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Russia update: New law aims to force out “unfriendly” foreign investors

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A new Russian law permits excluding investors from “unfriendly” States from holding shares in significant Russian companies by transferring their interests to Russian beneficiaries. As reported previously, the Russian State is stepping up countersanctions against foreign investors from so-called “unfriendly” countries that have sanctioned Russia over the invasion of Ukraine, including the EU, the USA, the UK (including British Overseas Territories and Crown Dependencies), Canada, Australia, Switzerland, Japan, South Korea, Singapore and Taiwan.

Investors from these States have faced a trilemma: whether to sell their business in Russia and exit the country, gradually wind down their operations, or “stick it out”. However, recent legislation has now heightened these challenges.

New law permits foreign shareholders to be forced out from significant Russian enterprises

On 4 August 2023, President Putin signed the law “On the specifics of regulating corporate relations in business entities that are economically significant organisations” (the “**Corporate Relations Law**”) that will take effect in 30 days, on 3 September 2023.

The Corporate Relations Law permits the exclusion of foreign holding companies associated with “unfriendly” countries from holding corporate rights in significant Russian businesses. Russian indirect shareholders or beneficial owners of those businesses will be able to apply to a Russian court to exclude foreign investors from the chain of ownership, transferring the foreign shareholdings to them.

The new law will apply to foreign holding companies connected to “unfriendly countries” that own more than 50 per cent of voting rights (or authorised capital) of a Russian “economically significant organisation” (“**ESO**”). A company, or other interested parties, will not be able to challenge its inclusion in the list of ESOs, defined as companies that:

a) together with any related Russian legal entities, meet one of the following financial thresholds:

- total revenue of USD 825 million (RUB 75 billion)
- total asset value of USD 1.65 billion (RUB 150 billion)
- taxes paid of USD 110 million (RUB 10 billion); or
- 4000+ employees.

b) participate in a significant industry (including information technology, systemically important banks, regional development or the creation of high-productivity or high-paying jobs); and

c) have significant direct or indirect ownership by Russian parties in the foreign holding company:

- Russian persons or entities own more than 20 per cent of the foreign holding company, if these Russian persons or entities or the ESO itself are under sanctions;
- Russian persons or entities own more than 30 per cent of the foreign holding company, if at the last meeting of the supreme governing body of the foreign holding company (in most cases, the shareholder general meeting), Russian persons or entities had decision-making power; or
- in all other cases, Russian persons or entities own more than 50 per cent of the foreign holding company.

Thus, the law may, in some situations, apply where Russian individuals or entities indirectly own as little as 20 per cent of the foreign holding company, as shown below:

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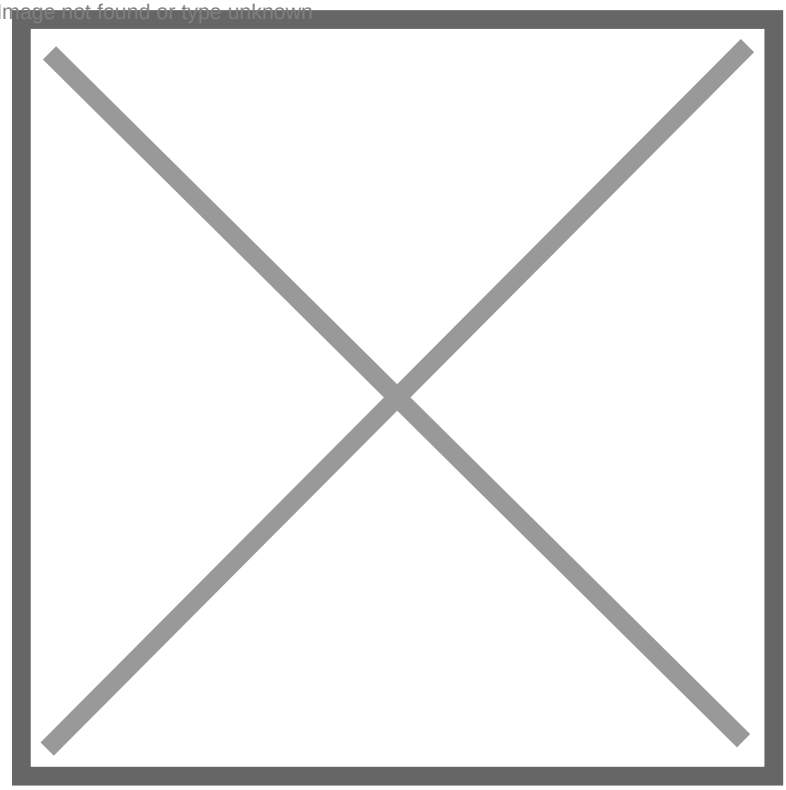

The Corporate Relations Law allows Russian shareholders to gain direct control over the ESO if the foreign holding company allegedly blocks or undermines its operations in Russia. This is the case if, *inter alia*, after 24 February 2022, a foreign holding company or local management appointed by it:

- complies (by act or omission) with international sanctions against Russia;
- makes the activity or development of the local company impossible or more difficult, or restricts markets for the sale of goods, work, or services of the local company;
- publicly declares that the local company is terminating its business, or that the foreign investor is withdrawing from the local company;
- unjustifiably terminates, or suspends performance, of significant contracts; or
- sends redundancy notices to more than one-third of the local company's employees.

On these grounds, Russian shareholders or beneficiaries, as well as federal executive authorities, may ask the Russian courts to order a so-called "suspension" of the foreign holding company's rights. The law provides for expedited proceedings, with the court issuing a decision within one month from the application. Shareholders located abroad are deemed to be notified by publication on the court's website.

The effect of such a decision is far-reaching:

- The foreign holding company cannot exercise its rights to vote, convene or participate in shareholder meetings, sell or alienate its shares, receive dividends and – most significantly – all shares in the ESO owned by the foreign holding company become the property of the ESO.
- Simultaneously, Russian shareholders or beneficiaries are obliged to take direct ownership of shares in the ESO in proportion to the interest that they previously owned indirectly.

The foreign holding company may apply to the ESO for compensation for any shares that it previously owned and that have not been redistributed to Russian shareholders or beneficiaries. While the law provides that compensation should be based on the market value of the shares, it grants the Russian government the power to determine the procedure for determining the amount and payment of compensation.

Thus, the foreign holding company is squeezed out of the ownership structure and foreign shareholders lose their rights in the local Russian company:

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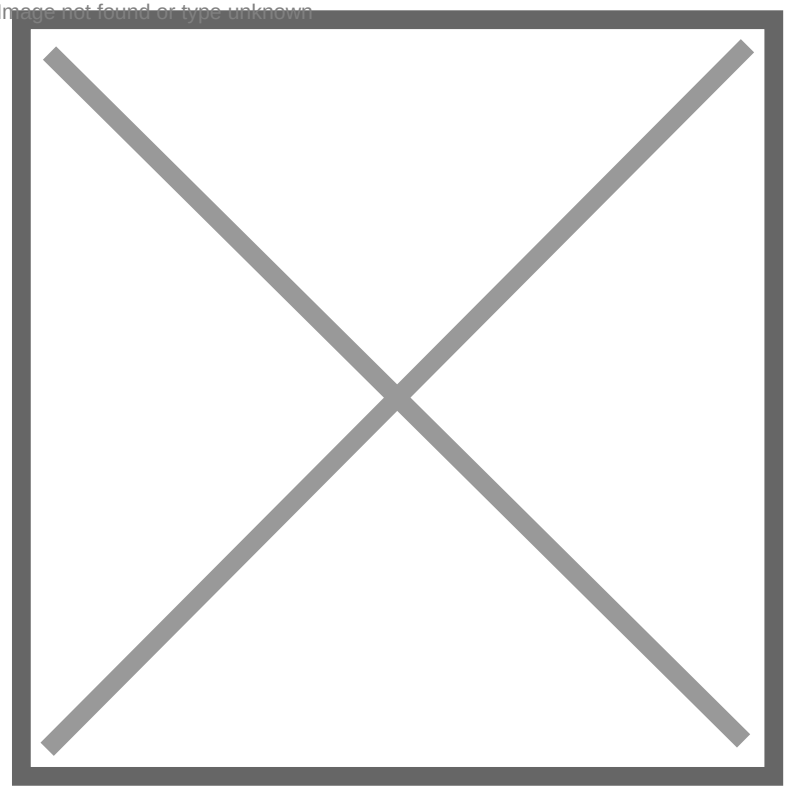

Russian indirect shareholders in the ESO – if they meet the ownership thresholds above – may also petition the Russian courts to receive dividends directly from an ESO in place of the foreign holding company. In this way, they can avoid the effect of capital controls and countersanctions, which may restrict the payment of dividends from Russia to foreign shareholders.

In theory, the above "restrictions" are temporary. They should not last beyond the deadline set by the court and, in any event, beyond 31 December 2024. In practice, however, once the "suspension" of the foreign company's rights is over, the law only allows it to claim back the shares (and related dividends) that

have not been distributed to Russian beneficiaries and are still held by the ESO, provided the ESO has not already compensated the foreign holding company for these shares.

The new law appears to be aimed at foreign investors that have decided for the time being to maintain their Russian operations – in many cases, having struggled to divest their local businesses. These "trapped" investors include many of the largest banks in Russia, an industry that is classed as economically significant under the new law. Where Russian parties have a significant interest in these businesses, as in the case of joint ventures for the Russian market, foreign shareholders could now find themselves forced out of their investments in Russia against their will.

Exiting Russia – the cost of divestment

Given the current investment climate, as well as potential compliance and reputational issues, many multinational companies have sought to exit their Russian investments over the past 18 months. However, recent Russian decrees have restricted investors' abilities to withdraw from Russia.

- Decree No. 520, enacted in August 2022 prohibits foreign investors from "unfriendly" States from restructuring or selling their interests in Russian strategic enterprises, banks, or certain energy and mining projects. Unless approved by the President, any transaction falling foul of this decree (the effect of which has since been extended to 31 December 2023) is null and void.
- Decree No. 618 (effective from 8 September 2022), requires the approval of the Russian Governmental Commission for Control over Foreign Investments for any transaction involving "unfriendly" investors that creates, modifies, or terminates ownership or management rights in Russian limited liability companies. Unlike Decree No. 520, this is not limited to specific sectors or enterprises and restrictions were extended to Russian joint stock companies in October 2022. In practice, this means that a decision by "unfriendly" foreign investors to divest their interests in a Russian subsidiary will generally require governmental approval.

The relevant sub-committee of the Governmental Commission for Control over Foreign Investments has stipulated that, to obtain its approval to a proposed sale, the sale must be made at a discount of at least 50 per cent from the market value of the asset (determined in an asset valuation report by an appraiser approved by, or belonging to a professional organisation approved by, the sub-committee). Another condition of sale is a "voluntary" contribution to the Russian State budget of at least 10 per cent of half the appraised market value. If the sale is made at a discount of more than 90 per cent, the contribution to the State budget must be at least 10 per cent of the appraised market value. The criteria do not state whether the buyer or seller must make the contribution, but even if borne by the buyer, this contribution would likely be reflected in a lower selling price.

The sub-committee is not bound by these criteria and may revise them at any time. In response to some foreign investors inserting buyback options in their sales agreements – in the hope that they might repurchase their investments in a post-war, post-sanctions world – the subcommittee has recently stipulated that any such option must be for a maximum of two years, with the exercise price set at market value. The effect of these rules is that any investor from an "unfriendly" State may be unable to realise any significant sales proceeds from its investments, and those proceeds may in any event, be reduced or even exceeded by the "exit ticket" in the form of the State budget contribution.

Appointment of external administrators

Even investors that manage to negotiate an exit from the Russian market may find their plans thwarted by new powers allowing “temporary” control over certain foreign investments. With effect from 23 May 2023, Decree No. 302 permits the government to impose “temporary” administration on investments of investors associated with “unfriendly” States, including:

a) movable and immovable property;

b) shares and other securities; and

c) property rights.

The decree permits external administration where the investor’s home State:

- has deprived or restricted – or threatened to deprive or restrict – the property rights of Russian legal entities or individuals; or
- poses a threat to the “national, economic, energy or other types of security of the Russian Federation or its defence capability”.

Where an investment is placed into administration, the Federal Agency for State Property Management (*Rosimushchestvo*), or any other person appointed by the President, assumes control of the property, including rights to change the management and dispose of the property. Administration of the property may be terminated by order of the Russian President.

Decree No. 302 was immediately employed against Russian subsidiaries of the Finnish and German energy companies Fortum and Uniper, following Finland’s accession to NATO and Germany’s move to sell Russian oil giant Rosneft’s stake in a German oil refinery. On 16 July 2023, President Putin also signed an executive order bringing the subsidiaries of French food corporation Danone and Danish brewer Carlsberg under government control.

All companies so far taken under administration were in the process of a “controlled exit” from Russia (and, in the case of Uniper and Carlsberg, were awaiting governmental approval for their divestment). The government’s decision to take control of their local operations highlights the difficulties for foreign investors in executing a clean break.

Key takeaways for investors

Recent legislation has heightened the difficulty for many foreign investors in continuing business in Russia (or even realising a controlled exit). Foreign investors should consider any applicable contractual remedies and confirm whether their investments are covered by investment protection treaties. Certain investors, including Fortum, have announced that they have filed notices of dispute under bilateral investment treaties with Russia.

- In previous cases, notably before the Iran-US Claims Tribunal, the appointment of external managers in respect of a local subsidiary – even on a “temporary” basis – has been held to amount to an unlawful expropriation. The same is true of the deprivation of shareholder rights. Restrictions on divestment and the repatriation of assets may also breach “free transfer” provisions in investment treaties.
- Investors in Russia should consider potential remedies under any relevant contracts with the authorities, such as concession agreements in the extractive industries, and investment protection treaties that may grant them the right to bring claims before a neutral forum. Parent companies and intermediate holding companies within the same corporate group may also be able to claim the benefit of investment treaties in force between their home jurisdictions and the Russian Federation.

- Press outlets have also reported that the Russian government plans to use its recently enacted powers to transfer assets from foreign investors to influential supporters of the government. In this case, some legal systems may grant investors remedies against the recipients of the assets, such as under the US Second Hickenlooper Amendment, originally enacted following the expropriation of US businesses by the Cuban government. Investors should therefore consider litigation outside Russia, as well as arbitration under investment treaties, as a potential means of redress.

For further questions or comments about this topic, please contact the authors.