

Joint ventures in the former Soviet Union

A Guest Article by Nigel Kotani
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Codified law versus common law

In England, and in most of the Commonwealth and English-speaking world, we have a common law system of law. In a common law system, laws develop through custom, with written laws that are based on that custom becoming developed over time.

It is a basic tenet of a common law system that one is free to do anything that is not prohibited. It is also a basic tenet of common law systems that parties to a contract are free, within certain legal parameters, to agree their own terms. English law will therefore not interfere if parties have made a bad bargain, but equally will not enforce anti-competitive provisions, even if agreed between the parties.

In the former Soviet Union (FSU), and indeed in a lot of Europe and the rest of the world, the legal system is codified. Codified systems start with abstract rules that set out the main principles of the law, and from which specific legal provisions are subsequently derived.

More prescriptive

Codified systems therefore tend to be more prescriptive than common law systems. In France, for example, the law will interfere in certain circumstances if it feels that one of the parties to a contract has made a bad bargain – an interesting irony from the country that gave us the expression *laissez-faire*.

In civil law countries, therefore, legislation is the primary source of law, and if an area of law is inadequately covered by the code, then the position may be uncertain.

Although immense change has overtaken parts of the FSU – both socially and economically – in the last 20 years, particularly in the main cities, the legal regime that governs business activities, and which was designed for use in a system where businesses were publicly owned, has not kept up with this pace of change.

Areas not covered

Large sections of modern business practice and law that we regard as commonplace in Western Europe are not covered by the codified legal systems of the FSU countries, and are accordingly not covered by their laws.

For example, although Russia is beginning to introduce legislation concerning share options, local advice in FSU countries is at best that the enforceability of

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share options is “uncertain”. More often than not, the advice is that share options are simply unenforceable.

Offshore companies – a popular solution

In order to enter into an effective joint venture in relation to an FSU business, the most effective and most common approach is to structure it through an offshore holding company.

This will require a restructuring of the local business in advance, whereby the local owners will transfer ownership of the underlying business to an offshore holding company, and will in return be issued shares in the offshore holding company. The overseas partner will then subscribe for shares in that offshore company for cash. (Joint ventures in the FSU almost invariably involve the local partner supplying the business and local knowledge, and the overseas partner supplying development funds – the credit crunch has been in effect in the FSU for over a decade.)

The holding company’s location will be driven by tax advantages permitting the easy remittance of profits from the business to the parent. Cyprus has favourable double taxation treaties for deals with most FSU countries, as do the British Virgin Islands and the Netherlands. Because of its closeness to English law, which is the prevalent law governing cross-border transactions involving the FSU, and because of its geographical proximity to the FSU, Cyprus is the jurisdiction of choice for holding companies of FSU businesses.

Shareholders’ agreement

A shareholders’ agreement will then be put in place at the level of the parent company. This will contain all the usual provisions that one would expect to see in a shareholders’ agreement, such as rights to appoint directors, veto rights, share options, transfer rights, deadlock resolutions and non-compete provisions.

These will be enforceable at the level of the offshore holding company, except in the case of non-compete provisions that have territorial application and are therefore subject to the laws prevailing in the relevant territory. This territory will invariably be an FSU country, where, predictably, the advice invariably seems to be that non-compete provisions are unenforceable.

The shareholders’ agreement can provide for arrangements imposed at the level of the offshore parent company, particularly as regards veto right, to have effect at the level of the local company. In the event of a breach of this provision by the local partner, this in itself would not enable one to go to the local courts and seek damages or an injunction. It would, however, enable one

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to bring an action for damages against one's local partner under the main agreement.

Overseas court judgements are generally unenforceable in FSU countries, whereas arbitration awards generally are. For this reason, shareholders' agreements in relation to FSU businesses tend to provide for arbitration, rather than court proceedings, even where the shareholder agreement is put in place at the level of the parent company. This enables awards against parties located in the FSU to be enforced against them.

Limited direct control

On the subject of enforcement of awards against local partners, anyone entering into a joint venture in the FSU for the first time must accept a degree of trust with their local partner, and must accept that their direct control over the local company will be limited.

One way around this would be to find a second local partner – perhaps a local private equity fund, or an overseas private equity fund with experience in the region – to see if they are prepared to go in as a co-investing partner. The commonality of interest, combined with their local knowledge, would bring enormous benefit to someone going into a joint venture in the region for the first time.

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If you would like more information on any of the points covered in this Guest Article, please contact **TCii** on **020 7099 2621**.