent. In the absence of such registration, they are deemed null and void.

The patent owner has the sole right to use an invention, utility model or industrial design that is protected by such patent. Without the patent owner's permission, no one is allowed to use a patented object in any way, including importation, manufacture, application, offer for sale, sale, other introduction into commercial interactions or storage for this purpose. Patent infringement entails civil, administrative and/or criminal liability.

15.3 Trademarks, Service Marks, and Appellation of Origin of Goods

Under the Russian Trademark Law, trademarks (service marks) are designations, individualizing goods or services of legal persons and individual entrepreneurs. Legal protection of trademarks and service marks is granted by virtue of their registration with Rospatent or by virtue of international agreements to which the Russian Federation is a party. A mark may be represented by a word or words, pictures, three-dimensional signs and other designations or combinations thereof. The trademark may be registered in any color or color combination.

The trademark and service mark protection is granted for a period of 10 years from the filing date of the application and may be renewed during the last year of its validity for subsequent 10-year periods. The trademark and service mark registration is cancelled when its term expires without having been renewed. The trademark and service mark legal protection may be terminated upon a request from any party in respect of all or part of goods and services due to non-use of the trademark or service mark during any uninterrupted three year period counted from the registration date.

Assignments and licenses of trademarks and service marks must be registered with Rospatent. In the absence of such registration, they are deemed null and void.

The appellation of origin of goods is a name constituting or containing a current or historical denomination of a country, settlement, locality or other geographic unit (hereinafter referred to as a “geographic unit”) or a derivative of such denomination that has become known as a result of its use with respect of goods the specific features of which are mainly or exclusively determined by natural conditions or human factors which are characteristic of such geographic unit.

The designation which, through representing or containing the name of a geographic place, has entered in the Russian Federation into the public domain as a designation of goods of a certain kind (has become generic), which are not related to the place of their manufacture, are not be deemed to be the appellation of the origin of goods.

Legal protection is given to an appellation of origin of goods based on its registration with Rospatent. An appellation of origin of goods may be registered in the name of one or more persons. Person/persons that have duly registered an appellation of origin of goods obtain a right to use such appellation, provided that the goods manufactured by such person/s satisfy the criteria mentioned above. The right to use an appellation of origin of goods may be granted to any legal entity or individual which produces the goods with the same specific features within the same territory.

The term of protection is for 10 years from the date of the application and may be renewed for subsequent 10-year periods. The owner may not grant licenses for the use of the appellation of origin of goods.

Infringement of rights in a trademark, service mark or appellation of origin of goods entails civil, administrative and/or criminal liability.

15.4 Company Names and Trade Names (Commercial Designations)

Company names are designations that identify or distinguish different legal entities in exercising of their respective commercial activities.

Legal protection is provided under the Russian *Civil Code* and respective legislation stemming therefrom. The right to a company name arises at the moment of official state registration of the company bearing the name. The owner of a company name is permitted to use the company name and to prohibit others from the unauthorized use of such company name.

Part IV of the *Civil Code* contains specific provisions relating to the registration and legal protection of company names. In particular, it establishes that a joint-stock company may use the official name of the Russian Federation or any words derived therefrom in its company name, provided the Russian Federation holds over seventy-five percent of its shares.

Under Part IV of the *Civil Code*, trade names (called “commercial designations”) are designations that individualize trading, industrial or other types of enterprises of legal entities and individual entrepreneurs. Trade names are not company names and are not subject to incorporation into constituent documents and the state register of legal entities. Legal protection is provided under the Russian *Civil Code*, respective legislation stemming therefrom, and the Paris Convention for the Protection of Industrial Property.

The exclusive right to the use of a trade name belongs to its owner who may prohibit others from the unauthorized use of such trade name.

15.5 Copyrights and Neighboring Rights

The *Copyright Law* protects works of science, literature and the arts (copyright), and grants protection to rights of performers, phonograms producers and organizations of on-air or cable broadcasting (neighboring rights). Copyright protection arises by virtue of the creation of a work of art without any registration requirements.

The author enjoys moral rights (right of authorship, right to a name, right to public disclosure, right to protect author’s reputation) and proprietary rights (right of reproduction, distribution, importation, public demonstration, public performance, translation, revision, etc.). The moral rights are unalienable and may not be granted to third parties. The proprietary rights to use a copyrighted object may be granted by virtue of exclusive or non-exclusive copyright agreement. Copyright is protected for the lifetime of the author, plus 70 years after his/her death.

Infringement of copyright entails civil, criminal and/or administrative liability.

15.6 Software Programs and Databases

General provisions of the *Copyright Law* also apply to software programs and databases, while specific regulation is provided under the *Software Law*.

Software programs enjoy protection as literary works, while databases are protected as anthologies. Although registration is not mandatory for protection, an author may voluntarily register its software/database with Rospatent.

A software program or a database is protected for the lifetime of the author(s) plus 50 years after his/her (their) death(s). The right to use a software program may be granted under a software license agreement that may be exclusive or non-exclusive.

Part IV of the *Civil Code* increases the term of copyright protection for a software program or database to the lifetime of the author, plus 70 years after his/her death.

15.7 Topologies of Integrated Microcircuits

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

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

15.7.1 Trade Secrets and Know-How

Under the Russian *Civil Code*, information is to be regarded as an official or a trade secret if it has an actual or potential commercial value which is unknown to third parties, if there is no free access to it on legal grounds and if its owner takes active measures to protect its confidentiality. The *Law On Trade Secrets* further defines information that constitutes a trade secret, governs the disclosure of such information, outlines confidentiality in respect of trade secrets and sets out the types of information which do not constitute a trade secret. The *Law On Trade Secrets* provides for disciplinary, civil, administrative, and criminal liability for breaching legislation relating to the protection of trade secrets.

Persons who illegally obtained information containing an official or a trade secret or know-how are obliged to compensate damages incurred. The same liability is imposed upon employees who have divulged an official or a trade secret in breach of a labor contract and on a party, which has done the same in breach of a civil agreement. Pursuant to Part IV of the *Civil Code*, a person who used a trade secret without authorization and was not or should not have been aware of the fact such use was illegal, including the instances where such information was obtained inadvertently or erroneously, should not be held liable.

Part IV of the *Civil Code* contains a specific chapter on the regulation of trade secrets and know-how that will essentially substitute the provisions of the *Law on Trade Secrets*.

15.7.2 Domain Names

Domain names are registered in Russia on a first-come, first-served basis by several registrars.

Part IV of the *Civil Code* prohibits the registration of a trademark designation that is identical to a domain name, where the right to the domain name has been allotted prior to the priority date of the trademark submitted for registration.

16. BANKRUPTCY

16.1 Legislation

Bankruptcies are governed by Part I of the *Civil Code of the Russian Federation*, the *Federal Law on Insolvency (Bankruptcy)*, dated 26 October 2002 (the *Bankruptcy Law*), and by several specialized laws including the *Federal Law on the Insolvency (Bankruptcy) of Lending Organizations*, dated 25 February 1999, and the *Federal Law on the Insolvency (Bankruptcy) of Natural Monopoly Companies in the Fuel and Energy Complex*, dated 24 June 1999 (in force until 1 July 2009, when the relevant provisions of the *Bankruptcy Law* will come into force), as well as by a number of rules and regulations adopted by the Government, and various state bodies and agencies.

16.2 Bankruptcy Criteria

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

Under the *Bankruptcy Law*, a legal entity may be subject to bankruptcy proceedings if it has failed to satisfy the “monetary claims” of its creditors and/or to make “obligatory payments” in full within three months of the due date, provided that the overdue amount exceeds RUR 100,000 (approximately USD 3,800). Individuals may be subject to bankruptcy proceedings if their debts exceed the value of their assets and the overdue amount is at least RUR 10,000 (approximately USD 380). (Currently it is

not possible under the *Bankruptcy Law* to institute bankruptcy proceedings against an individual who is not self-employed.) Special rules are established for the initiation of bankruptcy proceedings against lending institutions (*par. 0*).

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

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

16.3 Initiating Bankruptcy Proceedings

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

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

16.4 Bankruptcy Procedures

Legal entities may be subject to the following bankruptcy procedures:

- Supervision;
- Financial rehabilitation;

- External management;
- Bankruptcy liquidation; and
- Composition.

Individuals may be subject to:

- Bankruptcy liquidation; and
- Composition.

16.5 Supervision

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

16.6 Financial Rehabilitation

This bankruptcy procedure is somewhat akin to the American "Debtor-in-Possession" Model. It may be introduced by the arbitrazh court if requested by the debtor's shareholders or a third party(ies) willing to financially back the restructuring. Financial rehabilitation may last no longer than two years and is aimed at restoring the debtor's solvency and ensuring that its debts are repaid. The court order initiating financial rehabilitation should set a schedule for the repayment of overdue debts.

The governing bodies of the debtor company retain their powers. However, any corporate reorganization requires the prior approval of the creditors' meeting and

the person(s) who provided security for the repayment of the overdue debts. Any assignments, loans, or transactions which result in an increase of the debtor's accounts payable (as of the date of introduction of financial rehabilitation) by more than 5%, or disposal of the debtor's assets (except goods sold or services provided in the ordinary course of business), require the prior approval of the administrative manager appointed by the court.

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

16.7 External Management

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

While under external management, the debtor may issue new shares and may incorporate new open joint stock companies by contributing the debtor's assets to such companies. If the debtor's solvency is restored during the external administration, the creditors or external manager may apply to the court for termination of the bankruptcy proceedings.

16.8 Bankruptcy Liquidation

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

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

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

- First priority: personal injury claims, including “moral damages” claims, a concept in Russian law similar to “emotional suffering” claims in the West;
- Second priority: employees' claims for severance pay and unpaid wages, as well as the payment of royalties to authors;
- Third priority: other creditors' claims.

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

Creditors whose claims are secured with pledge(s) over the debtor's assets enjoy priority over other creditors in satisfying their claims from the proceeds of the sale of pledged assets, except for those creditors of first and second priority whose claims originated prior to the execution of the relevant pledge agreements. Creditors whose claims have been secured with pledge(s) and are not satisfied from the proceeds of the sale of pledge assets shall be satisfied together with the other creditors' claims of the third priority.

16.9 Composition Agreement

A composition agreement may be concluded at any stage of bankruptcy proceedings, but not earlier than the first meeting of creditors. To conclude a composition agreement a majority of the bankruptcy creditors and all secured creditors must support it. The composition agreement must be approved by the relevant arbitrazh court, but only after the repayment of all creditors of first and second priority.

16.10 Bankruptcy of Banks and Other Lending Institutions

A lending institution is deemed unable to satisfy the monetary claims of its creditors and/or to make compulsory payments, if it fails to meet the corresponding obligations within fourteen days after such obligation has become due; and/or if the lending institution's license has been revoked and its assets are insufficient to repay outstanding creditor's obligations and/or to make compulsory payments.

The Central Bank of the Russian Federation must first revoke the license of a bank or other lending institution before the liquidation process can start. Once the license has been revoked, the court may order the bank to be liquidated. In contrast to the bankruptcy of companies, banks and other lending institutions may only be subject to the liquidation bankruptcy procedure; supervision, financial rehabilitation, external management and composition are not available for banks and other lending institutions. This is due to the fact that banks are not permitted to engage in business following the revocation of their licenses.

If a bank is declared bankrupt, the order of priority in the satisfaction of its creditors' claims is the same as that described above, with one important exception: the claims of individual bank depositors must be satisfied as a matter of first priority. Also, subordinated claims (*i.e.* those that are based on credit (loan) agreements with a maturity date of not less than five years, which cannot be terminated before the maturity date, and which have an express provision stating that they are subordinated) may be satisfied only after payments to all other creditors have been made in full. Certain specific rules of priority would also apply to banks that issue mortgage-backed securities according to the Federal Law *On Mortgage-Backed Securities*, dated 11 November 2003.

17. THE RUSSIAN JUDICIAL SYSTEM

17.1 Introduction

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

17.2 State Arbitrazh Courts

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

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

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

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

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

17.3 International Arbitration

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

The principal rules of international arbitration are governed by the Federal Law *On International Commercial Arbitration*, enacted 7 July 1993; these rules are identical to provisions of the Model UNCITRAL Law.

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

17.4 Enforcement of Judgments

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

A foreign court judgment may be enforced in Russia only if such judgment has been recognized by a Russian court. Such recognition is available if supported by a relevant international treaty and federal law that applies. Despite a lack of direct regulation, Russian courts now recognize and enforce foreign court judgments on the basis of reciprocity.

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

Arbitral awards rendered by arbitration tribunals located within or outside of the Russian Federation are also executed by the bailiff service after such awards are recognized and ordered to be enforced by the Russian courts. As a rule, Russian courts may not review any foreign arbitral award on its merits. The grounds for the refusal to recognize and enforce foreign arbitral awards are generally the same as those set forth in the *New York Convention*.

17.5 Alternative Dispute Resolution

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

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