

Memorandum

Date: **1st of February, 2013**
Subject: **Corporate forms of business conducting in Russia**

1. Analysis

There are several forms through which a foreign company can conduct its business activity in Russia. The most frequently used business legal structures are:

- **direct presence in Russia**
 - Representative office of a foreign company in Russia
 - Branch of a foreign company in Russia
- **indirect presence in Russia**
 - Limited liability company
 - Joint-stock company (open or closed)

1.1. Direct presence in Russia

Foreign companies may operate in Russia without creating a legal entity by establishing a branch or a representative office. The main advantages of operating through a branch or representative office, compared with a JSC or an LLC, are that a branch or representative office has fewer administrative, tax, and accounting obligations and is considered to be non-resident for currency control purposes. But it should be noted that a foreign company acts through its representative office or branch by itself, therefore, it takes all obligations connected with its activity in Russia.

1.1.1. Representative office.

A representative office is entitled to carry out liaison and ancillary functions in order to promote the business of its foreign founder and gather information about Russian market.

Note: Representative offices are not expected to engage in commercial activities in Russia.

Consequently, most representative offices are not subject to corporate profits tax, unless their activities give rise to a “permanent establishment” for tax purposes, i.e., when a foreign legal entity engages in regular commercial activity through its representative office. Such regular commercial activity shall be performed within the territory of the Russian Federation and connected with subsoil use, works on construction, installation, service or exploitation of equipment, sale of goods on the warehouses situated within the borders of the Russian Federation, other commercial activity. Activity on creation of a “permanent establishment” shall not be considered as such “permanent establishment”.

Note: Also preparatory or supporting activity does not give rise to a “permanent establishment” for tax purposes, if it does not contain features of “permanent establishment” directly stated in law. For example, such activity as using a permanent place of business only for the purposes of goods purchase, accounting, marketing, advertisement, research, if these activities are not basic activities of the company.

A representative office should be accredited with the State Registration Chamber or with the Chamber of Commerce and Industry and registered with the State Registration Chamber, as well as with the tax authorities, social funds, and other state bodies. The maximum accreditation term is three years but can be renewed.

1.1.2. Branch of a foreign company.

A branch is a subdivision of a foreign legal entity, which may exercise all or part of the functions of its foreign founder. These functions include contracting with Russian entities with payments in foreign currency and rubles, sales and marketing and other business activities.

Note: A branch should have a manager or head of branch who acts on the basis of a power of attorney issued by its parent company.

A branch may be inappropriate for certain activities, such as those that require licenses that are issued only to Russian legal entities. In addition, a branch is not recommended if it is expected that significant import activity will take place, since it is easier to manage customs procedures when the importer is a Russian legal entity.

A branch of a foreign company must be accredited and registered with the State Registration Chamber. The accreditation must be renewed every five years (whereas the registration of a JSC or LLC is usually for an indefinite period of time). In addition, a branch of a foreign company must be registered with the tax authorities, social funds, and other state bodies. The nature of the activities performed will determine whether the activities are subject to Russian taxation. Generally, tax filings must be made even if no taxable activities are performed or if no income is generated.

1.2. Indirect presence in Russia via Russian subsidiary company

The most commonly used legal entities in Russia are Limited liability company and Joint stock company. There are also other types of corporate forms, but they are rarely used.

If a foreign legal entity uses the model of indirect presence via Russian subsidiary, its liability will be limited to a loss of value of the shares or participation interest in this subsidiary. In some rare cases a participant or a shareholder can become liable for subsidiary’s obligations, but it would be necessary to prove that shareholder’s acts or omissions lead to such consequences which caused damages to the company to hold him or her liable.

Therefore, the foreign company itself will not be liable for violations of Russian legislation committed by its subsidiary in Russia. In case of a court procedure initiation the “mother” company will not be involved in it, and such violations and/or proceeding will not have an impact on its business reputation.

1.2.1. Limited liability company

Limited liability company (further referred to as “LLC”) can be incorporated by one or more persons or legal entities. Maximum number of participants of an LLC shall not be over 50.

Note: LLC cannot be incorporated by one legal entity which has only one participant in case if this legal entity is a Russian legal entity. If a foreign legal entity has only one participant, it is questionable whether it can, as a sole participant, incorporate an LLC in Russia. In most cases we would recommend to refrain from such activity. A wide-spread way to circumvent this restriction is using a second participant, being a related person (e.g. a natural person chosen to be the CEO of the subsidiary) and having a nominal stake in the subsidiary’s share capital (e.g. 0.01%).

The charter capital of an LLC is divided into participation interests. The minimum charter capital is 10,000 Rubles (approximately USD 322). 50% of the charter capital must be paid before state registration (incorporation) of an LLC. Payment for participation interest may be in form of both cash and in-kind payment when it is paid with shares of other companies, assets, equipment, etc.

If the net assets of an LLC are lower than its charter capital amount for two years from its incorporation or subsequent year, it must reduce the charter capital to the amount of its net assets. And if in this case the amount of the net assets is lower than its minimum charter capital (currently 10,000 Rubles), an LLC must take a decision on voluntary liquidation. Otherwise tax authority can claim to the court for the forced liquidation of such LLC.

Note: In case of reduction of the charter capital LLC’s creditors are entitled to demand acceleration of LLC’s obligations to these creditors.

A participation interest in an LLC is not considered a security under Russian legislation and it is not to be registered in any state authority. In day-to-day business activities there’s no difference between shares or participation interests.

Participation interests in an LLC may be sold to third parties if allowed by the LLC charter, but other participants must be given the right of first refusal to purchase the participation interests at the price offered to third parties. Also participants in an LLC (if allowed by the charter) may have a unilateral right to withdraw from the LLC and to be compensated for their participation interests out of LLC’s assets.

Note: The transfer of participation interests of an LLC is now relatively burdensome as it now requires significant involvement of a Russian notary. In particular, a participation interest can be considered as transferred to another person or legal entity only after the notarization of the transaction.

Participants in an LLC have the right to participate in the management of the company, obtain information concerning the activities of an LLC (including accounting and other documents), participate in distribution of profits, sell or otherwise assign participation interests (if not prohibited by the charter of an LLC).

Note: The participants in an LLC may have additional rights specified in the LLC, thus allowing to maximize company’s direct control over subsidiary’s day to day management.

The general meeting of the participants (further referred to as the “Meeting”) is the highest management body of an LLC. The Meeting has the right to define general goals and directions of an LLC, amend the charter, approve major transactions, annual financial report, alter the amount of

charter capital, assign additional rights and duties to the participants, reorganize or liquidate an LLC. Each participant of an LLC has a number of votes on the Meeting that is proportional to its participation interest in such LLC. Decisions on amendments to the LLC charter or on change of the charter capital amount shall be taken by a majority of voices not less than two thirds of the whole number of voices or by their larger quantity, if it is stated in the charter or in federal laws. Decisions on liquidation or reorganization of an LLC shall be taken unanimously.

The charter of an LLC may provide additional matters falling in the scope of the participants' Meeting, as well provide that LLC participants are entitled to vote not proportional to their participation interest but otherwise, thus allowing much more flexibility in corporate governance than JSC.

The charter of an LLC may specify creation and competence of the Board of directors. This is not a mandatory requirement and usually there is no Board of directors in an LLC.

Profit of an LLC is to be allocated pro rata to participation interests, unless other profit allocation provisions are stated in the charter.

The day-to-day operations are administrated by an executive body - the general director, who may be supplemented by a collective executive body (management board etc.), which is however quite rarely done. The general director and a collective executive body (if any) are responsible for all matters that do not fall within the authority of either the board of directors or the Meeting.

Participants of an LLC can conclude a participation agreement in which they shall state their rights and duties to each other or other important issues (the same as a shareholders agreement in JSCs). Please note that although this may resemble a common law shareholder agreement, this concept is new to Russian law, is approached rather cautiously (if not reluctantly) by the courts and the overall framework of civil law does not provide the level of complexity and flexibility usually required to structure a typical SHA. We do not recommend relying on Russian-level participation agreements as a substitute to common law SHA.

LLC is a quite transparent structure, because information on amount and nominal value of each participant's participation interest must be entered into the participants' register and Unified State Register of Legal Entities, from which everybody can obtain an extract with such information.

1.2.2. Joint stock company

Two types of joint stock companies (further referred to as the "JSC") exist in Russia:

- Closed joint stock company
- Open joint stock company

An open JSC may have an unlimited number of shareholders. Shareholders in an open JSC are entitled to freely dispose of their shares.

The number of shareholders in a closed JSC may not exceed 50. As with participants in an LLC, shareholders in a closed JSC have a right of first refusal to acquire shares sold by other shareholders to third parties, at the price offered to the third parties.

Shareholders in both open and closed JSCs have a preemptive right to acquire newly issued shares that are to be privately placed, in proportion to their existing shareholdings. Shareholders in an open

JSC also have a preemptive right to acquire newly issued shares that are to be publicly placed, in proportion to their existing shareholdings, but do not have a right of first refusal to acquire shares sold by another shareholder to third parties.

Note: A shareholder may not waive its preemptive right but, at the appropriate time, elects either to exercise it or not on its own discretion which can not be contracted around.

All JSCs are required to maintain a shareholder register. The register includes information about each registered shareholder including the number, category, and classes of shares held. Information on amount and nominal value of each shareholder's shares must be entered in the shareholders' register only. Please note that the register may be kept either by the company itself or by a external licensed registrar, and in the former case there may be a substantial risk of abuse as all evidence of shareholder having a stake in the company would be held by the company management.

Note: A JSC with more than 50 shareholders must delegate the keeping of the shareholder register to a licensed registrar. We advise that this shall be done in all cases.

JSC can be incorporated by one or more persons or legal entities. Maximum number of participants of closed JSC shall not be over 50, otherwise closed JSC must be reorganized into an open joint stock company within a year.

Note: JSC cannot be incorporated by one legal entity which has only one shareholder/participant in case if this legal entity is a Russian legal entity. If a foreign legal entity has only one participant, it is questionable whether it can incorporate a JSC being the sole shareholder. In most cases we would recommend to refrain from such activity.

The charter capital of an open JSC may not be less than 100,000 Rubles (approximately USD 3,225). A closed joint stock company must have a minimum charter capital equivalent to at least 10,000 Rubles (approximately USD 322). 50% of the charter capital of a JSC shall be paid within 3 months following its state registration, and 100% must be paid within the first year.

The charter capital of a JSC is divided into shares which shall be registered with the Federal Service for the Financial Markets of the Russian Federation (the "FSFM"). A charter of a JSC shall contain the amount of issued shares and its nominal value. Also the amount of authorized shares which the company is entitled to issue in the future can be specified in the charter.

JSC can issue common shares and several classes of preferred shares. The total nominal value of preferred shares shall not exceed 25% of its charter capital. Usually shareholders of preferred shares are not entitled to vote on the general meeting of the shareholders (exceptional cases when they have right to vote are stipulated in law).

JSC can issue other securities in the form of bonds or issuer's options, which are also registered.

Shareholders of ordinary shares are entitled to receive dividends according to the amount of shares. The dividend amount is determined by the general meeting of the shareholders.

Note: the dividends for the shareholders of the preferred shares shall be stipulated in the charter of a JSC as a fixed amount, percentage from the nominal value of the preferred shares or calculation formula for such amount.

An open JSC must comply with a number of information disclosure requirements, including preparing annual report, annual financial statement, list of affiliates, charter and inner documents, etc. An open JSC is usually used for establishing publicly traded companies.

The management structure of a JSC is usually consists of:

- General meeting of the shareholders
- Board of directors
- Executive body

Similar to as it is in an LLC, the general meeting of the shareholders is the highest governing body overseeing and directing the activity of a JSC, but unlike LLC its scope is strictly limited by the statutory provisions and can't be increased by the Charter.

Each common share carries one vote at the general meeting of shareholders, and most decisions are made by a simple majority vote, although for certain key decisions a majority of 75% is required (e.g. reorganization, liquidation, etc.).

Note: In a JSC the majority of votes shall be determined on the basis of the shareholders present at the meeting. In an LLC it shall be determined on the basis of all participants, not dependent on their presence at the meeting.

An open JSC with less than 50 shareholders and all closed JSCs may appoint a board of directors, although this is not a requirement. The competence of the board of directors is defined by the charter of the JSC and, if a board is not provided for in the charter, the corresponding authority is held by the general meeting of the shareholders.

The daily management of a JSC is the responsibility of the executive body– the general director, or it may consist of both the general director and the managing board. The executive body is responsible for all matters that do not fall within the authority of either the board of directors or the general meeting of shareholders. The general meeting may (by a majority vote) choose to delegate the powers of the executive body to an external commercial organization or to an individual manager on a contractual basis; however this decision may be taken only pursuant to a proposal from the board of directors (if the company has a board of directors).

Shareholders of a JSC have a right to conclude a shareholders agreement in which they shall state their rights and duties to each other or other important issues. Please note that although this may resemble a common law shareholder agreement, this concept is new to Russian law, is approached rather cautiously (if not reluctantly) by the courts and the overall framework of civil law does not provide the level of complexity and flexibility usually required to structure a typical SHA. We do not recommend relying on Russian-level shareholders agreements as a substitute to common law SHA.

1.2.3. Registration of LLC or JSC

Authority for state registration of commercial legal entities (such as LLC or JSC) in Russia is the Federal tax service (its local divisions).

Federal law “On state registration of legal entities and individual entrepreneurs” provides the list of documents that are required to be filed for the state registration, including application for

registration, decision/protocol of founders' meeting, foundation documents legal entity, extract from a trade register of a foreign legal entity which acts as a founder of the legal entity that is registered etc. Please note that the application for registration shall be signed in the presence of a notary, and if the founder of the legal entity is a foreign legal entity, than the director of such legal entity shall come to a Russian notary, or he or she shall find a foreign notary who can certify the signature in the application. In the latter case the application shall be apostilled, if the country of the notary has ratified Hague Apostille Convention dated October 05th, 1961, or legalized in another case.

All documents from a foreign legal entity must be notarized and apostilled/legalized in the country of preparation. Any document supplied in a language other than Russian must be accompanied by a Russian translation which has a notarized certification.

The state registration of legal entities shall not exceed 5 working days from the date of filing documents.

In addition for the state registration of a JSC as a legal entity the registration of shares shall be made with the FSFM.

Following registration, a legal entity must carry out a number of post-registration procedures before it becomes fully operative, including registration with the State Statistics Committee, with the tax authorities, and with the Russian social benefits funds. Also additional steps are necessary for legal entities to be fully operational, e.g., opening of bank accounts, manufacture of a corporate seal etc.

Legal entities need not wait until the end of the entire registration process including post-registration procedures before starting their activities. They can begin operations after their state and tax registrations, production of a company seal and opening of permanent bank account.

1.2.4. LLC vs JSC

In choosing between an LLC and a JSC, if it is necessary to establish a subsidiary, LLCs are more popular because they are easier to incorporate and finance, since there is no legal requirement that an LLC must register its shares. Also an LLC has more flexibility in decision-making procedure. An LLC can have a charter in which it would be stated that all essential decisions shall be made by its sole participant. Such provision is quite suitable for a subsidiary of a foreign company because it creates more possibilities for internal control of the subsidiary management.

In an LLC a participant is entitled to leave the company in certain circumstances and receive his/her proportionate share of the value of the LLC's assets if it is directly provided in its charter. In addition, participants in an LLC who either individually or collectively hold at least a 10% interest in the company's charter capital can apply to a court seeking expulsion of another participant. In order to actually exclude a participant from the LLC the other participant(s) must prove that the participant substantially hindered the company's operations or materially breached its obligations. Please note that such cases in Russian court practice are very rare. Therefore, it is quite complicated to prove such substantial hindering of the company's operations or breach of its obligations, and companies in fact do not use this procedure. For instance, according to Information letter of the Presidium of the Supreme Arbitration Court dated May 24th, 2012 #151, a participant from an LLC has been excluded because of counterfeiting of a minutes of this LLC general meeting, in which it was stated that authorities of the sole executive body of this LLC had been entrusted to a determined person.

In contrast to a JSC, it is legally permitted to an LLC a large number of issues that require a unanimous vote of all the LLC participants. Also LLC has less strict legal requirements and limitations concerning the order of managing of the company.

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We hope that this Memorandum will be useful to you. If you have any questions or comments, please do not hesitate to contact us.