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DOING BUSINESS ON SAKHALIN

LEGAL CONSIDERATIONS[1]

Management and Control of Joint Venture Companies

Both Sakhalin Energy Investment Company (SEIC) and Exxon Neftegas Limited (ENL) are obligated under their Production Sharing Agreements (PSAs) with the Russian Government to use at least 70 % Russian materials and services (Russian Content) in the construction and operation of their projects.[2] In many cases both SEIC and ENL are requiring contractors to meet the Russian Content requirement as a condition to qualifying to bid on their projects.

Bidders for both SEIC and ENL[3] contracts are faced with the requirement of forming a bidding company whose shares are at least 50% owned by Russian shareholders. The usual corporate form to comply with the 50% Russian ownership requirement is the formation of a Russian[4] limited liability company or LLC (sometimes known by its Russian initials as an "OOO"). One of the principal issues confronted by the non-Russian shareholders in this situation is how to deal with the issue of control and direction of the 50:50 joint venture company. In our experience there are three main approaches to this question.

Mutual Sharing of Control

Russian law governing the formation and operation of LLCs is relatively extensively detailed and sets out a number of requirements that cannot be varied by the parties. One of the fundamental rules is that the requirements of Russian law cannot be varied by an agreement between the shareholders that attempts to override the obligatory provisions of Russian law. The

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[1] Remarks by Jonathan Russin, Managing Partner of Russin & Vecchi LLC, at the Fourth International RusEnergylaw Conference, and updated in accordance with current legislation of the Russian Federation as of December 2009.

[2] There are slight differences in the definition of Russian Content in the two PSAs; however, the differences are not material as far as the obligations of contractors to meet Russian Content requirements are concerned.

[3] In some instances ENL has accepted bids by companies incorporated in Russia but 100% foreign owned. We understand, however, that these are considered to be exceptions from ENL's general 50% Russian ownership requirement.

[4] The use of an offshore company with 50% Russian ownership is also permitted; however, Russian companies and individuals are restricted in investing in companies outside Russia, making the use of an offshore joint venture more theoretical than realistic.

type of Shareholders Agreement often used in the United States and England in which the shareholders agree in advance on the division of seats on the Board of Directors, on the selection of the Managing Director, and on the budgeting and financing of future operations of the LLC has frequently been found by Russian courts to be unenforceable. Russian law requires that these issues remain open for review and decision by the shareholders at the yearly meeting or at the times established in the company bylaws.[5]

The standard Russian LLC with relations between shareholders subject to review and decision at regular shareholder meetings is probably best suited for a situation where the Russian and foreign parties are making equal contributions to the management and operations of the joint venture company. Both parties will look to Russian company law to regulate the mutual control features of their joint venture.

It should be noted, however, that Russian custom and tradition gives substantial authority to the Managing Director of a Russian LLC. Although the authorities of the Managing Director can be limited by the bylaws and by narrow delegations of authority from the shareholders or the Board of Directors, much operational discretion will still rest with the Managing Director. The choice of this officer will be a major decision for the joint venture partners.[6]

Disproportionate Control Via Management Agreement

One of the classic solutions used in situations where the foreign shareholder is in fact providing a disproportionate part of the financing and expertise of the LLC is to have the shareholders unanimously agree in the charter of the LLC that the management functions of the company will be contracted to a third party[7]. A Management Contract between the LLC (usually approved by unanimous vote of the shareholders) and the foreign shareholder conveys operating responsibility on the foreign party. The Management Contract can be for a definite or indefinite period, and can be drafted to allow for termination only by decision of the shareholders (where a 50:50 structure could block any decision in which the shareholders are divided) or for breach by the management company, which would require a final court decision that such a breach had occurred.

Delegation of control under a Management Contract does not remove all aspects of participation by the Russian partner. Russian company law requires that changes in the structure of the LLC such as decisions to amend the Charter, to increase or decrease authorized capital, to reorganize or liquidate, and to pay dividends are in the exclusive competence of the shareholders and cannot be delegated through a Management Contract. One additional technique used to address a situation where there is an imbalance between the contributions of the two partners in a 50:50 joint venture is to create different attributes to the shares held by each partner, for example, by establishing that the shares held by the partner making the disproportionate contribution are entitled to a greater percentage of dividends.

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[5] Major changes were introduced to the Limited Liability Companies Law in July 2009, and the Law now expressly permits the use of Shareholder Agreements to define certain rights. However, the interpretation to be given by the courts to the application of this provision remains uncertain. We recommend that any provision in a Shareholder Agreement that might be challenged as a limitation on the general rule that shareholder decisions must be taken pursuant to the voting procedure established in the company charter should be viewed as vulnerable to possible adverse court action.

[6] However, the Charter of the LLC may grant the right to make a decision on a specified question to the Board of Directors. (pursuant to the current version of art. 33 of the Federal Law "On Limited Liability Companies").

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In general the solution to the problems associated with disproportionate contributions by the partners is to address the issues presented through structures permitted by and consistent with Russian company law, rather than to attempt solutions through the use of standard U.S. or English style Shareholders Agreements which run the risk of being ruled unenforceable by Russian courts.

Undivided Control Through Two Tiered Structures

The third approach to the issue of control is to create a Russian structure that avoids the participation of a local partner. For this purpose it is necessary to incorporate two Russian companies. For example, Company A is established as a Russian LLC and is 100% owned by foreign shareholders.[8] Company A then incorporates a Russian subsidiary, Company B, that is 100% owned by Company A. Company B is eligible to bid on Sakhalin I and II projects because it is a Russian company, the shares of which are 50% or more owned by a Russian shareholder. Although this structure meets the legal requirement for Russian Content, it also results in the creation of two companies both subject to the payment of Russian taxes on their operations.

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There are obviously advantages and disadvantages to each of these three approaches. The choice will depend on an assessment of all the circumstances involved in each tender offered by SEIC and ENL. Relevant issues will include: Will the services required be performed in Russia or offshore? How much of the required work will be subcontracted? To which partner? What will be the resultant cash flow and tax structure? The control issue will be an important -- but not the sole -- factor determining the structure of the Russian LLC.

Cost Overrun Provisions

There is no easy solution to cost overrun issues. The enforceability in Russian courts of an agreement between joint venture partners in which they obligate themselves, if required, to increase their contributions to the capital of the joint venture company is questionable, since it can be argued that these obligations violate the principle that the shareholders of a Russian LLC are only at risk for the original amount of their paid-in capital. It is also doubtful that Russian courts will enforce the typical cost overrun provision that requires the partner who fails to provide additional financing to agree in advance that the share ownership of the Russian LLC will be increased by the amount of the additional contribution from the other partner. Faced with the enforceability of such a provision, it is likely that a Russian court will rule that a decision on the increase of share capital can only be made at a meeting of shareholders called to approve the actual increase, and that the shareholders cannot be obligated to approve such increase by contract in advance of the actual meeting.

Russian law will permit one of the partners to provide additional financing through a loan to the joint venture company, and the loan will be enforceable against the Russian LLC. However, changes in the proportion of share ownership or in other aspects of the structure of the LLC

[8] In this situation Russian company law requires that one of the two Russian companies have more than one shareholder.

cannot be determined by Shareholders Agreement in advance and will require the decision of all parties at a shareholders meeting called to specifically approve the proposed changes.

Dispute Resolution

Regrettably there is significant distrust of the fairness and evenhandedness of Russian courts among both foreigners and Russian citizens. As a result, many contracts involving agreements between Russian and non-Russian parties call for arbitration of disputes outside of Russia. The Russian Federation adheres to the New York Convention on the Enforcement of Arbitral Awards,[9] however, the record in Russia for enforcement of foreign arbitral awards without independent reexamination by Russian courts is spotty at best.

In addition to enforceability questions the process of obtaining a foreign arbitral award and then requesting enforcement in Russia is likely to be both more time consuming and less effective than seeking redress for grievances directly from a Russian Arbitrazh Court.[10] One of the distinctive features of the Arbitrazh Court system is the availability of pre-trial injunctive relief which can often spell the difference between immediately stopping a partner's violation of shareholder rights and waiting for the enforcement of a final foreign arbitration award.

Unfortunately I cannot yet report to you on the decisions rendered by Sakhalin courts on the enforcement of foreign arbitral awards. To our knowledge there have not been decisions by Sakhalin courts on this issue.

Workforce Issues: Russian Labor Law, Employment Contracts, Overtime, "Extreme North" Considerations

Russian Employment Law and Employment Contracts

The Russian Labor Code expressly provides that its terms apply to labor issues involving foreign persons and foreign legal entities. The labor relationship of a non-Russian citizen employed by a foreign company to provide services in Russia will be governed by the Russian Labor Code. The key to the applicability of the Code is the place of employment. If the employee is rendering services in Russia, the Code is applicable. Other provisions of the Code make unenforceable any employment agreement provisions that contradict obligatory provisions established by the Code, including any agreement that attempts to make the law of another jurisdiction applicable to the employment relationship. Contractors and subcontractors on PSA projects who use foreign employees for services in Russia must understand that their ex-patriot employees, even though hired under contracts governed by the law of their home jurisdiction, are entitled to all the pro-employee benefits provided by the Russian Labor Code.

Overtime Work

[9] Court judgments, as distinguished from arbitral awards, are only enforceable where the issuing country and Russia are signatories to treaties providing for enforcement of court judgments, or where it can be proven to the satisfaction of the Russian court considering the request for enforcement that reciprocal enforcement is available for Russian court judgments in the country where the judgment was granted.

[10] The Arbitrazh Court system in Russia should not be confused with private arbitration. The Arbitrazh Courts grew out of the Soviet system for resolution of disputes between State enterprises, and these Courts today have jurisdiction over most commercial disputes between juridical persons.

The Labor Code generally restricts the use of overtime employment to a very limited set of emergency circumstances faced by the employer, such as the making of emergency repairs to gas, heating electric and other public services or when work is required "…to prevent a catastrophe, an industrial accident or to undertake remedial actions after catastrophe, industrial accident or environmental disaster."[11] The Code requirements permitting overtime services are very restrictive and do not allow employers to use overtime for such usual purposes as meeting contract or other non-emergency deadlines.

Important flexibility is provided, however, through the Russian concept of the "Non-fixed Work Day" and through seasonal adjustments to the work day, The Non-fixed Work Day is used by many private and governmental organizations to provide the type of additional time flexibility that is needed to meet deadlines and extra work requirements. While sanctioning the general concept of the non-fixed work day, the Labor Code is largely silent on its detailed implementation. In practice most employers negotiate the terms of the non-fixed work day in written employment agreements with designated employees. Under such agreements employees are not subject to the eight hour daily or forty hour weekly time limits; they may be required to stay at work beyond the standard work day or to begin work earlier than the usual opening hour. For construction work the use of the non-fixed work day allows the employer to set the hours of work in accordance with actual construction needs. The usual practice is for the employer to divide his employment roster between persons employed on fixed schedules and those employed under the non-fixed work day concept.

The extra hours worked by non-fixed work day employees, however, are not considered overtime work, and they are not separately compensated. Instead the employer and employee agree in advance to the total compensation to be paid per month under the non-fixed work day agreement. This agreed compensation is deemed by the Labor Code as compensation for the full service rendered, although the employer has the right to make bonus payments at its discretion. The only additional benefit required by the Code is that the employer must provide additional vacation time to the employee in the amount they negotiate in the employment agreement, but not less than three calendar days in addition to the statutory vacation time.

The Labor Code also permits the employer to adjust the work day seasonally so as to require a longer work day in the daylight hours of summer balanced by shorter work days in the winter. So long as the total of work per year does not exceed normal quantity of working hours established by the Labor Code,[12] no overtime pay is required.[13]

"Extreme North" Conditions

Under the Russian labor law the entire island of Sakhalin is considered to be a hardship zone, and all employees are entitled to special benefits as a result of working in hardship conditions. The law distinguishes areas on Sakhalin classified as "approaching" the Extreme North (the city of Yuzhno-Sakhalinsk is included in the "approaching" category) and actual Extreme North areas (the towns of Nogliki and Oha, for example). The major benefit to employees is increased salary and vacation allowances. Salaries in Yuzhno-Sakhalinsk are increased by coefficients amounting to 2.1 times base salary, and in Nogliki and Oha the coefficients amount to 2.6 times base salary. In labor agreements with employees working on Sakhalin it is important to break down the total amount of compensation and to separately show

[11] Labor Code of the Russian Federation, Article 99.
[12] According to art. 91 of Labor Code normal duration of working time cannot exceed 40 hours per week.
[13] Labor Code, Article 104.

the calculations for base salary, area coefficients and seniority increases. Failure to do so can result in a court ruling that the employee is entitled to receive these hardship benefits in addition to the stated salary. The result could entitle the employee to receive from 10 to 60 percent of total compensation as additional hardship benefits.

An employee working a standard 40-hour week in Yuzhno-Sakhalinsk is entitled to 16 calendar days of vacation in addition to the standard 28 calendar days required for all employees. In the cities of Nogliki and Oha the employee receives an additional 24 calendar days above the required 28.

Other Laws and Regulations Affecting Contractor/Subcontractor Operations

Income Tax Applicable to Expatriate Employees

The Russian Tax Code provides that foreign individuals resident in Russia will be subject to a flat 13% income tax on all compensation received for their services in Russia. A resident is defined as any person spending 183 days or more in Russia during 12 successive months. This lower tax rate is also applicable to all Russian employees.

The Tax Code now also requires, however, that persons spending less than 183 days on Russian territory are subject to withholding and payment of income tax at a flat 30% rate on income received for the time spent in Russia. This provision appears to apply even where the expatriate employee is employed by an offshore company and is paid in foreign currency at an offshore bank. The key question triggering Russian income tax liability is whether the expatriate employee receives compensation for services rendered on Russian territory. This requirement, however, is not reconciled with the practical question of how an offshore company not registered for tax purposes in Russia is to withhold and pay such employee's Russian tax. No regulations have yet been issued by the tax authorities on this point.

Work Permits for Foreign Employees

Article 18 of the Russian Law "On the Legal Status of Foreign Citizens" establishes requirements for obtaining work invitations and work permits in Russia. The Law provides that the government will establish an annual quota stipulating the number of expatriates who will be allowed to work in Russia. The quota for 2003 was 530,000 work invitations. For 2004 year the Government has decreased the quota twice and the current total is 213,000. Later on the RF Government started to increase quotas: for example, the quota for 2008 was 1,140,633 work invitations and for 2009 – 1,250,769. Work invitations and work permits for expatriates working in Russia are issued by the Federal Migration Service or its territorial bodies. The law contemplates that for each work invitation the employer will make a security deposit with the Federal Migration Service covering the costs of return transportation from Russia to the employee's home country. However, as currently interpreted, the deposit can be avoided by providing a guarantee letter from the employer for home transport expenses. Employers can only obtain work invitations and work permits for expatriate employees with whom they have direct employment contracts.

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Note: This paper attempts to outline the principle requirements for the topics addressed which are likely to be relevant for companies planning to provide contract services to the operators of the Sakhalin I and II projects. In order to provide a general overview, the paper necessarily simplifies and in some cases omits dealing with many of the requirements and considerations which will affect any specific transaction.

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