

Legal Russia: bear market

1 February 2016 By Marialuisa Taddia

Sanctions and a shrinking economy have severely affected legal business in Russia. But there is cause for optimism, reports Marialuisa Taddia.

Since 2014, the energy-dependent Russian economy has been hit by western sanctions and low oil prices, tipping it into recession. Russia's GDP was expected to shrink by 3.8% in 2015 and a further 0.7% in 2016, according to the World Bank.

The legal sector has also suffered, according to Brian Zimble, managing partner of the Moscow office of US firm Morgan Lewis: 'We see a general fall in all forms of legal business.'

Advertisement



Working together
with the legal
profession

Click to find
out more

FOLK 2 FOLK
Local Secured Lending



Elite
Choose from a wide range of
legal indemnity covers

Countrywide
LEGAL INDEMNITIES

EU-US sanctions, introduced in 2014 in response to Russia's annexation of Crimea and the crisis in eastern Ukraine, dealt a big blow to foreign law firms. 'When the sanctions came into effect in 2014 the impact on legal business was very severe,' Zimble says. 'There was a lot of confusion. Many international companies stopped doing business with Russia because they were worried about the impact of the sanctions.'

Sanctions target individuals (dozens of Russian officials have been blacklisted), major Russian state banks, and corporations in the energy and arms sectors – among them Sberbank and VTB Bank, Rosneft, Transneft and Novatek. They restrict access to EU and US capital markets, and western imports of high-tech goods, including those used for shale oil projects, and arctic oil exploration and production.

Zimble says: 'Our EU and US clients who had been very active in the Russian market stopped making new investments and providing financing to the Russian banks and energy companies that are on the list.' Adding to the woes caused by sanctions is the oil price, which has fallen dramatically since June 2014.

Many foreign law firms have seen reduced Russian business, particularly in capital markets, M&A and projects. Sergei Voitishkin, managing partner of Baker & McKenzie CIS offices, says: 'A small number of clients stopped their projects in Russia as a result of sanctions. We abide by US and EU sanctions and have withdrawn from several projects or have had to pass [up] new projects if they fall under the sanctions.'

'Until three years ago our desk was full of Russian debt and equity capital market deals, but we are not seeing many new bond issues or equity deals coming out of Russia,' says Nick Hayday, senior associate at Freshfields Bruckhaus Deringer's capital markets practice in London.

There are also fewer and smaller-value transactions in the corporate and M&A space, consisting of 'mostly mid-market deals', notes Voitishkin, who heads Bakers' CIS corporate and M&A practice group. This is true of Russian and foreign law firms. 'Russia-focused M&A, which was popular over the last few years, has become limited and more focused on the small and medium-sized market,' says Vladislav Zabrodin, managing partner of Russian firm Capital Legal Services (CLS).

It is not just the reduced size and value of deals but, as Zimble notes: 'The business is changing. The M&A deals we do are more heavily negotiated because the parties that are still willing to provide money, or to do a transaction, have stronger bargaining leverage.'

International law firms also have to contend with retaliatory measures, including legislation curtailing foreign ownership. For example, amendments introduced in 2014 to the Russian law on mass media that took effect on 1 January set the maximum foreign stake in Russian broadcasters and magazine publishers at 20%. 'Short-term, that has actually produced a lot of work for international lawyers. We have been working hard to help clients restructure their media business and bring in a new Russian partner,' Zimble says. But he adds: 'There will be Russians who will own these companies and, once they get restructured this way, may not need much help in the future.'

In the current economic climate firms also have to respond to clients' belt tightening in a crowded legal market where competition for work has become 'very intense', Voitishkin says: 'Many clients are cutting costs and legal budgets. It is also increasingly difficult to get paid for work done.'

Profession reforms

Reforms of the legal profession, currently being finalised, could represent a further challenge. 'If [the government] decides to allow only members of the local bar (advocates) to practise law, international and local firms operating in Russia may have to change their structure and use corporate forms available only for advocates in Russia,' Voitishkin says.

Advokatura, or the profession of advocates, accounts for a small proportion of legal practitioners in the Russian Federation, and it is recognised and regulated by law. Only a licensed *advokat* can conduct criminal litigation in court and must be registered with one of the regional bar associations overseen by the Federal Chamber of Advocates of the Russian Federation.

Non-advocates, also known as legal consultants or jurists, are unregulated, but there are proposals to unite the legal profession under the regional and federal bar associations. Currently, there are two types of law firm in Russia: commercial law firms and advocate entities.

A foreign law firm may establish an office in the country, either by incorporation as a Russian commercial company or as a branch or representative office of a foreign law firm, according to the International Bar Association.

In such a difficult climate, foreign businesses are downsizing. 'The number of expats in Moscow has declined enormously,' notes Dentons' Moscow-based partner Doran Doeh. And law firms are no different.

Clifford Chance laid off 10 staff, including five lawyers, from its Moscow-based team last year. At the end of 2014 Allen & Overy consolidated its Russian international capital markets practice within its wider finance team, which resulted in the departure of four Moscow associates.

With sanctions and low oil prices likely to remain for some time yet, observers say the cutbacks may get worse. A Moscow-based international lawyer, who wishes to remain anonymous, says: 'Quietly, everybody is staffing down. At least one US firm in Moscow closed their offices recently and there are rumours that other firms are going to shut, although everybody is trying to keep it quiet.'

Going up

But it is not all doom and gloom. If international sanctions have stifled certain areas of activity they have also generated plenty of work elsewhere.

'Sanctions have become a big part of the practice for all international corporate lawyers in Russia,' Zimble says. Although his practice focuses on M&A and private equity, in the past year Zimble has spent about half his time on sanctions or sanction-related matters, making sure that foreign clients do not violate them and Russian clients 'adjust their business so that they don't have problems with their foreign partners'. Others confirm that picture.

Oxana Balayan, Hogan Lovells managing partner in Moscow, highlights the positive, if wholly unintended, knock-on effects of western sanctions. There are now sanctions aspects in compliance checks and due diligence exercises, and in the structuring and execution of corporate deals. 'While conducting due diligence or working on structuring a deal, we must now seek input from our dispute resolution colleagues who have expertise in sanctions to make sure the target company is compliant, or a particular corporate structure of the deal will not raise any sanctions and liabilities issues,' Balayan says.

Another side-effect has been the shift of activity, including M&A and disputes, towards Asia. Balayan argues that investors from sanctions-free Asian jurisdictions have 'proved to be keen to step in and reshape the traditional dominance of western sources for funding', and that 'both Hong Kong and Singapore have attracted many [Russian] investors looking for an alternative place of arbitration'.

The increase in Asia-focused business is also benefiting other firms. 'More and more Russian clients are interested not just in London, but also in Singapore as a place for arbitration,' Zimble says. Morgan Lewis last year entered the city-state by combining its operations with Singapore's Stamford Law Corporation.

Certainly, the global footprint of international firms means they are well placed to capture increasing workflows to and from Russia from their far-eastern outposts. 'We expect to see more projects involving companies from Asia-Pacific, as Russia looks for ways to replace [services] and products that are under western sanctions,' Voitishkin notes.

Florian Schneider, Russia managing partner at Dentons, says: 'Like every other international law firm, we have seen a reduction in corporate, M&A and finance, and foreign direct investment from the west is very low.' But, he adds: 'Increasingly we see interest from China.'

Schneider stresses that this is not just because of the recent combination of Dentons and Dacheng, China's biggest law firm. China is not bound by western sanctions and Russia was already reorienting its economy toward China when sanctions came in. Every other day, Schneider says, he receives requests for legal support from Chinese companies, ranging from establishing offices, branches, subsidiaries and joint ventures with Russian partners, to setting up international funds to support Chinese and Russian businesses.

It also helps to have a diversified practice. Dentons has a full-service offering in Russia, Schneider says, pointing to increased activity in 2015 in arbitration and litigation, employment and tax, competition, and bankruptcy. That made up for the drop in corporate and M&A business, which accounts for almost 40% of fee-earning income in Russia.

In 2015 Dentons hired 13 fee-earners, including three partners, in Moscow: Maria Oleinik and Evgenia Laurson from White & Case, and Richard Cowie from Hogan Lovells, beefing up the firm's corporate and M&A, banking and finance, and energy practices. Another new arrival was counsel Galina Dontsova who joined Dentons' Russia tax and customs practice, which now has 11 lawyers. Staff also increased in the St Petersburg office with three fee-earners, including one partner.

Speaking to the *Gazette* in December, Schneider said Dentons was on course to meet its budget, albeit a conservative one, for 2015 and that he expected stronger financial results in 2016 owing to the recent lateral partner hires.

Dentons has a 'polycentric' model with no single headquarters. In the federation, the firm operates as a 'independent subsidiary' incorporated in Russia (unlike other foreign firms, which tend to operate through branches or representative offices of foreign-registered entities). That means it can take on referrals for work which other EU and US firms have had to refuse due to the sanctions, Schneider says.

A diversified offering of legal services has also helped Baker & McKenzie, one of the largest international firms in Russia, with 162 fee-earners, including 30 partners, between Moscow and St Petersburg. The firm's headcount remained stable over the past year, according to Voitishkin: 'Our practice in Russia is quite diversified, and sanctions have not had a serious effect on our business so far.'

In numbers

3.8%

Estimated contraction of Russia's economy in 2015

20%

Maximum foreign stake in Russian broadcasters and magazine publishers

51st

Russia's ranking in the World Bank 'ease of doing business' index 2016 – up from 62nd in 2015

\$680m

Amount paid by Thailand's Charoen Pokphand Foods for Dutch Agro-Invest Brinky's Russian poultry operations

\$306m

Amount paid by US pharmaceutical and healthcare company Abbott Laboratories for Russian pharmaceutical producer Veropharm

In Russia, the Chicago-headquartered firm has been 'reasonably busy' advising on regulatory and litigation matters in the areas of compliance, tax, employment and intellectual property, Voitishkin says. Highlights in 2015 included acting as tax counsel to US pharmaceutical and healthcare company Abbott Laboratories on its \$306m acquisition of Russia's pharmaceutical producer Veropharm and its various subsidiaries in Russia, Kazakhstan and Ukraine.

As Russian banks and energy companies struggle to cope with the crippling effects of sanctions and low oil prices, 2016 is expected to bring 'more distressed owners' on to the market, Zabrodin notes, resulting in an increase in M&As and transactions for the sale of assets. 'Hopefully this will also help the legal market,' he adds.

Corporate and M&A remain among the 'busiest areas' for CLS. 'There are actually significant issues tied to new investments and the need to support and restructure existing ones,' Zabrodin says. Amendments to the corporate legislation of the Russian Federation, which came into force in July and affect the registration and operation of companies limited by shares, should spur further corporate activity.

Localisation

In response to its economic woes, including the collapse of the rouble (which has made imports more expensive), the Russian government is implementing an 'import substitution policy' in a range of economic sectors such as manufacturing, petrochemical and pharmaceutical. This favours local producers through subsidies and procurement. 'Localisation of production is supported by the government, and those who manufacture locally and/or export their products are now considered the most attractive targets for foreign and domestic investments,' Balayan says.

'Localisation projects involve a lot of legal work and that's good news for lawyers,' Zimbley says. He highlights the example of Russian Gas Turbines LLC, a joint venture of GE, Russia's utility company Inter RAO and United Engine Corporation, a subsidiary of Russia's state-owned defence industrial giant Rostec. Russian Gas Turbines LLC launched a gas turbine manufacturing facility in Rybinsk at the end of 2014. Morgan Lewis advised GE on the deal.

Dispute resolution tends to increase in difficult economic times. Consequently, firms are seeing an upturn in litigation and arbitration.

Hogan Lovells is acting for Kazakhstan's BTA Bank in a number of claims worth more than \$6bn against Kazakhstan billionaire Mukhtar Ablyazov and his companies in a number of worldwide proceedings, including the UK, Cyprus, BVI and Russia (Ablyazov's lawyers have described the cases as 'politically motivated').

Kennedys established a footprint in Russia last year. Senior partner Nick Thomas says: 'In the insurance world, recessions don't really matter; they don't really impact on claims, if anything they increase them. We consider ourselves an a-recessionary business.'

Last May, the UK insurance law specialist opened an office in Moscow through a tie-up with local chambers CIS Advocates. Kennedys CIS Advocates is headed by Russian-qualified advocate Constantin Saranchouk, who specialises in high-value insurance claims, the resolution of insurance disputes in the Russian commercial courts and international arbitrations seated in Russia.

'Our clients are not Russian,' Thomas says. 'They are American, British, German and Swiss insurers with exposure in Russia, so we are not acting for anyone who is subject to sanctions.' But, he adds: 'It is of enormous assistance to our clients that we have people on the ground in Moscow.'

Working jointly with its new Russia-based team, Kennedys is acting for the insurers in claims arising from Russia's Metrojet plane crash over the Sinai desert in Egypt that killed 224 people, and the explosion of a Rosneft oil refinery in Siberia in June 2014. 'The insurance market has for a long time been looking for specialists like us to be able to deliver locally for them throughout the CIS,' Thomas says.

Russian firms

To support sanction-hit Russian clients, local law firms are filling the gap left by their international counterparts. Unlike UK and US firms, Russian law firms are not constrained by sanctions, or at least not to the same extent. They also tend to have a more diversified business than international law firms, which tend to focus on M&A, corporate finance and capital markets. They are also cheaper.

'The layout of the market has changed, since most international firms face limitations in representing the major Russian corporations that are under sanctions,' Zabrodin says, although he adds that 'many are able to avoid or overcome this restriction by applying special procedures and receiving special approvals from regulators in their own countries'.

As foreign firms scale back their operations, 'Russian firms are still growing,' Zabrodin says. CLS employs 50 fee-earners and is hiring. It is also widening its scope, moving into new areas of practice such as compliance and personal data protection. One growth area for CLS is anti-trust. 'Russian anti-trust authorities are becoming more active,' Zabrodin says. For example, CLS advised Toyota on antitrust matters in Russia.

Domestic firms are also taking market share from foreign law firms. Last year, CLS acted for Dutch Agro-Invest Brinky BV on the \$680m sale of its Russian poultry operations to Thailand's Charoen Pokphand Foods PCL – one of the top 10 M&A deals in Russia in 2015.

Less affected by sanctions, local firms are also profiting from their familiarity with the local legal system and a greater responsiveness to client demands for keen pricing.

KK&P Trial Lawyers, a litigation boutique, was launched in March 2015 by Maxim Kulkov, former head of Freshfields' Russian dispute resolution practice, and four other Russian partners who left the magic circle firm's office in Moscow.

KK&P Trial Lawyers' focus is litigation and domestic arbitration cases with 'some international elements', says managing partner Kulkov: 'Many traditional Russian law firms don't have enough expertise for such cases and many large international law firms cannot compete with us here, either because they are not comfortable dealing with Russian courts and arbitral tribunals or because their fees discourage clients.' Kulkov adds that clients are unwilling to pay half or even a third of the value of a claim to their lawyers, especially since in Russian courts it is 'very hard' to recover even a small part of the legal fees from the losing party.

International law firms will continue to be at a disadvantage to local firms in this respect until the sanctions are lifted. Voitishkin notes: 'In transactional work, there will be more deals governed by Russian, rather than English law, and Russian companies are likely to prefer non-western arbitration institutions for their disputes.'

However, most of Baker & McKenzie's clients remain committed to their Russian business interests and continue to invest in Russia to maintain market share and be competitive, he says. 'We expect that work in such areas as compliance, anti-trust, litigation, pharmaceutical, tax, IP and corporate, mostly joint ventures and M&A, to continue to be reasonably active,' Voitishkin predicts.

And there is evidence of progress on Russia's efforts to modernise and streamline how businesses are run. In its latest ease-of-doing-business index for 2016, the World Bank moved Russia from 62nd to 51st place (out of 189 countries measured), ahead of Luxembourg. Russia leapt 30 places in the bank's survey for 2015; and was ranked 120th in 2012.

And even if the federation has lost some of its shine, with about 144 million people and a GDP of \$1.861 trillion, it is hard to believe there won't be enough work for international firms that are capable of adapting and diversifying quickly, and following intensifying trade with Asia.

Zimbley says: 'It is going to be a difficult year, but we anticipate that the legal market won't get worse. There's work for international lawyers, and that's because clients are still doing business in Russia.'

Marialuisa Taddia is a freelance journalist