The Mergers & Acquisitions Review

Ninth Edition

Editor
Mark Zerdin

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CONTENTS

EDITOR'S PREFACE

By a number of measures, it could be argued that it has been some time since the outlook for the M&A market looked healthier. The past year has seen a boom in deal making, with many markets seeing post-crisis peaks and some recording all-time highs. Looking behind the headline figures, however, a number of factors suggest deal making may not continue to grow as rapidly as it has done recently.

One key driver affecting global figures is the widely expected rise of US interest rates. Cheap debt has played a significant part in the surge of US deal making in the first few months of 2015, and the prospects of a rate rise may have some dampening effects. However, the most recent indications from the Federal Reserve have suggested that any rise will be gradual and some market participants have pushed back predictions for the first rate rise to December 2015. Meanwhile, eurozone and UK interest rates look likely to remain low for some time further.

The eurozone returned to the headlines in June as the prospect of a Greek exit looked increasingly real. Even assuming Greece remains in the euro (as now seems likely), the crisis has severely damaged the relationship between Greece and its creditors. The brinksmanship exhibited by all parties means that meaningful progress cannot occur except at the conclusion of a crisis: the idea that reform will benefit Greece has been lost and each measure extracted by creditors is couched as a concession. However, while the political debate has become ever more fractious, the market's response to the crisis has been relatively sanguine. This is largely a result of the fact that the volume of Greek debt is no longer in the market, but in the hands of institutions. But it is also a sign of the general market recovery and expectations that major economies will continue to grow.

Perhaps one of the more interesting emerging trends in the last year is the interplay between growth and productivity. Some commentators have suggested that the recent rise in deal making is a symptom of a climate in which businesses remain reluctant to invest in capital and productivity. Pessimistic about the opportunities for organic growth, companies instead seek to grow profits through cost savings on mergers. It is difficult to generalise about such matters: inevitably, deal drivers will vary from industry to industry, from market to market. However, if synergies have been the principal motivation in

much of the year's deal making (it certainly has been in a number of large-cap deals) then it may be that the market is a little farther from sustainable growth than some would like to think.

I would like to thank the contributors for their support in producing the ninth edition of *The Mergers & Acquisitions Review*. I hope that the commentary in the following chapters will provide a richer understanding of the shape of the global markets, together with the challenges and opportunities facing market participants.

Mark Zerdin
Slaughter and May
London
August 2015

Chapter 55

RUSSIA

Scott Senecal, Yulia Solomakhina, Polina Tulupova,
Yury Babichev and Alexander Mandzhiev[1]

I OVERVIEW OF M&A ACTIVITY

Since 2012, overall M&A activity involving Russian businesses has declined in terms of the number of completed significant deals.[2] In terms of deal value, although 2013 was a record year with approximately US$110 billion of completed deals because of the largest takeover in Russian history – the US$55 billion acquisitions of TNK-BP by Rosneft – overall Russian M&A activity was stagnant. In 2014, Russian M&A slightly exceeded US$30 billion, roughly a quarter of the 2013 value level (or half excluding the *Rosneft/TNK-BP* transactions). In 2014, as in the previous years, Russian M&A transactions were principally driven by domestic buyers and in particular by state-affiliated buyers. In total, in 2014, domestic M&A accounted for around 57 per cent of all Russian M&A (by value).[3]

1 Scott Senecal and Yulia Solomakhina are partners and Polina Tulupova, Yury Babichev and Alexander Mandzhiev are associates at Cleary Gottlieb Steen & Hamilton LLC. They are resident in the firm's Moscow office.

2 Source: Thomson Reuters. In this article, Russian M&A activity refers to acquisitions of businesses in Russia by domestic investors, irrespective of the place of incorporation of their holding structures (domestic M&A), and by foreign investors (inbound M&A), as well as acquisitions by Russian investors of businesses abroad (outbound M&A). All data and references to legislation are as of 15 June 2015.

3 Source: Thomson Reuters.

II GENERAL INTRODUCTION TO THE LEGAL FRAMEWORK FOR M&A

The Civil Code of the Russian Federation,[4] federal laws on particular forms of legal entities (such as joint-stock companies[5] or limited liability companies) and the Securities Market Law[6] constitute the fundamental framework of the federal legislation governing the legal status of Russian companies and their securities, as well as relations between a company and its shareholders and among shareholders. This framework is hierarchically subject to the Constitution of the Russian Federation, which by its own terms has direct effect in Russian law, and to ratified international treaties of the Russian Federation.

This framework is further complemented by:

a legislation setting forth restrictions on the economic concentration affecting the Russian markets generally (competition law) and on various forms of control over assets in particular industries, including banking, insurance and the media, as well as industries deemed 'strategic' in Russia;[7]

b procedural and enforcement legislation relevant, for example, in the context of shareholder remedies and the resolution of corporate disputes; and

c subordinate normative acts of various federal authorities of the Russian Federation, including decrees of the President and regulations of the government and the CBR,[8] which implement federal legislation.

Although Russia is commonly referred to as a 'civil law' country, implying that its legal system does not rely on judicial precedent, in fact, court practice can have normative effect and is often of persuasive authority, especially rulings by higher courts.

The legal framework for M&A activities in Russia has been recently subject to major reforms, both in institutional and substantive respects, and reforms are still ongoing. Currently, there are four central developments:

a the 'de-offshorisation' reform (which is still being implemented), principally concerning Russian taxation regulations which are having a substantial effect on the structuring of asset holdings and M&A transactions for domestic buyers, both inbound and outbound;[9]

b the reform of the Civil Code;[10]

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4 Civil Code of the Russian Federation, Part I (Federal Law No. 51-FZ of 30 November 1994), Part II (Federal Law No. 14-FZ of 26 January 1996), Part III (Federal Law No. 146-FZ of 26 November 2001), Part IV (Federal law No. 230-FZ of 18 December 2006), in each case, as amended (the Civil Code).

5 Federal Law No. 208-FZ on Joint-Stock Companies of 26 December 1995, as amended (the Joint-Stock Company Law).

6 Federal Law No. 39-FZ on the Securities Market of 22 April 1996, as amended (the Securities Market Law).

7 See Sections IV and IX, *infra*.

8 The Central Bank of the Russian Federation (CBR).

9 See Section VIII, *infra*.

10 See Section III, *infra*.

c the merger of the Supreme Commercial Court of the Russian Federation (SCC), which served as the top judicial body for the resolution of economic disputes, and the Supreme Court of the Russian Federation, with effect from 6 August 2014; and

d the creation of the financial mega-regulator in Russia completed in 2013 when the Federal Service for Financial Markets became part of the CBR, which has combined regulatory and supervision powers to better manage systemic risks and stability of domestic financial markets in response to the 2008–2009 crisis.

In regard to item (c) above, prior to the merger with the Supreme Court, the SCC had been quite active and authoritative in issuing interpretative guidance on business law matters. Two types of its decisions – a resolution of the Plenum of the SCC (usually summarising court practice related to a particular issue or area of law) and a resolution of the Presidium of the SCC in an individual case declared to have 'precedential value' – were effectively binding in other cases considered by commercial courts. The earlier binding practice of the SCC should continue to have effect for lower commercial courts until repealed or changed by the Supreme Court. However, it is still uncertain whether the Supreme Court will be as inclined to and adept in resolving business legal issues as the SCC had been.

In terms of the form of M&A deals in Russia, privately negotiated deals, including auction sales, are prevalent, as Russian businesses tend to have one or several controlling or significant shareholders. Even in the context of acquiring companies publicly traded in Russia, non-solicited or voluntary public tender offers are rare.

At the same time, any acquisition of equities in a Russian public joint-stock company is subject to the Russian takeover regulations, should the acquisition exceed certain thresholds. Generally, a person who, alone or together with its affiliates, has acquired more than 30 per cent of the total number of ordinary and certain other voting shares (if any) of a public joint-stock company must submit a mandatory bid for the remaining shares of such classes.[11] The CBR supervises compliance with the takeover regulations, including in the form of an advance review of any mandatory bid for publicly traded shares. Furthermore, Russian takeover regulations provide for a possibility of squeezing out minority shareholders once an acquiror's stake exceeds 95 per cent of ordinary and certain other voting shares (if any) of a public joint-stock company, subject to rules as to how the 95 per cent threshold is accomplished, the timing of a squeeze-out and its price.

11 Russian takeover regulations are concentrated in Chapter XI.1 of the Joint-Stock Company Law, as well as implementing acts of the CBR and its predecessor. Prior to the 2014 Civil Code amendments, the mandatory bid rule applied to any equity acquisition above a certain threshold in an open joint-stock company, irrespective of whether its shares were publicly traded or not. Although the corporate form of an open joint-stock company has ceased to exist, the mandatory bid rule continues to apply in certain cases to open joint-stock companies that have not been transformed into a current corporate form, as well as to public joint-stock companies.

Finally, corporate shareholdings of Russian businesses have been commonly arranged as multiple-layer structures, where an offshore company (for example, Cypriot or Dutch) holds Russian operational entities (first layer), while investors participate in that offshore holding company (second layer) or even at 'higher' layers of the holding structure. These structures historically emerged for a combination of reasons, including a possibility to benefit from (believed to be) flexible foreign law and legal institutions to govern relations between investors. Although Russian-law documentation is increasingly used for M&A transactions, foreign law, especially English law, still tends to govern significant M&A deals in Russia.[12] It would not be surprising if greater 'Russification' of M&A occurs, spurred by the 'de-offshorisation' reform and related changes in tax, corporate and civil law.

III DEVELOPMENTS IN CORPORATE AND TAKEOVER LAW AND THEIR IMPACT

i 2012–2015 amendments to the Civil Code

The reform of the Civil Code in 2012–2015 stems from the 2008 initiative to revise the Civil Code, 15 years after it was originally adopted. The reform has been implemented by the 'packages' of amendments, the earliest in December 2012[13] and the latest in March 2015,[14] including a package comprising the corporate law reform.[15]

In terms of their scope, the 2012–2015 amendments to the Civil Code substantially affect the civil law regime of business activities with respect to Russian assets and entities.[16] The amendments touch upon core areas of Russian business law, such as: permissible corporate forms for commercial legal entities; corporate structure and governance; the validity of transactions and challenges thereto; the validity of corporate decisions; statutes of limitations; rules of agency and powers of attorney; and the basic concept of an 'obligation' that underlies any business relationship. We discuss below some of the major changes from 2014 relevant in the Russian M&A context.[17] As

12 D Afanasiev, 'Competition of Jurisdiction: 10% Sovereignty', Vedomosti No. 117 (3131) of 27 June 2012 (in Russian).

13 Federal Law No. 302-FZ 'On Amendments to Chapters 1, 2, 3 and 4 of Part I of the Civil Code of the Russian Federation' of 30 December 2012.

14 Federal Law No. 42-FZ 'On Amendments to Part I of the Civil Code of the Russian Federation' of 8 March 2015.

15 Federal Law No. 99-FZ 'On Amendments to Chapter 4 of Part I of the Civil Code of the Russian Federation […]' of 5 May 2014 (the Corporate Law Amendments), generally effective from 1 September 2014.

16 The amendments to the Civil Code adopted as part of the reform described here gradually entered into force over 2013 and 2014, with some some changes becoming effective on 1 June 2015.

17 Changes in core civil law institutions relevant for M&A, such as validity of transactions, statutes of limitations, agency and taking security (pledges), were discussed in the 'Russia' chapter of the previous edition hereof.

with any similar overhaul of core business law regulations, the practical effects of these amendments will be better understood as courts apply their provisions in litigations.

Reform of Russian corporate norms

General rules on corporate forms

The Corporate Law Amendments have codified an earlier doctrinal division of business organisations into two main categories, corporate organisations and 'unitary' entities. Corporations may be established in the form of joint-stock companies or limited liability companies, the most widely used types of business organisations, or other forms provided for by law. Unitary entities, an idiosyncratic form of non-corporate state-owned commercial enterprises, continue to be used in the non-privatised sectors of the Russian economy and represent a legacy of the Soviet legal system.

Public and non-public companies

As their most significant development, the Corporate Law Amendments distinguish public from non-public companies and establish two distinct regimes of corporate governance for each (superseding the prior distinction of 'open joint-stock companies' from 'closed joint-stock companies'). Under the Corporate Law Amendments, a joint-stock company can obtain the status of a public company if (i) its equity instruments have been publicly offered or are publicly traded or (ii) it has (regardless of its number of shareholders) voluntarily opted for the public company regime by stating such in its charter. All other joint-stock companies and all limited liability companies are deemed non-public.[18] Amendments to the Joint-Stock Company Law modified the process by which a joint-stock company obtains the status of a public company. Such status is generally effective once it is disclosed on the public register of legal entities.

Non-public companies enjoy greater flexibility in structuring their corporate governance and regulation of internal procedures. In particular, non-public companies have certain discretion to redistribute default statutory powers between the general meeting of shareholders and management bodies, as well as to settle their internal corporate structure. In addition, shareholders of a non-public company may agree to disproportionate distribution of their voting and other rights, provided that the respective rules are set forth in the charter or corporate agreements and disclosed in the public register of legal entities. Conversely, public companies must comply with mandatory rules of corporate governance.

Expulsion of a shareholder

The Corporate Law Amendments provide that a shareholder of a non-public company that has caused 'material harm to the company' or otherwise has 'significantly complicated its business operations' (including by violating her or his corporate duties by consistently failing to appear at general meetings voting on a CEO candidacy where his or her presence

18 After this chapter was submitted, further amendments to the Joint-Stock Company Law modified the process by which a joint-stock company obtains the status of a public company. Such status is generally effective once it is disclosed in the public register of legal entities.

was needed for the decision to be adopted or unreasonably pursuing a corporate conflict) may be squeezed out from the company for a fair value consideration upon a court ruling solicited by another shareholder. The concepts of 'material harm to the company' or causing 'significant complications to business operations' are not defined in the law, but similar concepts have already applied to limited liability companies where courts have construed them to encompass the above shareholder behaviour. In 2014, the Supreme Court warned lower courts as to the exceptional nature of the expulsion remedy in the context of a limited liability company with two 50 per cent shareholders, stating that it should not be a court-administered solution to a deadlock where neither shareholder has breached its corporate duties.[19]

Restoration of corporate rights

The Corporate Law Amendments introduce a remedy of restoration of corporate rights which is different from the classic action of vindication (replevin) earlier applied by Russian courts to restoration of illegally deprived share ownership. Under the new rules, a shareholder may reclaim shares that he or she has been illegally deprived of from any third party owning such shares (without regard as to whether the latter acquired the shares in good faith) so long as it pays the third party fair market consideration for such shares as set by court, possibly together with a recovery of such shareholder's losses from those responsible for the original loss of the shares. However, the court has discretion to deny this claim if the third-party owner would be 'unfairly' deprived of its shareholding rights, or if such reclamation would cause 'grossly negative social consequences' or other negative effects significant for the public interest. In the latter case, the claimant would be entitled to a fair market consideration for the deprived ownership payable by the person who originally caused the loss of the shares. This new remedy has not yet been tested.

'Two-key' principle

The Corporate Law Amendments provide for the 'two-key' principle, previously unknown in Russia, under which functions of the chief executive officer may be exercised by several persons acting jointly or severally. A company applying this dual management structure must make an appropriate disclosure in the public register of legal entities. Several major Russian public companies have already implemented the senior executive structure based on the 'two-key' principle.

Corporate agreements

The amendments to the Civil Code now also provide for a general concept of 'corporate agreements', confirming and expanding upon rules regulating shareholder agreements that were introduced in Russian statutory law in 2009.[20] In addition to a company's

19 Determination of the Supreme Court No. 306-ES14-14 of 8 October 2014.

20 Article 32.1 of the Joint-Stock Company Law, as amended by Federal Law No. 119-FZ of 3 June 2009; a similar provision exists in respect of limited liability companies since 1 July 2009.

shareholders, parties to a corporate agreement may now include creditors or other third parties aiming to protect their legitimate interests (but the company itself cannot be a party). The company must be notified of the execution of a corporate agreement, while disclosure of its contents is generally discretionary. If a corporate agreement is entered into with regard to a public company, the company must disclose such, but the scope of such disclosure is yet to be defined by law. Corporate agreements may provide for special voting arrangements, as well as restrictions on selling shares (which may include put/calls), but cannot oblige shareholders to vote in accordance with instructions of the company's own management bodies.

According to the Corporate Law Amendments, a corporate decision may be declared void if it violates a corporate agreement to which all company's shareholders are parties. Furthermore, a shareholder participating in such corporate agreement may demand that a company's transaction in breach of a corporate agreement be voided if the other party to such transaction knew or should have known about the conflicting provisions of the corporate agreement.

Liability of officers and directors in Russia

The starting point for directors' and officers' liability under Russian law is a long-standing basic statutory rule that a corporate officer or director must act in the interests of the company reasonably and in good faith, and in case of a breach of any of such duties must compensate for the damages caused, upon a claim of the company itself or, in certain cases, of a company's shareholder. Until quite recently, high-level court practice on holding officers or directors financially liable to their companies was relatively scarce. Nor were the legislative provisions (outside of the bankruptcy context) any more detailed.

In its 2013 guidance to lower courts, the SCC formulated a Russian analogue of the 'business judgement rule' and its limits.[21] Recognising normal entrepreneurial risk, the SCC stated that the mere fact of a company's losses is not in itself evidence of managerial bad faith or unreasonableness, and that the courts should not second-guess the commercial sense of managerial decisions. The SCC also stated that, as a rule, the burden of proving bad faith and losses falls on the claimant (while the respondent officer or director should provide explanations as to the cause of losses). Notably, the burden can shift to the officer or director to prove that he or she acted in good faith and reasonably, for example, where he or she does not cooperate in providing good faith explanations to the court.

Effectively building on the SCC practice, the Corporate Law Amendments provide that an officer or a director shall be liable for a failure to act in good faith or reasonably, including if his or her actions (inactions) were inconsistent with common business practices or normal entrepreneurial risk. The Corporate Law Amendments also extend the standard of good faith and reasonable behaviour, as well as the liability regime, to persons who have *de facto* ability to determine activities of a legal entity.[22] This change

21 Resolution of the Plenum of the SCC No. 62 'On Certain Questions of Compensating Damages by Members of the Governance Bodies of a Legal Entity' of 30 July 2013.

22 Article 53.1 of the Civil Code (in effect from 1 September 2014).

has been viewed as a tool for piercing the corporate veil in appropriate circumstances, although to date there are no reported court cases which have applied it as such.

Further, in its 2013 guidance, the SCC formulated a list of presumptions of managerial bad faith and unreasonableness, where the burden to prove the opposite shifts to the manager. The SCC explicitly stated that an act effectively in the interests of one or several shareholders, but to the detriment of the company, is not an act in the best interests of the company.

The SCC's resolution incorporates further guidance for officers and directors on the importance of proper procedure in decision-making and creating an adequate system of controls. In this regard, the SCC noted that officers and directors may be liable for damages caused as a result of a failure to establish an appropriate governance system within their company. According to the SCC, this can be assessed by the court, for example, taking into consideration the scale of the company's business, usual commercial practices and the officer's or director's personal involvement in his or her duties and their performance. In 2014, in a ruling against a CEO for inappropriate delegation of the CEO's powers, the SCC re-emphasised the importance of senior officers' immediate and personal involvement in the management of a company, supervision of subordinates and maintaining the governance structure appropriate for the scale of the business.[23]

IV FOREIGN INVOLVEMENT IN M&A TRANSACTIONS

i 2014 overview

In 2014, inbound deals where foreign investors acquired Russian assets accounted for almost 30 per cent of Russian M&A activity by value.[24] Some of this is likely Russian money 'round-tripped' via offshore structures and reinvested in Russia. Cash investments in the range of US$1 billion in total were made from each of China and the Netherlands.[25]

In 2014, Russian acquisitions abroad comprised around 15 per cent of overall Russian M&A activity, with value of US$4.3 billion; top destinations for Russian investments abroad included the EEA (particularly Italy), Kazakhstan and Venezuela.[26]

ii Legal regime for foreign investments in Russia

Russian law generally promotes foreign investments in the Russian economy, but also imposes certain limitations and restrictions on such investments. Russia is a party to over 70 bilateral and multilateral treaties (over 50 of which are currently in force)[27] that guarantee fair and equitable treatment, national and most-favoured nation treatment, repatriation of investments and profits, and protection against expropriation without

23 Resolution of the SCC No. 9324/13 of 21 January 2014. In this case, damages in the amount of 100 million roubles were awarded against personally the CEO for a failure to act in good faith and reasonably.

24 Source: Thomson Reuters. Investments with a disclosed amount exceeding US$50 million.

25 Source: Thomson Reuters.

26 Source: Thomson Reuters. Investments with a disclosed amount exceeding US$50 million.

27 Source: http://unctad.org/Sections/dite_pcbb/docs/bits_russia.pdf.

adequate compensation.[28] These and other guarantees are further provided in the Foreign Investments Law.[29] Moreover, Russian authorities aim to extend the network of such investment protection treaties in order to provide for reciprocal protection for Russian businesses investing abroad.[30]

In 2008, Russia enacted the Foreign Strategic Investments Law[31] that established a special clearance procedure (outlined below) for foreign investments into companies engaged in, currently, 45 strategic activities, which can be grouped into the following categories: (1) geological survey and exploration and production of subsoil of federal significance; (2) weaponry, cryptography, eavesdropping devices and other similar devices; (3) nuclear production and radiation safety; (4) aerospace and aviation; (5) 'natural monopolies', including pipelines to transport gas, oil and petroleum products, power stations, railways, airports and seaports; (6) companies dominant (under the Competition Law)[32] in a particular market; (7) the fishing industry; (8) television and radio broadcasters dominant in a particular region of Russia, certain large telecommunication providers (excluding the internet), large printing and publishing companies; (9) activities that 'actively influence' hydro-meteorological and geological processes; (10) pathogens of infectious diseases; and (11) transportation security. In November 2014, food production involving use of pathogens of infectious diseases was removed from the scope of strategic activities,[33] with the practical result that foreign investments in industries such as brewing and dairy would not be subject to the FSIL review.

28 Resolution of the Government of the Russian Federation No. 456 'On the Conclusion of Agreements Between the Government of the Russian Federation and the Governments of Foreign States on Promotion and Reciprocal Protection of Investments' of 9 June 2001, as amended.

29 Federal Law No. 160-FZ 'On Foreign Investments in the Russian Federation' of 9 July 1999, as amended (the FIL).

30 Order of the Ministry of Economic Development of the Russian Federation No. 195 'On Approval of the Plan of the Negotiations on the Conclusion of Inter-Governmental Agreements on the Promotion and Reciprocal Protection of Investments in 2015' of 1 April 2015 available at http://merit.consultant.ru/page.aspx?74752 (in Russian).

31 Federal Law No. 57-FZ 'On the Order of Accomplishing Foreign Investment In Entities Having Strategic Importance for Procuring State Defence and Security' of 29 April 2008, as amended (the FSIL).

32 Federal Law No. 135-FZ 'On Protection of Competition' of 26 July 2006, as amended (the Competition Law).

33 Federal Law No.343-FZ 'On Amendments to the Federal Law 'On the Order of Accomplishing Foreign Investment In Entities Having Strategic Importance for Procuring State Defense and Security' and Certain Other Legislative Acts of the Russian Feederation' of 4 November 2014 (the 2014 FSIL Amendments).

Key FSIL requirements, restrictions and exemptions

Under the FSIL, the acquisition of control by a foreign investor (or a group of affiliated persons to which the foreign investor belongs), directly or through third parties, over a Russian strategic company is generally subject to an advance approval by a special governmental commission chaired by the Prime Minister (the Commission). In addition, the 2014 FSIL Amendments extend the application of the FSIL to (1) acquisitions of rights of ownership, possession, or use of fixed production assets representing 25 per cent or more of the balance sheet value of assets of a Russian strategic company, as well as (2) any arrangements enabling foreign investors to obtain rights to determine corporate decisions of such a company.

Subsequent approval is required if a change of control happens as a result of buy-back or redemption of shares, conversion of preferred stock into voting shares or for similar reasons.

The FSIL also requires foreign investors to notify the Federal Antimonopoly Service of Russia (the FAS), which administers the clearance procedure under the FSIL, of any acquisition of 5 per cent (or more) of voting rights in a Russian strategic company within 45 days of the acquisition. In line with the prior FAS practice, the 2014 FSIL Amendments explicitly established that the applicants shall notify the FAS regarding completion of the transaction previously approved by the Commission in accordance with the FSIL.

The FSIL expressly prohibits sovereign states or entities under their control (such as sovereign wealth funds) to acquire (1) direct or indirect control over a Russian strategic company or (2) rights of ownership, possession, or use of fixed production assets representing 25 per cent and more of the balance sheet value of assets of the relevant strategic company – the Commission cannot waive this rule. Within these limits, minority sovereign investments into the equity of strategic companies are allowed, subject to prior approval if the relevant equity thresholds are exceeded (which may be as low as 5 per cent). Moreover, the FIL extends the application of the FSIL approval requirements to sovereign investments in a non-strategic Russian company, if the sovereign acquirer would exercise direct or indirect control over more than 25 per cent of voting rights in such Russian company.

There are several exemptions from the FSIL jurisdiction. One set of exemptions relate to a foreign investor adding to an existing, approved investment in a strategic target. With respect to most strategic targets, no clearance is needed when the foreign investor already controls the target by virtue of a FSIL-cleared investment. However, in the case of a 'strategic mining company' (i.e., a company with a licence for a subsoil field of federal importance), that exemption in narrowed to the situation where the foreign investor already holds over 75 per cent of the voting rights of the target (unless the Russian state holds over 50 per cent of the voting rights of the target, in which case the foreign investor can make its further investment without FSIL-clearance so long as such further investment does not change such voting power of the Russian Federation in the strategic target); this exemption is unavailable for investments into strategic mining companies by sovereign acquirers. Another exemption establishes that where a foreign acquisition vehicle is used that is ultimately controlled by a Russian citizen and tax resident with no dual citizenship no FSIL clearance is required.

Notion of control under the FSIL

The FSIL uses a robust definition of control. In addition to clear-cut situations such as the acquisition of over 50 per cent of voting shares or the right to appoint over 50 per cent of the members of the management bodies of a strategic target, control may exist in other less obvious situations. Under the FSIL, control may also exist where a foreign investor has less than 50 per cent of votes, but the allocation of votes is such that the foreign investor is still able to determine the decisions of a strategic company. For example, in the *FAS v. Telenor et al* case, the FAS asserted that the largest, 40 per cent shareholder (Telenor, the telecommunications conglomerate controlled by Norway) had control over publicly traded VimpelCom, one of the largest Russian telecom companies, despite the fact that there were other shareholders with significant shareholdings in VimpelCom.[34] Further, according to published guidelines by the FAS, there is no *de minimis* (safe harbour) equity threshold (for example, 10 per cent) and control might be acquired with no equity stake.[35]

Moreover, a lower threshold of 'control' applies for strategic mining companies: the ability (directly or indirectly) to control 25 per cent of a mining company's votes, and any subsequent acquisition of shares in a strategic mining company is subject to additional prior approval, unless the relevant size of the stake to overall equity does not increase.[36]

The 2014 FSIL Amendments introduce a notion of 'collective control' over a strategic company as control of several foreign investors, which do not form a 'group of persons' but are directly or indirectly controlled by foreign states, international organisations and (or) entities under their control and are able to dispose of more than 50 per cent (and, in certain cases, even less than 50 per cent) of voting rights in a strategic company. This particular amendment appears to build on the *TeliaSonera* case of 2010 where Russian courts ruled that Sonera Group was indirectly 'collectively' controlled by foreign states (Sweden and Finland). As a result, the JV agreement structured so that Sonera Group would acquire a substantial stake in MegaFon, a major Russian telecom company, was declared void due to its violation of the FSIL.[37]

Clearance process

The FSIL clearance process comprises two stages. At the initial stage, the FAS determines whether the applicant would acquire control over a strategic entity as a result of the reported transaction. Upon the results of the initial review, two alternative options are

34 Ruling of the Moscow Commercial Court in Case No. A40-57614/12-56-542 of 24 April 2013, upheld by Resolution of the Ninth Commercial Appellate Court of 28 September 2012.

35 FAS Guidelines on 57-FZ of 6 December 2013 (FSIL Guidelines), available at: http://fas.gov.ru/clarifications/clarifications_30428.html (in Russian), Item 4.

36 FSIL Guidelines, Item 3.

37 Resolution of the Ninth Commercial Appellate Court in Case No. A40-40521/10-22-354 of 21 October 2010, upheld by Resolution of the Federal Commercial Court of the Moscow District of 21 February 2011 and Ruling of the Supreme Commercial Court of 22 June 2011.

possible. If the FAS determines that either control would not be acquired or the target is not strategic, it should inform the applicant that the FSIL approval is not required. Alternatively, if the FAS determines that the applicant would acquire control over a strategic entity, the FAS follows a standard, full-scale review, and the application is referred to the Commission.

In case of a standard, full-scale review, while processing the application, the FAS liaises with other agencies, including the Federal Security Service and the Ministry of Defence, which shall provide their opinions to the Commission regarding the proposed transaction from the perspectives of state defence and national security. The Commission, however, makes the final decision. The FSIL does not establish specific criteria that should be applied by the Commission,[38] which thus has full discretion in determining whether the transaction constitutes any possible potential threat to national security interests. The FSIL does not envisage any possibility for the applicant to participate in the approval process (other than making the filing and responding to follow-up requests by the FAS) or any grounds to challenge the Commission's decision. If the transaction was approved by the Commission it may be consummated within the term specified in the decision. This term can be prolonged by the decision of the FAS upon the applicant's request.

While the statutory deadline for an application review is three months (which may be extended to six months in exceptional cases), in practice the FSIL approval process can take longer. The FAS will suspend its review of the related antitrust filing and will not issue its approval under the Competition Law until the FSIL clearance is granted.

As of June 2015, of the 372 applications submitted under the FSIL since its enactment in 2008, 180 applications were reviewed by the Commission. Only 10 applications were denied and 169 applications received positive clearances by the Commission, of which 44 approvals were given subject to conditions usually set forth in mitigation agreements. 137 applications were returned by the FAS because no approval was required, 40 applications were withdrawn by applicants and 15 applications were still under consideration.[39] So far, only one FAS decision premised on the FSIL has been challenged by an acquirer,[40] and no decision of the Commission has been challenged.

Violations of the FSIL

Failure to comply with the FSIL can lead to severe consequences. A transaction consummated in breach of the FSIL filing requirements or prohibition is void and may be unwound (in other words, the parties returned to *status quo ante*). This may also potentially lead to voidance of any and all post-investment decisions of the shareholders

38 FSIL merely requires FAS to check a number of factors with respect to a strategic target, such as whether it has IP rights in relation to technologies important for social, economic or national defence and security (critical technologies), the licence to conduct works using state secret data and other factors.

39 Source: www.fas.gov.ru/analytical-materials/analytical-materials_31194.html (in Russian).

40 Resolution of the Federal Commercial Court of the Moscow District in Case No. A40-120785/12-120-1184 of 21 October 2013, upheld by Ruling of the Supreme Commercial Court No. 798/14 of 4 April 2014.

or governance bodies of the strategic company. Other potential consequences include the loss or suspension of voting rights[41] attached to the acquired interest and administrative fines between 500,000 and 1 million roubles for companies.[42]

The FAS is authorised to prosecute FSIL violations. When applying to a Russian court to unwind an acquisition violating the FSIL, the FAS usually applies – *ex parte* – for interim relief broadly aimed at blocking cash disbursements from the strategic company to the acquirer and its affiliates, preserving the existing management of the strategic company and prohibiting approvals of major and interested party transactions to be entered by the strategic company.[43] Moreover, as the ongoing litigation regarding the Astrakhan Port shows, the FAS also utilises a robust arsenal to obtain evidence supporting its position, such as intelligence reports by the Federal Security Service evidencing concerted actions by foreign companies aimed at obtaining control over the Russian strategic company.[44] Finally, based on several cases, private parties may have a cause of action under the FSIL to unwind a transaction entered into in violation of the FSIL.[45]

V SIGNIFICANT TRANSACTIONS, KEY TRENDS AND HOT INDUSTRIES

As a result of a confluence of negative factors (i.e., the decline in global energy prices combined with international economic sanctions imposed on Russia, with the result that GDP growth in Russia slowed down in 2014 and turned negative in the first quarter of 2015) the Russian M&A market in 2014 has been less than buoyant. In contrast to previous years, the 10 largest Russian M&A deals[46] in 2014 had no non-CIS principals.

The contraction of inbound foreign M&A (in value terms) and the prevalence of domestic M&A, combined with the new 'deoffshorisation' concerns for domestic buyers

41 Ruling of the Ninth Commercial Appellate Court in case No. A40-124526/11-138-1056 of 21 June 2012, upheld by the Ruling of the Moscow Region Commercial Court of 24 September 2012.

42 The Code of Administrative Offences of the Russian Federation, Article 19.8.2.

43 Ruling of the Moscow Commercial Court in Case No. A40-57614/12-56-542 of 24 April 2012, upheld by Resolution of the Ninth Commercial Appellate Court of 28 September 2012; Ruling of the Moscow Commercial Court in Case No. A40-57614/12-56-542 of 23 May 2012, upheld by Resolution of the Ninth Commercial Appellate Court of 16 November 2012; and Rulings of the Astrakhan Region Commercial Court in Case No. A06-2683/2012 of 1 June 2012 and 16 July 2012.

44 Decision of the Astrakhan Region Commercial Court in Case No. A06-2683/2012 of May 23, 2014 (currently pending on appeal).

45 See, for example, Resolution of Ninth Commercial Appellate Court in Case No. A40-40521/10-22-354 of 21 October 2010, upheld by Resolution of the Federal Commercial Court of the Moscow District of 21 February 2011 and Ruling of the Supreme Commercial Court of 22 June 2011.

46 Source: KPMG, Russian M&A Market Review, 2014 (March 2015), p. 10.

and generally the substantial role of state-affiliated counterparties resulted in continued emergence of Russian law as the governing law in significant Russian M&A transactions. In fact, what a few years ago started as an attempt to replicate foreign contractual M&A concepts in the Russian law-governed documentation is now clearly visible as a distinct and independent approach to Russian law documentation.

VI FINANCING OF M&A: MAIN SOURCES AND DEVELOPMENTS

The forms of financing M&A deals commonly used in major foreign markets also apply for a Russian M&A deal. Traditionally, the prevailing structures of equity holdings in Russian businesses, which involve multi-layer offshore holdings, as well as the financial infrastructure, including major Russian and Western investment banks working in the Russian market, provided the flexibility of using multiple financing instruments.

Market intelligence reports that 40–50 per cent of cash payments in Russian M&A deals in 2013 were debt-financed (the remainder being financed predominantly with corporate cash reserves), consistent with the 2012 levels.[47] Debt financing tends to take the form of bank loans,[48] and is occasionally in the form of leveraged buy-outs (which require tax structuring). Sometimes acquisitions are funded with public debt – for example, Eurobond issuances of US$1 billion and 15 billion roubles by Novatek, Russia's largest independent gas producer, helped to finance its US$1.4 billion purchase price for Nortgas (acquired in June 2013). A notable trend is the active and large-scale involvement of state-affiliated banks in financing Russian M&A transactions due to a range of factors: their generally cheaper cost of financing, their proximity to M&A deals on the advisory side, the prevalence of state-affiliated buyers in the domestic market and, specifically in 2014, limited foreign borrowing opportunities for Russian borrowers in light of the Ukraine-related sanctions.

At the peak period of the financial crisis in 2009, the share of direct state investments in financing Russian M&A deals (among others, via Vnesheconombank, the Russian development bank) exceeded 20 per cent, but had decreased by 2010 and remained under 5 per cent in 2013.[49] In view of the tightening liquidity conditions for Russian borrowers, in 2014, the CBR came up with a new refinancing instrument for Russian banks, which allows banks to use loans provided for certain investment projects as collateral for obtaining financing from the CBR.

47 Source: 'Review of M&A Deals – 2008-2013. Structure and Financing of Transactions' by OJSC Gazprombank, January 2014 (excluding the financing for the *Rosneft/TNK-BP* deals). More recent data is unavailable, although the percentage share of debt financing could have somewhat decreased, as borrowing opportunities for Russian entities drained in 2014 in view of the Ukraine-related sanctions.

48 Source: ibid.

49 Source: ibid.

The private equity (PE) market in Russia is underdeveloped, as evidenced by its moderate size[50] and the changing composition of the players that make PE investments in Russian assets from year to year. Prominent PE funds active in the Russian market include TPG, Baring Vostok, the Russian Direct Investment Fund (RDIF), Rosnano and the PE arms of Russian state-affiliated banks. The IPO of Lenta, Russia's leading hypermarket chain, in March 2014 in a secondary sale of the shares by TPG, VTB Capital and the EBRD marked a classic partial monetisation of a very successful PE investment.

In recent years, Russian government-backed sponsors (such as the RDIF and PE divisions of state-affiliated banks) have strengthened the domestic segment of PE investments in Russia, which is expected to continue to increase. The RDIF was created in 2011 to catalyse PE investments in the Russian economy, including by way of attracting foreign co-investors who would otherwise be reluctant to invest on their own.[51] The RDIF has participated in deals valued at 400 billion roubles, out of which 350 billion roubles was provided by foreign co-investors, partners and banks.[52] In recent years, private equity in the Russian M&A markets has focused on the consumer retail, telecommunications and IT, financial services, and real estate sectors.

VII EMPLOYMENT LAW

In Russia, executive compensation falls within the purview of employment law. In principle, the CEO of a Russian company can be dismissed at any time upon the decision of the corporate body that has the relevant competence under the company's charter. Until recently, upon dismissal, the CEO of any Russian company was entitled under law to compensation equal to three average monthly salaries or, if greater, in the amount set forth in the CEO's employment agreement. This is no longer the case for certain state-controlled companies and all banks operating in Russia, as explained below, and a question remains about whether other contractually agreed executive 'parachutes' could be curtailed in court.

Unlike in some other jurisdictions, executive compensation did not become a hot topic in Russia at the time of the financial crisis. However, a case that started in 2013[53] and dealt with a 'golden parachute' of around 200 million roubles to the dismissed CEO of the state-controlled company Rostelecom drew attention. Certain

50 In 2013, completed deals in respect of Russian businesses, which involved PE buyers or sellers, reached US$2 billion, compared, for example, with Brazil (US$6.6 billion), India (US$3 billion) and China (US$17.8 billion). More recent data is unavailable. Source: Thomson Reuters.

51 Source: http://rdif.ru/InvestModel/ (in Russian).

52 Source: http://rdif.ru/About/.

53 Decision of the Commercial Court of St Petersburg and the Leningrad Region in Case No. A56-31942/2013 of 2 December 2013, ultimately upheld by Determination of the Supreme Court No. 307-ES14-8853 of 30 March 2015. The dismissed CEO received the pay-out, but later returned around 75 per cent of it to Rostelecom.

shareholders of Rostelecom challenged the board's decision on the pay-out. The Supreme Court has sided with the claimants, stating, among other reasons for its decision, that compensation upon early termination must be consistent with its purpose (i.e., to be an adequate protection for an ex-CEO upon his or her loss of employment) and, given its amount, should have been well-justified by the company.

In February 2014, the Russian legislature reacted to this case by passing a law that retroactively limited 'golden parachutes' to various categories of executives of companies more than 50 per cent owned by the Russian Federation to three average monthly salaries.[54] Possibly, Russian courts may adopt a similarly restrictive approach to 'golden parachutes' for outgoing executives of non-state owned companies (particularly, those with public shareholdings), relying on the concepts of reasonableness, good faith and best interests of shareholders.

Separately, new rules for the compensation in the banking industry (both in its private and state-controlled segments) were adopted in 2013 and 2014.[55] The CBR now has supervisory powers over the executive compensation in all Russian credit organisations. The new rules oblige credit organisations to implement a system of compensation, including executive compensation, under which remuneration can be cancelled, reduced or clawed back in case of a negative financial result of the entire organisation or its individual business segment.

VIII TAX LAW

In late 2014, Russia adopted the law comprising the core part of the 'deoffshorisation' legislative package.[56] Although the 'deoffshorisation' reform is principally carried out in respect of taxation, it directly affects corporate aspects of structuring Russia-related M&A transactions (traditionally structured via foreign jurisdictions) and corporate holdings of Russian businesses and individuals, to the extent they rely on foreign companies, such as SPVs, trading or cash management companies. This and other legislative measures followed calls by Russian leadership to stimulate the relocation of *de facto* Russian businesses, in particular their ownership structures, into the realm of Russian law and Russian jurisdiction; such calls intensified in the first half of 2014. In parallel, there are efforts to make Russian corporate law more 'user-friendly' (such as the new rules on

54 Federal Law No. 56-FZ 'On Amendments to the Labour Code of the Russian Federation Regarding Introduction of Limitations on Severance Payments, Compensations and Other Payments in Connection with Termination of Employment Contracts with Selected Categories of Employees' of 2 April 2014.

55 Federal Law No. 146-FZ 'On Amendments to Selected Legislative Acts of the Russian Federation' of 2 July 2013; Instruction of the CBR No. 154-I 'On Procedure of Assessment of Compensation System in Credit Organisations and Procedure for a Directive to a Credit Organisation on Curing Deficiencies in Its Compensation System' of 14 June 2014.

56 Federal Law No. 376-FZ 'On Amendments to Parts One and Two of the Tax Code of the Russian Federation (With Respect to Taxation of Profits of Controlled Foreign Companies and Revenues of Foreign Organisations)' of 24 November 2014.

corporate forms and institutions discussed above) so as to incentivise the use of Russian corporate vehicles and Russian law by the business and legal community.

In Russia, tax advice, including for major M&A deals, is often provided by the 'Big Four' companies. We suggest the reader review their alert memoranda (available on their websites regularly) on Russian tax law developments related to M&A activities.

IX COMPETITION LAW

Russian competition law and practice, including merger control, have been developing rapidly over the last decade. After administrative reforms in 2004, the Russian antitrust regulator, the FAS, has achieved substantial and visible results in the enforcement of Russian competition law and its evolution.[57] Since the enactment of the Competition Law in 2006 (which replaced the 1991 law), there have been three major sets of amendments to the Competition Law. The fourth set of amendments has been debated for over two years by the FAS, other Russian authorities and the Russian business community and it is now pending with the Russian parliament undergoing further revisions between the parliamentary readings.[58]

Generally modelled on EU competition law,[59] the merger control rules of the Competition Law require prior approval by the FAS for the incorporation and merger of Russian business entities and the acquisition of equity in a business entity (Russian or foreign with substantial sales into Russia) above certain acquisition thresholds, provided that an asset or revenue test is met.[60] In practice, given that asset or revenue tests consider group assets of the acquirer and the target, the FAS's approval is almost always required if the acquirer takes over 50 per cent ownership at any level (including an offshore parent of Russian operating subsidiaries). For a minority investment, FAS approval is needed to acquire over 25 per cent of voting shares in a Russian joint-stock company, over one-third's interest in a Russian limited liability company, or over 20 per cent of the target company's assets. An investment constituting less than 50 per cent of equity in an offshore parent is not *per se* subject to FAS approval under the Competition Law.

57 For example, in recognition of this achievement, the Global Competition Review rated FAS at the 17th place globally out of 140. Meeting with FAS Director Igor Artemyev, 17 June 2014 available at http://eng.kremlin.ru/news/22494 (in English).

58 Source: www.rg.ru/2015/03/31/paket.html (in Russian).

59 Russian Competition Law Textbook, ed. by I Artemiev, S Puzyrevskiy and A Sushkevich (2014), p. 37.

60 These asset/revenue tests are the following: (a) the combined asset value of the acquirer and the target exceeds 7 billion roubles, and the total assets of the target exceed 250 million roubles; (b) the combined annual revenues of the acquirer and the target for the preceding calendar year exceed 10 billion roubles and the total assets of the target exceed 250 million roubles; or (c) the acquirer, the target or any entity within the acquirer's or the target's group is included in the FAS's register of entities having a 35 per cent or larger market share for a commodity. Acquisitions of assets located in Russia (as opposed to share deals) are subject to separate thresholds for competition law clearance.

The general review period by the FAS is 30 days following the submission of the complete application package. The FAS may extend this period for an additional 60 days if it needs extra time to review the transaction and request additional information. The FAS may do so if it believes that the transaction may restrain competition, for example, as result of the establishment or an increase of the 'dominant position' of the acquirer. The Competition Law also provides that the FAS may extend the review period in order to determine conditions precedent for its approval of the reported transaction and set the deadline for their satisfaction, which may not be longer than nine months. The FAS may also suspend the review of the application pending the approval of the transaction under the FSIL, if it finds that the transaction is subject to FSIL approval. Upon review, the FAS may clear the transaction without any conditions if there are no competition concerns; issue its approval subject to behavioural conditions or divestiture remedies; or withhold its approval (1) if the transaction may lead to the restriction of competition, including as a result of the establishment or increase of the 'dominant position' of the acquirer, or (2) if the FAS was not provided with requested information or the information provided was inaccurate. Also, the FAS will withhold its antimonopoly approval if the FSIL approval is not obtained.

X OUTLOOK

The outlook for M&A activity in the Russian market in 2015 remains unclear at the time of writing. Western sanctions imposed as a result of events in Crimea and Ukraine have had a chilling effect both on foreign investment in Russia and Western financing to Russian businesses. Significant foreign investment of a predominantly Western origin is unlikely before the resolution of the situation in Ukraine and the de-escalation of wider political tensions between Russia and the West. Despite long-standing expectations that a strategic reorientation will facilitate greater Sino-Russian M&A activity, we have not yet seen a major shift in that direction, as evidenced by relatively modest Chinese M&A investments in Russia in 2014 (in terms of value and number).[61] The government privatisation plans that were announced in recent years have largely stalled. That said, given the devaluation of the rouble, sustainable Russian assets might at some point become attractive acquisition targets in M&A and capital markets. Buoyancy is likely to return to the Russian M&A market only when global energy prices turn bullish, which they will inevitably.

61 Approximately US$1.1 billion worth of M&A investments in two deals in 2014, compared with US$2 billion worth of M&A investments in four deals in 2013. Source: Thomson Reuters.

Appendix 1

ABOUT THE AUTHORS

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Scott Senecal has headed the Moscow office of the firm since 1996. Mr Senecal's practice focuses on financial and corporate law. Mr Senecal is consistently cited as one of the leading lawyers in Russia by such publications as *Chambers Global* and *The European Legal 500*. He regularly advises on M&A transactions and joint ventures, representing foreign investors (both private equity and corporate) and Russian entities, such as TPG (including investments in the food retail and banking sectors), Citigroup Venture Capital (including investments in the real estate and warehousing sectors), and Finmeccanica/Alenia (including its joint venture with Sukhoi to manufacture and market the SuperJet-100). Mr Senecal has advised on many significant securities offerings by Russian corporates and banks such as the initial public offerings of Lenta, Rosinter Restaurants and Wimm-Bill-Dann and equity and debt offerings by Gazprom neft, Novatek, Sberbank and VTB. Mr Senecal joined the firm in 1989, became counsel in 1999 and was elected partner in 2005. Mr Senecal received a JD degree, *cum laude*, from New York University School of Law in 1987. Mr Senecal is a member of the Bar in New York.

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Yulia Solomakhina is a partner based in the Moscow office. Her practice focuses on corporate and financial transactions, particularly capital markets, M&A and cross-border transactions involving businesses in Russia. *Vedomosti*, Russia's leading business newspaper, has distinguished Ms Solomakhina as a leading lawyer in Russia in the areas of capital markets and M&A, the result of a survey of the leading legal practitioners in Russia. She has also been distinguished as a leading capital markets lawyer in Russia by *Chambers Global* and *Chambers Europe* and in 2015 was named a 'Rising Star' in Corporate by IFLR's European Women in Business Law Awards. Ms Solomakhina's

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