

Avoiding Pitfalls in Russian Market Exits

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Ongoing hostilities in Ukraine and expansion of Western sanctions and Russian “counter-sanctions” measures has made it virtually impossible for non-Russian companies, especially those from the states Russia considers “hostile”,¹ to continue to operate as usual in Russia. This Client Update analyzes key issues faced by corporates that are planning or considering an exit from Russia, and the lessons learned from successful exits earlier this year.

RUSSIAN REGULATORY OBSTACLES

Since late February 2022, the Russian authorities have enacted numerous decrees and regulations that restrict the exit of Western companies from Russia and impose strict controls on outflow of capital.

Initially, the Russian authorities announced plans to adopt legislation that would penalize any foreign business that withdrew from Russia in a “disorderly” way through bankruptcy measures and even nationalization. The Russian Government was concerned that such “disorderly” exits would lead to interruptions in critical supply chains, mass unemployment and social unrest. These initiatives have stalled in the Russian Parliament, but the Russian President has adopted decrees that require foreign companies to obtain prior approval for disposal of interests in their Russian subsidiaries or affiliates.

Transactions with shares in Russian joint-stock companies (JSCs) and with participatory interests in Russian limited liability companies (LLCs) are subject to pre-approval by

¹ The Russian Government, in its Regulation No. 430-r dated March 5, 2022, identified the states and territories that imposed sanctions on Russia or otherwise condemned Russia’s actions in the Ukraine as “hostile” jurisdictions. As of the date of this Update, the list of “hostile” jurisdictions contains more than 50 states and territories, including the United States, all EU member states, the United Kingdom (including all British Overseas Territories and Crown Dependencies), Australia, and Canada. Jurisdictions not included in this list are considered “friendly” by the Russian Government.

Russian authorities if undertaken by residents of “hostile” jurisdictions, regardless of the residency of the counterparty.²

Pre-approval is required for a broad range of transactions, including not only direct sales but also shareholder agreements and options, as well as “*other rights allowing to determine the business or management of LLCs / JSCs*” and indirect sales through overseas holding companies.³ Buybacks of participatory interests by LLCs, exits of members of LLCs, transfers of participatory interests to investment funds, convertible loan agreements, pledges over a participatory interest and agreements with management companies also require pre-approval.⁴

Pre-clearance can also be required for transactions involving:⁵

- “strategic” enterprises and joint-stock companies and their subsidiaries;
- certain businesses (i) producing equipment for organizations operating in the fuel and energy sector and servicing such equipment; (ii) generating heat and / or electrical energy; and (iii) acting as oil refineries;
- financial institutions (including banks, insurance companies, pension funds, microfinance organizations and investment funds); and
- certain subsoil users, mainly hydrocarbon producers and precious-metals miners.

Generally, applications to authorize the restricted transactions are considered by the Russian Governmental Commission for Control over Foreign Investments (the “Commission”), which can approve, conditionally approve (including conditional upon a decrease in the purchase price) or deny the application. In respect of particular industries (e.g., certain financial institutions⁶ and the energy sector), there is a requirement to obtain a special authorization (license) from the Russian President. In addition, for certain transactions, a recommendation from other regulators must be submitted to the Commission or the President.

² Decree of the Russian President No. 81 dated March 1, 2022; Decree of the Russian President No. 618 dated September 8, 2022 (“Decree No. 618”); Decree of the Russian President No. 737 dated October 15, 2022 (“Decree No. 737”).

³ Decree No. 618; Decree No. 737.

⁴ Letter of the Russian Ministry of Finance No. 05-06-14RM/99138 dated October 13, 2022.

⁵ Decree of the Russian President No. 520 dated August 5, 2022 (“Decree No. 520”); Decree No. 737.

⁶ Under Decree No. 737, transactions with shares and voting rights of Russian financial institutions are subject to clearance by the Commission unless the respective company is a credit institution (bank or payment system) and is subject to presidential approval under Decree No. 520. On October 26, 2022, the Russian President issued list of such credit institutions, which includes Russian subsidiaries of Credit Suisse, Natixis, Raiffeisen, UniCredit, Citi, J.P. Morgan and Goldman Sachs.

Receipt of the approvals through the above-mentioned procedure does not obviate the need to obtain the usual regulatory approvals such as those from the Federal Antimonopoly Service or, with respect to financial institutions, the Central Bank of Russia.

Given that the Russian counter-sanctions regulations do not specify any limits on the duration of the consideration of applications to the Commission and the President and a significant back log of pending applications, companies should now expect the approval process to take several months. Competition and other regular approvals generally remain on schedule and usually take about six weeks.

KEY COMMERCIAL CONSIDERATIONS

MBOs vs Third-Party Acquisitions

The vast majority of exits from the Russian market involve sales of Russian businesses to their local management: management buyouts (“MBOs”). MBOs include sales of Russian subsidiaries to special-purpose vehicles (“SPVs”) incorporated in so-called “friendly” jurisdictions, as described below.

An MBO has become the preferred approach for many Western companies because it provides assurance that the local management would be able to maintain business operations, preserve jobs and redirect supply chains without economic or infrastructure support of the foreign parent. This option should also mitigate the risk of retaliatory action by the Russian authorities because it is often consistent with the goals of the regulators to ensure an “orderly” exit without mass layoffs.

Another option available to Western companies is to sell the Russian business to a third party that is able to maintain business continuity. This option often attracts increased scrutiny as the Russian authorities carefully evaluate the identity of the buyer from the standpoint of its commitment to preserving the business and its employees as well as other factors that they may deem relevant. In some cases, competing bidders have emerged, with some of them able to leverage their government connections to gain preferential treatment by Russian authorities. In such circumstances, Western companies may end up having little choice but to transact with a party that they may consider high risk or unacceptable for sanctions, reputational, or other reasons.

If the required pre-approvals are not obtained, or if none of the potential buyers are acceptable to the seller, the remaining option for foreign companies unwilling to remain in Russia is liquidation. This is the path considered by some foreign banks that hold Russian banking licenses. Its main downside is that liquidation in Russia can take many

months and, for financial institutions, even years. During this period, foreign companies would have to navigate applicable sanctions and Russian countermeasures while following rigid liquidation procedures under Russian law.

Purchase Price Settlement Options

Most foreign companies have not been able to realize a fair value for their Russian business when exiting Russia due to challenges of finding an acceptable buyer and restrictions imposed on repatriation of capital.

MBOs commonly have been structured to provide for cashless settlement (for example, a setoff against the shareholder's existing obligations to its foreign parent) or for settlement at a nominal value. Specialist tax advice should be sought if structuring any transaction below market value.

If a foreign investor is negotiating a disposal of a Russian subsidiary to a third party for market-based consideration, it may be possible to structure the deal through a buy-side SPV established in a jurisdiction considered "*friendly*" by Russia (for example, the UAE or CIS countries) and controlled by Russian persons or persons from a "*friendly*" jurisdiction. This structure avoids certain hurdles such as the need to retain the proceeds of the sale in a restricted account with a Russian bank.

Upside Participation and Profit-Sharing

Instead of transferring valuable business for no or little consideration in an MBO or at a substantial discount to a third party, foreign companies often consider options to preserve upside participation. Such options have to be carefully evaluated to ensure compliance with restrictions on new investments in Russia imposed by the United States, the European Union, the United Kingdom and other jurisdictions.

Subject to careful consideration of applicable sanctions, the following options can be considered:

- Call options to buy back the businesses after a period of time when the sanctions no longer apply. Call options can also be used to secure lock-up provisions as outlined below.
- Lock-up and right of first refusal provisions restricting resale of shares and assets of the target by the new owner or enabling the seller to buy the respective shares on terms not worse than those offered to a third-party offeror. These rights should be made subject to compliance with applicable sanctions.

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- Profit-sharing and price-adjustment mechanisms enabling the seller to receive a certain portion of the purchase price funded by amounts that the buyer receives from a permitted resale of its business, which can be valid for an agreed period after the expiration of the call option or lock-up period.
 - Quasi-shareholder agreements allowing the seller to exercise certain economic and voting rights, as permitted by Russian law if the seller remains the creditor of the Russian target.
 - Transition services arrangements preserving the smooth operation of the existing business and providing for transfer of technological capabilities to the buyer.

Often, a foreign investor does not want to have any operations or investments in Russia after the exit. This requires testing the transaction terms, with particular focus on any upside participation, to ensure that the seller does not retain control or beneficial ownership of the Russian business. Under English law and U.S. federal securities regulations, the seller may be deemed to retain beneficial ownership if (i) the call option is immediately exercisable and unconditional (i.e., has no trigger events) or (ii) the purchase price has a nominal or significantly below-market valuation.

As more foreign companies look to exit Russia, Russian regulations are becoming more restrictive, and Western sanctions are further limiting the scope of permitted Russian operations of foreign companies. A successful exit requires a good understanding of Russian legal requirements, thorough analysis of applicable sanctions, and prompt execution in a constantly changing legal environment.

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