

Trade successfully with Russia: Ten Important Principles

INTRODUCTION

Supplies to Russia do not normally require any more preparation and legal review than supplies to any other country, which is generally good news. The legal basics that should be observed in relation to Russian customers are largely the same as those that apply in your home jurisdiction and in supply relationships with other customers. Having said that, there exist certain peculiarities in Russian law as well as practical specifics which a supplier should take into account when planning sales to customers located in Russia. The below overview lists 10 rules which we believe are easy to comply with and can help make your supply relationship a lasting and successful one.¹

RULE 1: CHOOSE THE LAW YOU FEEL COMFORTABLE WITH

In cross-border relationships between Russian and foreign companies, the parties are entitled to choose the law that should govern their supply relationship. Certain mandatory provisions of Russian law may apply to the supply agreement even if it is governed by a foreign law. The vast majority of contractual terms can, however, be agreed without limitation as there are very few mandatory rules applicable to supply arrangements.

It is common for a foreign supplier to make supplies to Russia based on agreements governed by the law of its home jurisdiction. In practice, there are a number of laws that are most frequently used, including in particular, German, English and Swiss law. Russian law is also used, although in a cross-border relationship the parties would typically tend to choose a foreign law. Agreements governed by the Vienna Convention on the Sale of Goods are rarely used.

As a rule of thumb, it is advisable for the parties to choose a law they both feel comfortable with and that can be easily applied by arbitrators in case of a dispute. In other words, it should be a law with settled court practice and for which both parties would be able to nominate experienced arbitrators.

RULE 2: GET THE BASICS RIGHT

In cross-border sales, it is common practice for foreign and Russian partners to enter into written supply agreements regulating all details of their relationship before starting any supplies. Nonetheless, it does regularly happen that supply agreements are concluded that are unlikely to be enforceable against the contracting party due to very basic insufficiencies. For example, it is not unusual in Russia to find more than one legal entity using the same corporate name. It is therefore essential to state the full corporate name, legal form and address in order to clearly identify the parties entering into the agreement.

In addition, any supply agreement must contain sufficient information about specification, quantity and quality of the products, the purchase price and payment provisions as well as the specific terms and time of the supply, e.g. by using INCOTERMS or otherwise.

Key Issues

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¹ This overview was prepared for Atradius N.V. and use by its insurance customers. The Atradius press-release and link to the checklist can be found at www.atradius.com.

RULE 3: KEEP IT SIMPLE

Over the last two decades, there was a tendency to structure supplies to Russia through complex import schemes, which often involved the use of one or more offshore entities, typically located in Cyprus, deliveries to non-Russian warehouses, imports via Russian special purpose vehicles and settlement of invoices by other offshore entities. In some sectors such schemes were only found occasionally, e.g. in the pharmaceuticals and construction equipment sectors. In other sectors, such as consumer electronics and various food products, such schemes were widespread. While valid reasons may exist for structuring supplies indirectly via non-Russian entities, one should generally act with caution whenever complex schemes are proposed by a potential counterparty. In the past, imports via offshore structures were often used to decrease or avoid Russian customs duties and evade import tax. Complex import schemes have therefore recently been under increasing scrutiny by the Russian authorities. There have been numerous investigations initiated by the Russian customs and prosecution authorities, which often lead to the confiscation of the imported goods, for which the importing entity then refuses to pay. There have also been cases (even if not many) where investigations were initiated not only against the importing entity, but also against the foreign seller suspected of aiding and abetting tax evasion by the importer.

Generally speaking, it is therefore advisable to use simple and transparent supply arrangements, namely in the form of direct deliveries from the foreign supplier to the Russian customer and, in turn, direct payment from the Russian partner's account to the account of the supplier. Where supply arrangements involve third parties, offshore entities and indirect deliveries, it should be ensured that there is a valid economic rationale that can be referred to as justification in the event of an investigation.

RULE 4: MAKE SURE YOU GET PAID

As a starting point, there is no reason to be concerned about the risk of non-payment merely due to the fact that supplies are made into Russia. The majority of supply relationships between foreign suppliers and Russian customers have been working successfully for many years and in accordance with the agreed supply arrangements. Having said this, a supplier should seek the same level of protection it requires when selling in its home country or to other parts of the world. Generally, this means that supplies should only be made to a creditworthy entity that has sufficient assets for payment claims to be enforceable. Where this cannot be guaranteed, a supplier should require additional security from a sufficiently solvent affiliated company or from a third party guarantor. In this context, the following types of security are generally available:

- The most commonly used security instrument is a *guarantee or surety granted by another group member*, typically the (ultimate) parent company of

the customer. It is a peculiarity of Russian law that a guarantee can only be issued by a bank, and not by other corporate entities. Corporate entities are limited to issuing a surety, which is, however, accessory in nature. In other words, the validity of the surety depends on the validity of the underlying supply agreement. As mentioned above, it is not uncommon that supplies are structured through complex offshore schemes and with the participation of third parties. It must then be borne in mind that any risk relating to the underlying supply agreement may also affect the enforceability of the surety. This is, hence, a further reason to make sure that the underlying supply relationship is transparent and fully legally compliant.

As an alternative to a Russian-law surety, the parties may use a guarantee issued under foreign, e.g. German or English, law, which is generally accepted by Russian courts and constitutes a non-accessory security instrument. In practice, both instruments – a Russian-law surety and a foreign-law guarantee – have certain disadvantages and weaknesses. The final decision in favour of one or the other must, therefore, be made on the basis of a risk assessment in the light of the specific circumstances and preferences of the parties.

- As mentioned above, the customer may arrange for a bank guarantee to be issued by its Russian bank. In practice, the provision of a *bank guarantee* in connection with a supply agreement is rare. The reason for this is that the costs associated with obtaining a bank guarantee are often considerable and may make the supply relationship unattractive. Bank guarantees can, however, be an option in situations where other security instruments are not available or where the value of the supplied goods is high.
- Depending on the circumstances of the particular case, the parties may consider the use of a *pledge*. A pledge over the supplied products or other movable property owned by the customer will, however, involve a certain amount of administrative work and can be difficult to enforce, e.g. in cases where the pledged property has been sold to a third party. A pledge can nonetheless be an option where products are sold that can be easily traced, such as heavy machinery or large equipment.
- Depending on the specific circumstances, a parent company of the customer may offer to pledge a certain number of shares in the customer entity rather than having to provide other security.

- A *mortgage* over immovable property owned by the customer or a third-party can likewise be very attractive and valuable security. The creation of a mortgage is, however, subject to the conclusion of a detailed mortgage agreement that is to be registered with the Russian property register. In addition, a mortgagee will typically wish to carry out a due diligence review of the property prior to accepting a mortgage. As a consequence, it is often not practical to negotiate a mortgage in connection with a supply relationship. Moreover, customers are often not ready to mortgage property for the purpose of purchasing goods. In practice, therefore, the use of a mortgage is rare in such cases unless exceptional circumstances exist. This may be the case if the value of the goods to be supplied is exceptionally high, if deferred payment arrangements are accepted by the supplier, or if large equipment is to be supplied and installed in a building or on land which can be mortgaged.

Whatever type of security the parties eventually agree to, it is, in any event, essential to clearly define the payment obligations in the underlying supply agreement to make sure that the secured obligations are defined in sufficiently specific terms. This is particularly important where the supply agreement takes the form of a framework agreement and deliveries and payments are made on the basis of separate orders. As a general rule, Russian as well as foreign courts apply very strict standards in this regard. The provision of collateral security only makes sense if it is ensured that any right to realize such security is enforceable by court action.

Last, but not least, it should be noted that enforcement proceedings in Russia can be lengthy and burdensome. Where the Russian customer belongs to an international group or owns assets outside of Russia, it may often be preferable to obtain *security outside Russia* in order to avoid the procedure of getting an arbitral award recognised and enforced in Russia.

RULE 5: BEWARE OF CORPORATE APPROVAL REQUIREMENTS

Supply agreements are usually signed by the general director of the Russian company. General directors of Russian companies are entitled by law to enter into agreements with third parties and to bind the company. To verify his authority, however, it is common practice to request submission of the company charter and of the shareholders' resolution on the basis of which the general director was appointed.

In addition, under specific circumstances, corporate approvals may be required on the Russian side. Essentially, there are two situations that should be borne in mind. Firstly, if the value of the supplied products is high, it may have to be checked if the supply agreement qualifies as a "major transaction" for the Russian customer and therefore required approval at the board

or shareholders' level. Secondly, if security is provided by an affiliate of the customer, the Russian regime on so called "interested party transactions" may be applicable. The issuing entity may then require a corporate approval to be adopted under a special procedure. Without going into details of this approval procedure, from the supplier's perspective it is important to determine whether a surety or guarantee could fall within the "interested party regime". It is therefore critical to obtain any relevant information on the relationship and any affiliation between the customer and the entity providing the security.

RULE 6: COMPLY WITH COMPETITION LAWS

Irrespective of the governing law chosen by the parties, any supply agreement relating to supplies into the Russian territory is subject to mandatory Russian competition rules. The Russian rules applicable to vertical supply relationships are similar to those existing in the European Union. In brief, Russian competition law prohibits contractual provisions concerning vertical supply relationships that (i) interfere with the setting of the resale price, (ii) restrict the customer's capability to sell goods of a competitor, or (iii) otherwise restrict competition in the relevant market.

There exists a safe harbour exemption for vertical agreements between parties that do not hold a market share of 20% in any of their markets. Unfortunately, such exemption is often not available as the 20% market share threshold extends to any markets in which the parties are active in Russia, whether related to the supplied goods or not.

Where one of the parties holds a market dominating position, which normally means that it has a market share of above 35% (or less in cases of collective dominance), special rules may apply, prohibiting, among other things, discrimination of customers, unjustified refusal to supply, any bundling and tying of products, etc.

RULE 7: JUST A SUPPLY, OR IS THERE ANYTHING IN ADDITION?

As a rule, the conclusion of a supply agreement is not subject to Russian licensing, registration or other administrative approval requirements. Something else may however apply if an agreement contains elements of other types of agreements for which Russian law provides mandatory requirements. It is therefore necessary to verify that none of the following applies:

- If a supply agreement contains features of a franchise relationship, this may mean that the mandatory provisions concerning franchise agreements apply. In particular, franchise agreements are subject to state registration with Rospatent, Russia's Federal Service for Intellectual Property, Patents and Trademarks, which includes

the obligatory registration of the agreement, any amendments to the agreement or its termination. Without such registration a franchise agreement is deemed void.

- If a supply agreement also relates to intellectual property rights (e.g. trademarks and/or patents) that are to be transferred to the customer, such transfer may constitute a licensing agreement. In this case, the agreement must be registered with Rospatent in order to be valid and protected by Russian law.

RULE 8: OBSERVE TAX AND CUSTOMS REGIMES

As mentioned above, tax and customs issues often arise where supplies are made through complex offshore schemes and not directly from the supplier to the actual customer. As a general rule, the supply relationship should therefore be kept simple and transparent. It is also important to keep on file all documentation relating to the supply relationship, including agreements, order documents, price lists and payment documentation.

In addition, supply arrangements for the import of goods into Russia from abroad often require an analysis from a Russian permanent establishment and VAT perspective, in particular, where supplies are made via an agent and/or via a warehouse in Russia.

Finally, applicable customs legislation, including the application of customs duties and import VAT, will have to be reviewed prior to entering into the supply agreement.

RULE 9: DON'T GO TO COURT

Russia is a party to only a very limited number of treaties on the mutual enforcement of court judgments. These treaties extend to CIS countries and various other countries, but not to most Western countries. As a result, decisions of a foreign court cannot normally be enforced in Russia. Vice-versa, Russian court decisions cannot normally be enforced against a foreign supplier.

The situation is much different in relation to arbitral awards, even if rendered by a foreign arbitration tribunal.

For any cross-border supply agreement, it is, therefore, a 'must' for the parties to include an arbitration clause into their agreement. Russian and foreign arbitral awards are generally recognised by Russian courts, provided that certain procedural requirements applicable to the presentation of such awards are complied with.

RULE 10: BE INSURED

As holds true for any supplies to other countries, there remain certain risks relating to supplies in Russia that cannot be fully excluded, even if all legal aspects are assessed and complied with. It is therefore common for suppliers to consider export insurance of their supplies to a Russian customer.

In case of cross-border supplies to Russia, it is common for suppliers to seek insurance outside Russia in their home country. Where supplies are made within Russia from a Russian supplier to a Russian customer, such supplies are typically insured by a Russian insurer. This is due to the fact that insurance activities on the Russian market are subject to mandatory licensing, which can only be obtained by Russian entities, but not by foreign insurers acting from abroad. Various international insurance groups have, however, entered into cooperation agreements with Russian insurance companies, enabling such local insurance companies to sell certain insurance policies on the Russian market with re-insurance backing by the foreign insurance group.

To obtain insurance for export supplies to Russia, a company will typically have to provide the underlying supply agreement and proof that sufficient security has been sought from the Russian customer, e.g. by obtaining a guarantee or surety from the customer's ultimate parent. Insurance policies will normally exclude coverage for risks arising out of circumstances that are under the supplier's control. Such circumstances may include the legal validity of the underlying supply agreement, validity of the security obtained by the insured and compliance with any corporate approval and regulatory requirements. In other words, observing the 10 rules listed in this overview is not only essential for the supply relationship with the Russian customer, but also forms the basis enabling the supplier to obtain and rely on its insurance coverage.

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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