



RUSSIA

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Russia is one of the most important trading partners of Germany. In the first eight months of 2013, the volume of trade between the two countries amounted to more than 36 billion euros. In the first half of the year, the scope of the German investment in Russia amounted to more than 15 million euros, of which more than eight million euros was for direct investments. According to figures from December 2013, the gross domestic product against expectations only grew by 1.4%. However, due to its size and the potential for development for foreign investors the Russian market remains lucrative. The country is continually improving the investment and legal conditions for business operations.

The dismantling of bureaucracy and the fight against corruption are being pushed. As a result, in the "Doing Business Report 2014" of the World Bank, in just one year Russia climbed up 19 positions to reach position 92 from a total of 189 and therefore leads the BRIC states. In addition, the political situation in Russia is stable. In total this creates positive prospects for foreign investors. More than 6,000 German companies are already doing business in Russia via representative offices, subsidiaries or own branch offices.

### Legal forms of business and founding a company

Russian corporate law is comparable to German corporate law. There is a range of legal forms which are essentially similar to the German legal forms.

#### Joint stock companies

##### Company with limited liability (OOO)

Most investors prefer a company with limited liability (OOO) which is very similar to the German GmbH. The OOO is able to acquire and transfer rights to real estate and can become a party to legal proceedings. Personal liability of the shareholders exists only in the case that the shareholding held is not fully paid up and is limited to the outstanding amount.

In order to found an OOO the decision of the shareholder to found the company and the articles of association are required. The registration of the founding is made by the tax authorities which are responsible for the maintenance of the register of the legal entities (commercial register) and for the issue of the tax number. In order to register an OOO which was founded by one or more foreign companies the presentation of the extract from the commercial register with apostille about the founders is required.

The company acts as a legal entity through its bodies of the managing director and the shareholders' meeting. The minimum share capital amounts to 10,000 roubles (approx. 230 euros). In order to benefit from the advantages of the German-Russian double taxation agreement, a share capital of 80,000 roubles is recommended.

### **Joint stock companies**

Russian law has two forms of joint stock companies – the open joint stock company (OAO) and the closed joint stock company (ZAO). The closed joint stock company is comparable to a small German AG. The open joint stock company is conceived as a big investment project. The form is recommended when a public offering is planned. For closed joint stock companies the number of shareholders is limited to a maximum of 50. The share capital of a closed joint stock company requires the minimum amount of approx. 80,000 roubles (approx. 1,800 euros) and for an open joint stock company the minimum amount is 800,000 roubles (approx. 18,000 euros). The shareholders of a closed joint stock company have the right of first refusal to acquire the shares of the other shareholders.

### **Economic partnership**

One year ago a new form of joint stock company was created, the economic partnership company. The legislator is of the opinion that this form is particularly suitable for joint ventures between Russian and foreign investors. The legal basis orients to the regulations of the American limited liability company or the British limited liability partnership or the German limited partnership with shares. The adoption of these regulations should enable the necessary flexibility which international investors expect. Shareholders are entitled to be actively involved in the administration of the economic partnership company. There is no legally required minimum share capital. The shareholders are free to define the time limits, the amounts and the type of the contributions to the capital.

### **Business partnerships**

Business partnerships are defined by law, but the practical importance of this form is minimal. The business partnerships mainly correspond to the German forms of the open trading company ("partnership" in Russian) and the limited partnership.

## Liquidation of a company

The company can be dissolved through the expiry of a period agreed by contract, through the establishment of insolvency or through a corresponding shareholders' resolution. Furthermore, the liquidation of a company can be ordered if no tax returns are submitted within a period of one year.

Before liquidation takes place, an obligatory tax and social security audit is carried out. Depending on the location of the company, the liquidation process can take from 10 to 16 months.

## Labour law and dismissal protection

The similarity between Russian and German labour law is limited to some basic structures. Russian labour law is characterised by its bureaucratic approach. Historically, in terms of the law, the employee protection is very strong.

Foreigners can be employed in Russia provided they are in possession of the corresponding residence and work permits. If the foreigner is employed as a so-called highly-qualified specialist, the procedure to obtain a work permit is much simpler. The definition of a highly qualified specialist is someone with an income of over two million roubles per year.

The regular working time amounts to 40 hours per week or 8 hours per working day with a five day working week. Overtime hours are only possible with the approval in writing of the employee which cannot be given in advance, i.e. in the employment contract. The wage has to be paid twice per month in roubles. The legally required minimum holiday days amount to 28 calendar days. At least one part of the holiday must be for a continuous period of 14 calendar days.

The maximum time for the trial period is three months for management personnel and six months for the company management. In contrast to German law, the employer must present the reasons for termination of employment during the trial period. Therefore it is recommendable to carefully consider the rules governing trial periods and in particular for management personnel.

There is also dismissal protection for management personnel and the company management. The notice of termination by the employer in the form common in Germany is seldom used in Russia. From a formal point of view, Russian law poses considerable challenges for notice of termination by the employer. Even small errors in the termination process regularly lead to the ineffectiveness of the dismissal. Employers are therefore forced to strive to achieve a consensual ending of the employment relationship with the payment of a settlement.

## Company management

The company management of the joint stock companies is usually carried out by the general director. The general director is a single body of the company management. He represents the company by himself without external power of attorney, manages transactions and remits instructions which are binding for all employees. The general director has to represent the company by law to the best of his knowledge and conscience. He must replace all damages to the company for which he is responsible.

The representative powers of the general director can be limited by the articles of association of the company and/or through the contract of employment. Business partners are obliged to take note of the articles of association of the company, the tax number and the registration certificate of the company with the first conclusion of transactions. In practice only a few people observe this rule.

Experience shows that many German companies neglect to effectively monitor the activity of the general director. One of the typical results of this neglect is the misappropriation of the assets of the Russian subsidiary company. This happens frequently through the assumption of fictitious liabilities owed to letter-box companies.

A number of German companies try to find a remedy for their distrust of the Russian general director by significantly limiting the authority of the general director in the articles of association and/or employment contract. These restrictions, however, can strongly compromise the ability of the company to act. For example, for tenders from companies run by the state the future business partner will not want to wait for the approval of the shareholders as stipulated in the articles of association and simply decide not to participate in the tendering process.

Russian law also has no knowledge of the dual control principle used in Germany. The appointment of several persons to be managing directors and the granting of power of attorney is not possible. For this reason a balanced system for powers of authority and control mechanisms for Russian companies is absolutely necessary.

Under Russian law the general director is accorded the status of an employee and therefore he is also covered by dismissal protection. Although notice of termination is possible at any time through a shareholders' resolution, the termination is linked to the payment of a settlement to the amount of at least three months' salary. The separation between the position of the general director in respect of corporate law and his protection as an employee in Russia has not been clearly made. The protection of the general director as an employee leads to the situation that in the case of an ineffective notice of termination he can also regain his position in respect

of corporate law. This could have fatal consequences for the company. For this reason a notice of termination of a general director should be planned in advance and implemented carefully.

## Foreign exchange law

Russian foreign exchange law is very strict and formal. The control functions are taken up by the central bank of the Russian Federation and the banks where accounts are maintained. Payments between residents in Russia in foreign currencies are prohibited. However, legal entities and natural persons can acquire foreign currencies without limitation. In order to prevent own liability against the central bank, the banks often demand excessive and sometimes unjustified requirements regarding the arrangement of the legal relationship between the resident maintaining an account at the bank and his foreign business partner. The banks frequently disregard the fact that a contract is subject to a different legal jurisdiction and demand the fulfilment of the formalities which Russian contract law foresees for Russian contracts. For exchange controls one has to have some degree of patience and assume that each case is an individual case.

## Professional access, permission for certain types of entrepreneurial activity

The access to a number of types of entrepreneurial activity necessitates a respective permission. This includes, for example, activities in the banking and insurance sectors and in telecommunications. The conditions to access these fields of activity are either regulated by authorisation for certain entrepreneurial activities required by law or regulated in specialist laws such as the law concerning the insurance sector. Access to a number of fields of activity is only possible with membership of a self-regulatory body (a kind of professional association). This is, for example, valid for the construction industry.

## Protection of intellectual property

In Russia the protection of intellectual property is increasingly more important. The regulations governing intellectual property and its protection are codified and mainly correspond to the standards existing in Germany since Russia is a member of the international convention in the field of intellectual property and commercial legal protection.

## Auditing

The conclusion of a contract with the auditor and the amount of his fee, which depends in particular on the legal form of the company to be audited, has to be approved by the founders/

shareholders. The auditor can also be appointed for a period of several years. The amount of the auditor's fee is not regulated by law. An audit of the annual financial statements is mandatory where certain criteria are satisfied and in particular it is mandatory for enterprises and bodies corporate with a turnover of over RUB 400 million for the previous financial year or with total assets of over RUB 60 million as of the previous balance sheet date. Therefore if either of the above threshold levels is exceeded in a financial year, the company becomes obliged to undergo an audit for the next year - but not for the year in which the threshold level has been exceeded. Furthermore the obligation to undergo an audit extends to all companies in certain legal forms, irrespective of whether they have or have not exceeded the above levels; this category includes in particular all open joint stock companies, banks and other lending institutions, insurance companies and stock exchanges.

## Income tax

The income tax rate amounts to 13 % for residents and persons residing in Russia for longer than 183 days in the year. A tax rate of 30 % is valid for non-residents. Highly-qualified specialists are treated as residents right from the start.

## Sales tax

Sales tax law in Russia is comparable to sales tax law in Germany. The sales tax rate amounts to 18 %. For some foods and children's goods a tax rate of 10 % is valid. The tax rate applicable for the export of goods is 0 %. However, for this tax rate the exporter is subject to higher documentary requirements from the tax authorities and proof must be provided. The sales tax return must be submitted on a quarterly basis by day 20 of the successive month after the end of the respective quarter.

## Profit tax

The profit tax which is roughly comparable to corporation tax in Germany is calculated at a flat rate of 20 % on the profit of the company.

## Wealth tax

The wealth tax is a Russian particularity. This tax has to be paid by companies which own real estate and/or movables acquired before January 1, 2013. The amount of the tax rate is defined at a regional level by the subjects of the Russian Federation (comparable to the federal states in Germany). The maximum tax rate amounts to 2.2 % of the average annual value of the available assets of the company. The tax is paid on a quarterly basis.

# Practical examples

## Law

### Background facts:

In 2006, given the structural difficulties in Russia the German R Group decided to acquire the company of its distributor, the S-W. Bau OOO in order to secure the sales of its goods manufactured in Germany. The former general director and sole shareholder of the S-W. Bau OOO is appointed general director of the acquired company. A comprehensive due diligence was dispensed with. The head of the financial accounting department and all other management personnel (director of warehousing and logistics, sales manager, finance director) remain in their positions or are appointed by the general director.

The auditing firm was also appointed on the recommendation of the general director. Although the newly established company recorded a regular increase in turnover, the profit margin steadily decreased. The general director explained the situation with the particularities of business life in Russia, i.e. bribery payments, corruption, theft. The controlling was limited to the analysis of the information supplied by the Russian financial accounting department in the form of Excel charts.

Rödl & Partner was commissioned to investigate and determined that the general director had systematically caused a considerable financial loss to the company through fictitious contracts/invoices, through excessive prices paid to service providers and through the sale of company assets at very low prices.

## What can be done now?

As far as being of economic importance, the transactions of the company can be contested. Furthermore, criminal charges should be brought against the general director. Under consideration of the new jurisdiction of the supreme economic court, compensation can be claimed from the general director.

## What should one have done differently from the beginning?

A series of measures could have prevented the situation. These would have included a comprehensive due diligence carried out beforehand to reveal the conditions in the company. Furthermore, the replacement of old personnel loyal to the general director would have been advisable. In particular, the further employment of the head of the financial accounting department turned out to be an error. The parent company should be more closely involved with the selection and taking on of employees. There should also have been better integration of the company into the group structure and a continual, professional analysis of the business processes in the subsidiary. Especially at the beginning a high degree of control is recommendable. Instead of relying on the statement that in Russia nothing works without bribery, the experts at Rödl & Partner advise implementation of a specially written compliance system for the Russian company and its strict implementation.

## Auditing

### Background facts:

A company from Germany founded a subsidiary in the form of an OOO in Russia with the company purpose of distributing equipment to end customers in Russia. In this process the parent company in Germany defines a certain purchase price, but the subsidiary decides at its discretion about the amount of the sales price. Due to discounts or clearance sales in Germany the goods can be procured to some extent at more favourable prices. In principle, the sales price is derived from the usual price lists or due to marketing or loyalty programs reduced across the board and respectively contractually agreed.

In the course of our audits we determined a decrease in sales which deviated considerably from the normal case. The goods purchased cheaply in Germany were indeed being sold with a small mark-up, but sold much cheaper than stated in the price lists to only a single customer. The one-sided preferential treatment for this customer could not be objectively understood and was not explained in the course of our audit.

In order to avoid tax penalties the OOO made a fictitious profit and turnover taxation to the amount of the margin between the actual sales price and the sales price on the price lists. The fictitious retroactive taxation, however, led to an operating loss. In terms of the financial accounting there was at first nothing to query, but the customer nevertheless commissioned us to examine the background of this unusual business situation in greater detail.

### What can be done now?

The company figures of the customer did not allow conclusions to be drawn on transactions between affiliated persons/companies. Despite this a plausible explanation had to be found for this unusual business situation. After an inspection of the shareholders, the customer, the managing director and the management personnel, the auditors from Rödl & Partner became aware of activities of the management personnel and connections in the wider social environment of the favoured customer which raised questions concerning compliance. In the circumstances of the case, the management personnel and the managing director of the company receiving one sided preferential treatment held shares in a common OOO. After questioning the parent company it was not possible to accuse the general director or the CFO of unlawful conduct as they were able to determine the sales prices by themselves, the financial accounting was made accordingly and even shareholdings in a competitor are not prohibited under employment contract law. The parent company now had to make a decision to dismiss the management personnel thereby jeopardising the existing business contacts and risk a decrease in business activity, or continue as before with an operating loss.

### What should one have done differently from the beginning?

Under consideration of the legally stipulated freedom of action for the managing director, an exact definition of his authority in the employment contract is of key importance in order to prevent misuse and non-compliance. In the circumstances of the case this could be limited by an exclusion clause in the employment contract which prohibits all forms of competition or co operation with customers. As regards the infringement, binding penalties should be foreseen or such an infringement named as a reason to terminate the employment contract. It is also possible to agree a statement of commitment, whereby shareholdings in other companies of more than 5 % or other activities as an employee must be disclosed to the parent company.

## Taxes

### Background facts:

A company based in Austria delivered a production line to the value of 90 million euros to Siberia. In this process there was no contractual price separation between the supplier components and the local service components (supervision, consultation and service). The customs duties charged to the buyer of the production line and import sales tax also related to the full sum without differentiation being made of the individual service elements.

In addition, it was not taken into account that among other things according to the regulations of the Russian tax code the execution of certain services are subject to registration for tax and this could lead to the founding of a branch office which in the Russian Federation is subject to a limited tax on profits.

The company had not registered with the tax authorities and neither profit tax returns nor sales tax returns were submitted. Furthermore, Russian subcontractors were partly used for the local services for which Russian sales tax was paid but input tax was not deducted. The tax authorities now assessed the contract partner of the company (here due to the absence of a tax registration the reverse charge method was used) liable for sales tax for the local service components, which the contract partner planned to "transfer" to the Austrian company and as a result the tax authorities treated the Austrian company as if it had founded a branch office, whereby the profit tax for the service performed locally was re-calculated.

Due to a lack of transparent contract design, the basis for the adjusted taxation was an estimate. In addition, the tax authorities decided on penalties and interest on arrears.

### What can be done now?

In the investigation, Rödl & Partner firstly carried out a tax assessment. Due to the lack of transparent contract design the tax authorities were given an especially wide range of discretion. The creation of respective documentation enabled the successful separation of the individual services and separate tax treatment which led to the lowering of the tax basis for assessment. The company nevertheless suffered a financial loss in the millions as profit tax had to be paid and in addition interest and penalties accrued due to the non declaration. The associated financial cost and loss of time could, however, have been avoided with simple measures.

## What should one have done differently from the beginning?

It is particularly important with the execution of cross-border deliveries with local (Russian) service components to always take care to clearly differentiate between the individual service components in the contract design (delivery and local service). A transparent contract situation and detailed description of the individual services also enables a better estimation of the branch office risk. Furthermore, the obligation to register for tax should be observed for foreign companies operating in the territory of the Russian Federation. If the obligation to register is not observed, penalties may well be served. In addition, the scope of the used subcontractors should be estimated as the possible associated input tax deduction can in individual cases reach a substantial amount but the entitlement to deduct input tax depends, among other things, on the tax registration in the Russian Federation.

## Law

### Parent guarantor

#### Background facts:

A successful company from Germany would like to help its new subsidiary on the Russian market to win a number of contracts. In order to do this, the company declares itself willing to stand as guarantor for the subsidiary with regard to potential orders with Russian customers. The Russian subsidiary is given the job of creating the guarantee contracts. However, in order to save time the subsidiary uses standard contracts from the internet. When at some point the subsidiary company does not pay, the business partner takes up direct contact with the parent company and demands the payment of the outstanding claims. However, the parent company is of the opinion that the payment obligation of the parent company is first valid when its subsidiary has no more liquidity at its disposal.

#### What can be done now?

In contrast to German law, Russian law does not recognise the defence of unexhausted remedies in connection with guarantee contracts. Under Russian law the guarantor is jointly liable with the principal debtor. Accordingly, in case of default the creditors can demand the fulfilment of the obligation from the debtor and also from the guarantor itself. In order to avoid the joint liability, the parties can agree on secondary liability of the guarantor to the creditor which corresponds to the defence of unexhausted remedies. In the circumstances of the case the experts from Rödl & Partner were successfully able to contest the contract as it contained both arrangements.

#### What should one have done differently from the beginning?

At the contractual level there is the option to select jurisdiction which best represents the interests of the parties. Although in particular the law on guarantees is very similar in both legal systems, the emphasis is from a different point of view. Russian law sees its priority in the protection of creditors. German law on the other hand protects the guarantor. If the legal position is known it is possible regardless of the choice of law to design contracts individually such that the interests of all involved are addressed. The experts at Rödl & Partner therefore recommend that clients obtain professional advice in connection with international security arrangements.

## Law

### Reservation of title

#### Background facts:

A German company which is a manufacturer of high quality oil filters for trucks concludes a long-term delivery contract with a Russian forwarding agent with intensive operations in the Siberian city of Novosibirsk. The parties agree on the application of German law and a court of jurisdiction in Novosibirsk. In addition, the contract includes reservation of title until payment of the complete purchase price has been made to the German company. The business relationship runs for years without any problems. Due to a very severe winter a number of vehicles cannot be used because of failing oil filters. After that the forwarding agent refuses to pay. In response the German company invokes his reservation of title and now requires the handing over of its oil filters. However, the purchaser refuses this with the statement that the reservation of title according to German law does not apply under Russian law.

#### What can be done now?

Unfortunately, the claim of the purchaser is not entirely incorrect. Although Russian law also foresees reservation of title, this can only seldom be enforced according to foreign law. It is therefore questionable whether a Russian court would approve the reservation of title. The experts at Rödl & Partner in this case therefore advised the direct assertion of claims from the purchase contract. Using the available documentation they were subsequently successful in determining and enforcing the claim to the purchase price at the competent court.

#### What should one have done differently from the beginning?

In the beginning one should have collected information concerning the effectiveness of German security interests abroad. Unfortunately, not all rights can be enforced outside Germany. However, there are always a number of possibilities to secure entitlements. In the circumstances of the case a surety from a German or Russian bank could minimise the risk. In addition, it might be possible to agree to a reservation of title according to Russian law, whereby here it is necessary to obtain expert help in order to ensure an effective formulation of the corresponding contract clause.

## Law

### Court of jurisdiction

#### Background facts:

A German entrepreneur manufactures ironmongery for the wholesale market and would now like to supply different customers on the Russian market. However, he is very sceptical about the Russian courts. Accordingly, he would like to have the contracts for his foreign activities subject to the jurisdiction of the German courts. He therefore changes his general terms of business slightly and declares that the court of jurisdiction is in Germany.

#### What can be done now?

In particular with cross-border relationships there are formal and procedural pitfalls which should be avoided. A corresponding agreement has not been concluded between Germany and Russia for the recognition and enforcement of court rulings. The result is that in principle German court rulings cannot be enforced in Russia. In the circumstances of the case the German court of jurisdiction would even have been a hindrance for the German entrepreneur because on the one hand court rulings could be enforced against him but he on the other hand could not have enforced rulings from Germany in Russia. He could only take hold of the German assets of the company, although this seldom exists. In this case the better choice for the German entrepreneur would have been a court of jurisdiction in Russia.

#### What should one have done differently from the beginning?

In general there is the option of integrating an arbitration clause in the contract. The advantage of such a clause is that the rulings of the arbitration court can be enforced at an international level when these are recognised by countries which have signed the New York convention. Germany and Russia are both members of the convention. However, for the effectiveness of the arbitration clause, the court should be clearly named. This type of court also offers the possibility of determining the process and arrangement of such proceedings oneself. This corresponds to common practice and serves the interests of both parties.

## Administration

### Background facts:

A Russian subsidiary is financed by the German parent company for more than two and a half years. In this time period more than 500,000 euros were made available for this purpose. In the process the general director was not carefully selected and at the same time given a 3 % shareholding in the subsidiary which later turned out to be a serious error. The question of the internal and external financial accounting of the Russian subsidiary was also left completely in the hands of the general director without the inclusion of any special control mechanisms. The managing director employed an external employee known to him to handle the financial accounting who was only allowed to act on the personal instructions of the managing director. For two and half years the German parent company waited in vain for traceable reporting from its Russian subsidiary. Requests to present the current reporting were ignored by the Russian general director and his trusted financial accounting employee. The parent company therefore had no overview of the entrepreneurial activities of its subsidiary. Instead, after a period of time had elapsed, the Russian general director demanded even more money to finance the company.

However, as the activity of the general director no longer inspired confidence, a decision was taken to liquidate the subsidiary.

### What can be done now?

As co-owner of the subsidiary the signature of the general director was required for the resolution to liquidate the company. He put pressure on the parent company and only gave his signature after the assurance that the parent company would release him from all liability. An examination of the documentation determined that a financial accounting database did not exist or at least this – most likely with intent – was not presented to the appointed insolvency administrator.

In addition, in the liquidation process it was established that for a long time no pension and health insurance contributions had been paid and also no reconciliation with the tax authorities had taken place. As a result, additional costs to the tune of 20,000 euros were incurred and the parent company had to settle the outstanding claims of the authorities before the liquidation could be executed as the subsidiary no longer had any liquidity. The execution of the liquidation, however, was still not possible as the tax authorities continued to assert new claims against the shareholders.

## What should one have done differently from the beginning?

This example also clearly shows how decisive a role the general director has in Russia. This position should always be very carefully selected. A participation in the subsidiary should only be made possible if there is an actual basis for trust. In addition, the establishment of a control system and of a transparent on-going (preferably on a monthly basis) reporting system is necessary. Any financing by the parent company should only be made based on specific, transparent calculations.

The management of the financial accounting required for commercial and tax matters and the on-going reporting should therefore preferably be left to independent, qualified experts who know the mandatory requirements at the subsidiary and can also act in keeping with compliance management in the interests of the parent company. High quality expert consultation is required in order to meet the local and international financial accounting standards.