LEGAL BUSINESS

Aboard the propaganda train – sweat and spin amid a turbulent Russian market

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by James Wood

Despite sanctions, a currency collapse and falling oil prices, Russia's lawyers are doing better than expected.

For now.

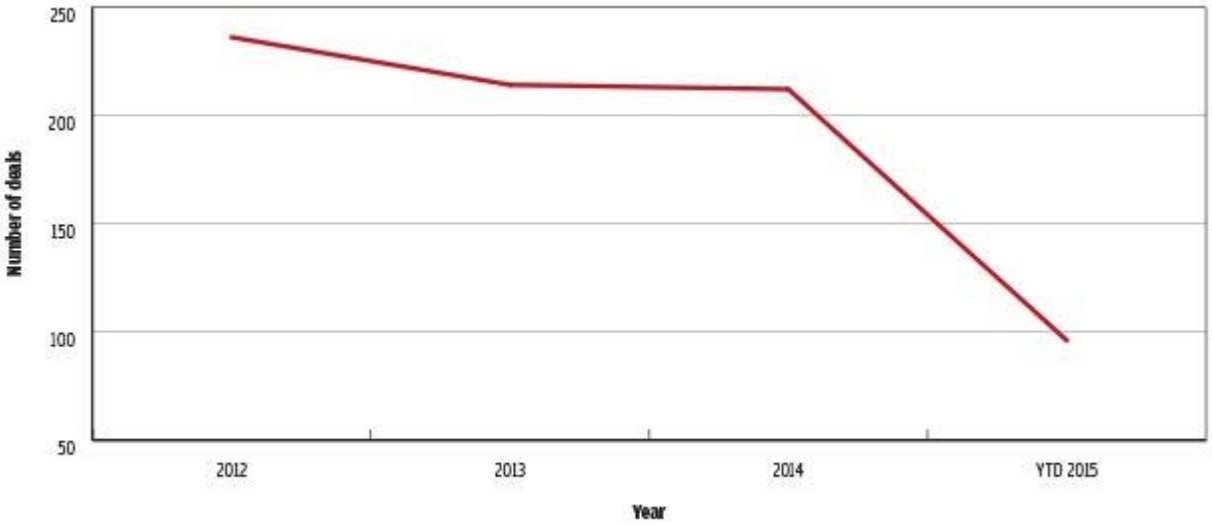
There's an old Russian joke about a foreigner who visits the Soviet Union. Knowing his letters will be read by the state censor, he devises a system to communicate with friends back home. If his letter is written in black ink, the message is true. If it is written in red ink, the message is false. Eventually his friends receive a letter from Russia written in black ink: 'Dear friends, I hope this letter reaches you. Contrary to the lies in our press, life in the Soviet Union is wonderful. Food is plentiful, apartments are spacious and well heated, and there are no shortages. In fact, the only thing I can't find here is red ink.'

Asking international lawyers about the year they have just had in the Russian market is a similar exercise in reading between the lines. While many firms report that they are still making money, fuelled largely by a boom in restructuring work, this picture is undoubtedly airbrushed by lawyers' unwillingness to discuss the negatives. No-one, however, is in any doubt that the precipitous decline of the Russian market is hitting revenues.

'Every time there is a crisis, the Russian firms say "now we will take the market", but they're always wrong.'
Oxana Balayan, Hogan Lovells

Ominously, the situation is set to get worse before it gets better. Although Russia's sovereign debt is relatively low, Standard & Poor's and Moody's still downgraded the country's sovereign credit rating to junk status. More worryingly, Russia's corporate debt pile is at an all-time high of around $700bn. Analysts at Sberbank believe Russian companies will need to refinance over $100bn of this debt in the coming year, with around 75% of this denominated in dollars. State guarantees and the National Wealth Fund have been used to prop up 'systemically important' companies in a bid to ward off the signs of collapse, but the pool is rapidly running dry. To compound the problem, there are very few private holding institutions in Russia that possess anything like sufficient capital to meet the shortfall, and those that do, such as Interros and Onexim, have been reluctant to invest.

Russian Deal Volumes



**All deals valued over USD 5m. Excludes property transactions and restructurings where the ultimate shareholders' interests are not changed. Source: Mergermarket*

Sanctions have undoubtedly had a negative impact on international firms operating in Russia. As Oxana Balayan, Moscow managing partner at Hogan Lovells, points out: 'The list of sanctioned entities reads very much as the list of targets for many international firms in the pre-sanctions period. Once these targets become sanctioned you have to think very differently. You have to be much more opportunistic in finding new work and you have to be more flexible in your business strategy.'

Co-publishing feature

The legislative framework for 'trapped' property buyers

Andreas Haviaras and Stalo Papoui - Haviaras & Philippou

Even more damaging than the sanctions themselves has been the expectation of further sanctions and the general lack of certainty investors now see in the Russian market. 'It's the "sanctions lite" companies like Sberbank and VTB, which are subject to more limited sanctions, that have affected the market and the general conduct of business. Major US and European corporations prefer not to get involved with these companies at all, which is of course bad', says Laura Brank, head of Dechert's Russia practice.

But according to Sergei Voitishkin, CIS managing partner at Baker & McKenzie, the impact has not been as bad as many feared. ‘We just had our financial year end and we are doing much better than would have been predicted when sanctions were first introduced.’

Brian Zimbler, managing partner at the Moscow office of Morgan, Lewis & Bockius, also believes that the impact of sanctions has been overstated, noting: ‘The market has adjusted to a large extent, and while nobody likes them they are all complying with them. Big Russian and international companies are not talking about sanctions anymore.’

Cyprus: bringing it all back home

Since 2012 Vladimir Putin has been keen to show Russia’s high-net-worth individuals he is serious about closing the tax loopholes that have let nearly a quarter of Russia’s private wealth move to tax havens. Cyprus has traditionally been the most popular choice for wealthy Russians looking to hold assets offshore.

Last year around $150bn of capital left Russia for offshore centres. The total amount of Russian capital held offshore currently stands at $500bn, around a quarter of the country’s private wealth. In a bid to stem this flow, the State Duma passed a series of amendments to the Russian tax code in November 2014. Under these amendments, known collectively as the ‘De-offshore-isation law’, all resident Russian taxpayers must report their interests in non-Russian profit-generating entities.

The laws apply to any controlled foreign company (CFC), an entity in which a Russian tax resident owns more than a 25% share. Though tax specialists are still not sure how the laws, which only came into effect on 1 January this year, will be interpreted, the assumption is that offshore businesses will eventually have to be moved back to Russia or face additional taxes under CFC rules.

In essence, the laws state that having a tax residency certificate for Cyprus and holding the occasional board meeting in Nicosia no longer exempt a Russian owner from paying Russian corporate tax. The reforms were followed in June this year by a new capital amnesty law promising that Russian tax residents who declare and repatriate offshore assets will not be punished with criminal charges or tax liabilities (or ‘dragged to law enforcement agencies’, as the Russian president put it). The amnesty applies to all violations occurring before 1 January 2015 provided a declaration of all assets falling under the law is made to the Russian tax authorities by 31 December.

The collapse of Cyprus’s economy in 2013 led to many Russians losing money and gave a much needed impetus to the Russian tax authority’s claims that its citizens’ wealth would be safer at home. The reality, many suspect, is quite the opposite. Russian assets have traditionally been held abroad not to avoid tax, which is relatively low in Russia, but because the courts are perceived as unreliable. Andreas Haviaras of Cypriot firm Haviaras & Philippou says: ‘Around 50% of our work as a firm is connected with Russian clients, but I haven’t seen a big change yet following the de-offshore-isation policies. I think the reason behind this lack of change is that Russians don’t trust Russian courts. The legal regime does not satisfy them and they want to feel covered by alternative structures.’

While Cyprus-based lawyers say that these new laws will do little to stop Russian businesses exploring offshore structures, the view from Russia is rather different. ‘These offshore structures are purely about tax optimisation; high-net-worth individuals who claim otherwise have strong

motives for doing so. If you are so concerned about political and legal risk that you think your property will be seized illegally then, clearly, a triple-layer BVI-Cyprus-Cayman Islands structure isn't going to help. It's a fiction on a piece of paper, it is not capable of preventing seizure of physical assets,' argues Andrey Zelenin, founding partner of Lidings Law Firm.

It is clear, however, that Cyprus-based lawyers are now fielding a lot of calls from Russian taxpayers with offshore holdings. To bypass the de-offshore-isation laws a Russian citizen can simply become a tax resident of another country, but few are exploring this option for the moment. 'For a lot of Russian companies the country itself is the source of wealth. This severely hampers the ability of businesspeople to leave the country,' says Andreas Neocleous of Andreas Neocleous & Co. 'If a Russian becomes a tax citizen of another country then he is liable to pay 30% tax on any activities in Russia, which is not ideal. Most of these businesses still have significant assets in Russia so that would not be tax optimal.'

Another option would be to restructure the offshore holding entity so it is not controlled by Russian tax residents, though it remains to be seen how the laws will treat this type of 'formal compliance'. With conditions in Russia not conducive to the voluntary mass repatriation of capital, many suspect that the screws will have to be tightened if the Russian Federation is to achieve its objective of stemming capital outflows.

Enter the dragon?

With European and US investors reluctant to invest, Russia's leaders have placed great emphasis on relations with China. The Eastern Economic Forum that took place in Vladivostok in September highlighted the extent of Russia's ambitions for closer economic ties. Russia's far eastern region is resource-rich and sparsely populated, bordering a densely populated country that needs resources to fuel its manufacturing sector. While trade volumes between Russia and China fell sharply in the first half of 2015, dropping to around $30bn compared with nearly $60bn in the first half of 2014, there is much political will for stronger trade links on both sides. Li Hui, the Chinese ambassador to Russia, recently declared his country's intent to increase bilateral trade with Russia to $100bn in 2015.

'There's a desire to get the raw materials from Russia, but there's very little appetite to invest in businesses there.'

Laura Brank, Dechert

Recent Russia-Sino financings have been similarly active. MegaFon, Russia's second-largest mobile phone operator, has obtained a new renminbi-denominated facility from China Development Bank. A number of Russian companies are also set to issue rouble bonds on the Chinese market. However, recent and much-publicised falls in the Chinese stock markets are likely to present a significant obstacle to these plans, and while deals signed at the state level have been encouraging, interest from Asian private investors has been, at best, muted. Asian investors, like their European or American counterparts, look for profitability and predictability, neither of which are on offer in Russia at the moment.

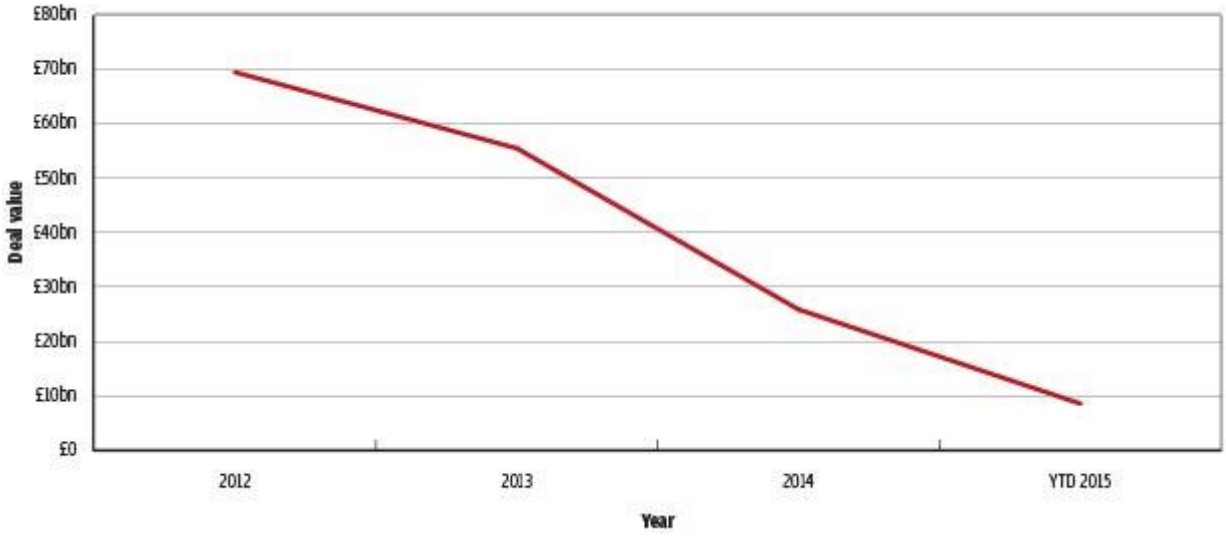
Noerr's Stefan Weber comments: 'The shift to Asia is a tricky one but I don't think it will lead to private investment. I was in Hong Kong recently speaking to investors and I have to say they

were just not that interested. Sophisticated Asian investment funds don't want to touch the Russian market at the moment. They're as concerned as everyone else.'

Brank shares this view. 'I've been to Beijing a couple of times since the sanctions came into effect and what I noticed is that yes, there's a desire to get raw materials from Russia, but there's very little appetite to invest in businesses there. And that cuts both ways. Business in Russia is reluctant to move closer to the Asian market because a lot of the c-suite was trained at big international companies and see dealing with China as a step backwards in terms of corporate transparency and governance.'

Another reason for the lack of interest may be the gap between buyer and seller valuations. Mikhail Kazantsev, partner at Egorov Puginsky Afanasiev & Partners, says: 'Without government backing I'm not seeing much investment, and I think the reason for that is that Asian private investors are still looking for prices to go down. In spite of the downturn there is not really a lot of distressed M&A in Russia at the moment. Russian companies, even if they are distressed, feel the crisis is temporary.'

Total Deal Value (£m)*



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Despite this scepticism, Russian law firms are looking eastward. The Pepeliaev Group has recently signalled its commitment to boost work with Asian clients by opening offices in Vladivostok and Yuzhno-Sakhalinsk, both of which lie near the far eastern border of Russia. According to the firm's founding partner Sergey Pepeliaev, there are also plans to open an office in Sakhalin, an island in the north Pacific close to Japan. YUST Law Firm is making similar moves, having recently signed an agreement with prominent South Korean firm Jipyong. This alliance will, says managing partner Evgeny Zhilin, target Korean clients seeking to invest in Russia.

The move to the east goes beyond courting Asian investment. Sanctions and tighter laws on holding assets offshore (see box, 'Cyprus') mean Russian money is increasingly likely to remain in Russia. In response, domestic law firms are planning to open offices in the country's regional centres. Victor Dumler, managing partner at St Petersburg practice Dumler & Partners, believes

the next big wave of office openings will be in cities like Yekaterinburg and Novosibirsk, ‘important industrial centres that will generate a lot of work. It is now time to develop a network of offices in Russia. Whether this will be through opening new offices, merging with regional firms or forming affiliations is unclear at the moment, but it is certainly a trend’.

Others are more sceptical, pointing out that locally-trained lawyers are unlikely to be of the desired quality, while Muscovite lawyers tend to have a Chekhovian fear of life in the provinces and are unlikely to make the move.

Overdrive: The frenetic business of Russian legal reform

In the past 18 months the Russian State Duma has gone into overdrive, making hundreds of amendments to the country’s legislation. Lawyers at both domestic and international law firms have waded through amendments while benefiting from the spike in client enquiries the new laws have generated.

Even a large firm with dozens of lawyers can struggle to monitor these legislative developments, says Victoria Bortkevicha, managing partner of Clifford Chance’s Moscow office. ‘It requires a lot of resources to analyse all new legislation and, what is most important, not to miss something. Often a new law on insolvency is buried as an amendment to an amendment on a law related to something else, so you need quite a lot of skill and resources and specialist staff to keep up with these laws.’

Amendments to the civil code, passed in July, have introduced common law concepts into Russian law for the first time. Says Bortkevicha: ‘Generally these amendments are creditor-friendly and resolve a lot of problems in the Russian laws. It is very actively used in practice right now and there is quite a lively interest from clients.’

However, most lawyers active in Russia question whether these amendments will lead to a rise in the number of deals governed by Russian law. Andrey Zelenin of Lidings says while the new provisions have been drafted with a sufficient level of clarity, clients are waiting to see how they will be interpreted before adopting them in contracts. ‘There is no body of solid jurisprudence and precedent institutionalised in the Russian courts. All the precedent is in the US and UK, which isn’t particularly helpful if you are taking a dispute to a Russian court.’

Similarly, Kim Latypov of DLA Piper points out: ‘Russian judges are very unlikely to use foreign precedent as guidance in the implementation of these laws, so the way these changes will operate in the Russian legal environment is still uncertain and that may make clients tread with caution.’

Meanwhile, amendments to the Russian law on mass media, due to come into force in 2016, will ban direct foreign ownership of Russian mass media channels and restrict indirect foreign ownership to a 20% holding. While the laws do not place any restrictions on foreign entities wishing to benefit economically from the Russian media, many fear they will be used to exert greater control over print and broadcast platforms. As one international firm partner says: ‘These laws are not sophisticated enough to prevent foreign ownership, you can just split the business into an operating company, which owns the licence, and then have a separate entity that owns and controls the content. All these laws do is make it appear more onerous to operate in Russia, which is not exactly the message the country needs to send right now.’

There are already signs that the new ownership laws will transform Russia's media sector. CTC Media, one of the handful of Nasdaq-listed Russian companies, has been placed on the market, apparently as a result of these sanctions. CNN left the Russian market in 2014, while other established players including the Disney Channel and the Discovery Channel have been forced to restructure their operations. All of which has been good news for Russia's lawyers. Oxana Balayan, Moscow managing partner at Hogan Lovells, says: 'The new media laws are leading to a lot of new work. While much of it is technically rearranging joint ventures, it's really like working on a big M&A transaction where you create a new set up with new agreements.'

The most widely discussed of Russia's new laws is Federal Law No. 526-FZ, better known as the Data Localisation Law. Under the new law, which came into force on 1 September, any business collecting the personal data of Russian citizens must record and store this information on databases and servers held on Russian territory (though copies of this data can be held elsewhere). Like many of the Duma's amendments, the law has raised questions of interpretation and scope and confused many lawyers. The initial assumption that it would only be applied to IT or online businesses has proved to be false, though it remains unclear who is expected to comply. Indeed, as a number of international firms pointed out, they themselves may eventually be expected to hold source data on a localised server.

The definition of 'personal data' is also unclear; Facebook has attempted to sidestep the expense of transferring information to local data centres by pointing out its user profiles are not personal data but self-created records that can contain any information the user likes. While the laws can be seen charitably as part of a general tendency to control data flows, they will contribute to more general concerns over privacy and client confidentiality in Russia and place further barriers to entering the market at a time when most investors are already looking for the exit.

Richard Cowie, corporate partner at Dentons, thinks many commentators have gone overboard in criticising the amendments. 'The law isn't as draconian as it is being perceived. It was brought in to deal with concerns about processing of Russian citizens' personal data and broadly requires such personal data to be stored on databases located in Russia. Businesses have adapted and will continue to adapt to these rules.'

Whiff of grapeshot

'The Russian legal market is probably the most open and competitive in the world', says Pepeliaev, 'and the competition is about to get a lot more intense.' The relationship between top-tier Russian law firms and their international counterparts can best be described as one of hostile admiration. With sanctions and currency fluctuations tilting the scales somewhat in the Russian firms' favour, many lawyers are detecting the first whiff of grapeshot in yet another battle for market share.

'The Russian legal market is changing,' notes Andrey Zelenin, founding partner of Lidings, 'not only because of the sanctions but because of the growing competition between international firms and local firms. Fifteen years ago we had almost two separate legal worlds. The world of international firms, populated mostly by expats, and then the Russian firms. But these two worlds have become less and less distinct. It's already not so much about the price competition. There is an experience contest now.'

Indeed, Vassily Rudomino, co-founder of ALRUD, argues that international clients increasingly prefer to work with domestic firms. ‘They believe they are better protected by a Russian firm, that Russian firms understand local reality better and that they are less exposed to risk.’

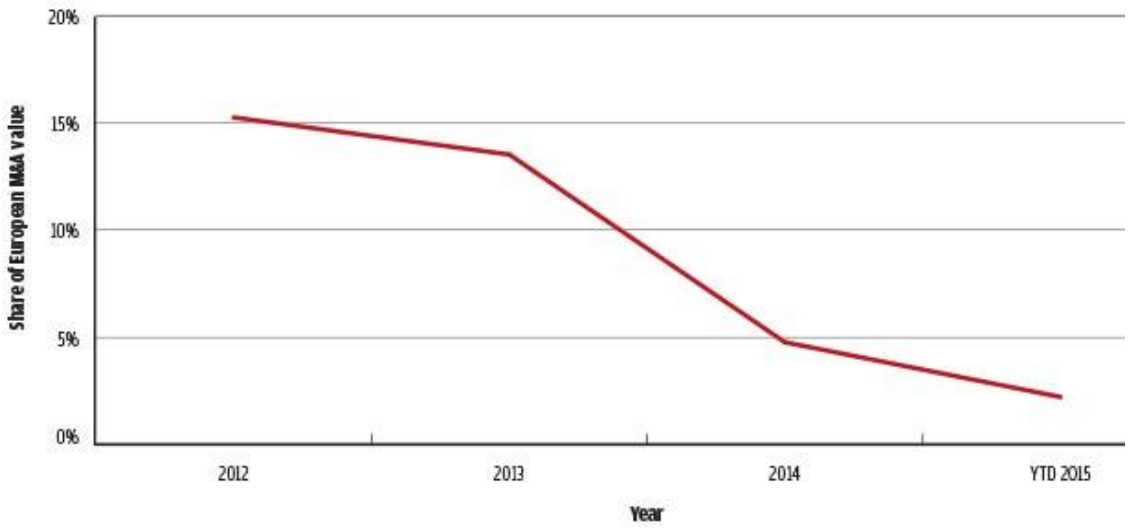
As a result, the suspicion is that many US and UK firms will withdraw from the market in the coming months. ‘I’m not sure the managing partners of Moscow offices are the best people to tell you how viable their practices are’, one partner at an international firm observes. ‘It might be that in the head office they’re looking at the numbers and wondering whether there is any point in having a Moscow office. The talk about town is that the smaller offices of international firms will just give up.’

Unsurprisingly, most international firms put forward a different analysis. Balayan at Hogan Lovells says predictions of international firms leaving the market are nothing new. ‘Every time there is a crisis, the Russian firms say “now we will take the market”, but they’re always wrong. There must be something the international firms are doing right to make themselves so successful in this market.’

Similarly, Victoria Bortkevicha, managing partner of Clifford Chance’s Moscow office, says that for any large deal a firm needs an international network. ‘Even a big debt restructuring would be difficult for a Russian firm. The creditors are not all based in Moscow. Loans and bonds involve international banks. It’s just not the type of work you would send to a Russian firm.’

It should also be noted that Russian firms, many of which denominate their fees in dollars or euros, have been hit nearly as hard by currency fluctuations as international firms.

Russia's Share of European M&A Value



Source: Mergermarket

One of the most interesting recent trends in the Russian legal market has been the formation of new boutiques, spinning out from the Moscow practices of large international firms. Among the new entrants to the market are Tertychny Law, a specialist financial services practice established by former White & Case and Norton Rose partner Ivan Tertychny; Tilling Peters, formed by ex-Baker Botts IP lawyer, Ekaterina Tilling, and tax expert Oxana Peters, formerly of Dechert; and Antitrust Advisory, set up by Evgeny Khokhlov, a competition law expert with experience at various international law firms.

While cynical observers would view this rash of spin-outs as an inevitable consequence of international firms falling out of favour in Russia, according to Maxim Kulkov, who left Freshfields Bruckhaus Deringer in February to set up Kulkov, Kolotilov and Partners, the local market is now ideally suited to these boutiques.

'The political situation is bad, but the overall sense I get is that business can't be stopped completely, no matter what goes on.'
Vladislav Zabrodin, Capital Legal Services

'Two or three years ago I noticed that we don't have many good small or boutique litigation and arbitration firms in Moscow. International firms often have to look for Russian local providers, whether because of conflict of interest or for political reasons, but it's extremely difficult to find the right partner. Big Russian firms are competitors and small firms have poor levels of service. I noticed the niche was quite empty so I thought the best solution was to set up a firm that would be a third cheaper while providing the same level of quality.'

While partners at international and Russian firms are prepared to fight for their share of the country's legal market, they want to do so on neutral terrain. With few political signs of optimism on the horizon, lawyers on the ground are comforted by the market's relative resilience. 'The political situation is undoubtedly bad, but the overall sense I get is that business can't be stopped completely, no matter what goes on. It's something to take comfort in,' says Vladislav Zabrodin, founder and managing partner of Capital Legal Services.

Generally, the feeling is Russia's lawyers will weather the storm until the next boom emerges. After all, as Dentons corporate partner Richard Cowie says: 'Looking at the bigger picture, you'll see 150 million consumers on the doorstep of Europe and a major supplier of the energy market. Russia simply cannot be ignored – it has to continue to be part of the equation. If you look at the companies who have interests in Russia then you realise it's too big an economy to leave behind.' LB