

THE ROLE OF OFFSHORE JURISDICTIONS IN RUSSIA

KRISTIAN WILSON,
Bedell Cristin Law Firm
(Singapore)

This paper will examine the interaction between offshore jurisdictions and Russia, with particular emphasis on the role played by the British Virgin Islands in structuring offshore transactions. This paper will look at popular narratives about offshore jurisdictions, including traditional arguments about round-tripping and corruption, before examining the legal rationale for the use of offshore structures in Russia. It will be argued that the use of offshore jurisdictions arose as a response to deficiencies in the Russian legal system, particularly in terms of Russian law as it relates to property rights, and the related problem of enforcing such rights. In contrast to these perceived deficiencies in the Russian legal framework, offshore jurisdictions provided a stable and modern legal environment, the use of which allowed Russian investors to gain access to Western common law principles of corporate governance, property rights and shareholder rights.

Keywords: Russia; British Virgin Islands; offshore; property rights; shareholder agreements.

DOI:10.17589/2309-8678-2015-3-2-119-136

1. Introduction

This article will examine the use of offshore jurisdictions in Russia, with particular emphasis on the role played by the British Virgin Islands [hereinafter BVI]. The objective of this paper is to understand the reasons behind the popularity of offshore structures in Russian commerce, and to shed some light on the legal rationale behind their use, by examining the interplay between Russian and offshore legal systems.

This is an important area for study, given the significant role that offshore jurisdictions play in Russian foreign direct investment [hereinafter FDI]. The prevalence of offshore structures in Russian FDI is well reported, and it has been

observed that in 2012, 11 of the main 40 recipients of Russian FDI were offshore jurisdictions which were seen as acting as a transit platform for the movement of capital to other destinations. Of these offshore zones, three jurisdictions are the largest recipients of Russian FDI, being the BVI, the Cayman Islands and Cyprus. These three jurisdictions have played host to increasing and significant volumes of Russian financial flows, with the growth of outward FDI stocks in Cyprus growing from \$206 million to nearly \$4 billion in the period between 1998 and 2006, the BVI increasing from almost zero in 1990 to \$123.5 billion in 2006 and the Cayman Islands increasing from almost zero to \$40.4 billion in the same period.

Given the popularity of offshore finance centres, and the significant FDI flows passing through such jurisdictions, the question then arises as to why offshore structures have been used in Russia. Unfortunately, this is an area in which there is a lack of significant academic analysis and the few studies that address the topic simply focus on questions of tax avoidance, round-tripping and corruption. The legal rationale, practical use and function of offshore structures are rarely considered. This is a significant deficiency in the existing literature on the topic as legal concerns have been a key consideration behind the use of offshore structures in Russia.

This paper will therefore attempt to redress this deficiency and cast some meaningful light on the role of offshore jurisdictions in Russia, by looking to the legal rationale for the use of offshore structures. It is only by looking at the actual use of offshore structures in practice, and the legal environment which gives rise to their use, that we can achieve an understanding of the purpose behind such structures. In order to understand the rationale behind the use of offshore structures, this paper will examine the ways in which the use of offshore jurisdictions arose as a response to certain deficiencies within the Russian legal system and the difficulties faced by Russian enterprises in accessing international finance. This paper will argue that offshore jurisdictions, such as the BVI, have been used as a platform to overcome legal inefficiencies in the Russian legal system and to manage legal risks in the face of an uncertain political and economic environment.

The rest of this paper is divided into three further sections which consider: (i) common narratives and popular misconceptions about the role of offshore jurisdictions in Russia; (ii) the historical and legal context to property rights in Russia; and (iii) the legal rationale for the use of offshore jurisdictions.

2. Common Narratives about the Role of Offshore Companies in Russia

Before looking at the legal rationale behind the use of offshore jurisdictions in Russia, it will be useful to examine the existing literature in this area in order to understand the popular narratives and misconceptions which frame analysis on this topic. This is important given that most studies in this field assume that

offshore structures are either used for the round-tripping of funds or for laundering the proceeds of corruption. It is notable that the studies in this area do not address the legal rationale for the use of offshore structures. As a result, the exclusion of legal issues from this discourse creates an imbalanced and incomplete picture of this topic. Therefore, before looking at the legal context, any discussion of this topic must first consider and address these popular narratives.

2.1. Round-Tripping Claims

The most common argument made about offshore jurisdictions is that they are used to facilitate the round-tripping of funds. Round-tripping is essentially a process whereby funds are moved overseas and then re-routed into Russia through the use of offshore vehicles, which thereby mask the original source of the funds. The traditional rationale given for round-tripping is that, by disguising Russian sourced capital as 'foreign' through the use of an offshore company, the Russian investor will have access to tax or regulatory benefits that are usually reserved for foreign investors.

The round-tripping thesis is commonly held by observers of Russian FDI patterns, although the assumptions underlying this theory are often undeveloped. For instance, one study states that 'according to data from the Bank of Russia, Bermuda, the British Virgin Islands and Cyprus were the three largest sources of FDI in Russia as of 2010. This reflects the importance of round-tripping Russian investments via tax-haven destinations.' However, no source is provided for the claim that offshore FDI statistics reflect the importance of round-tripping, nor is this point elaborated further. It is simply accepted as fact. This is unfortunately a common problem in this area of study, as many observers adopt the same approach and take the round-tripping argument as orthodoxy, without support or considered analysis.

A further problem with this approach is that the round-tripping thesis may not be an appropriate tool with which to understand Russian FDI patterns. For example, the round-tripping argument is generally founded on studies concerning the People's Republic of China [hereinafter PRC] where it is commonly argued that PRC investors route funds through offshore companies in order to gain foreign investment benefits. However, Russia has not given preferential tax and regulatory treatment to foreign investors in the same way as the PRC, so some caution is required in relying upon such theories when considering the Russian investment environment. This concern has been expressed by some observers, with one paper noting that, in contrast to the investment environment in the PRC,

[Russian] state policy towards inward FDI has been less supportive or even restrictive. Moreover, in many Russian regions the regional authorities have erected barriers to foreign investors to protect incumbent firms from outside competition than provided incentives for foreign investors. Hence the financial incentives granted to foreign investors are hardly a key explanatory factor for round-tripping behaviour.

Not only is it unsuitable to apply concepts of round-tripping as they relate to the PRC to the Russian experience, but it may also be inappropriate to overstate this concept at all. For instance, the theory rests upon the assumption that the money being routed through offshore centres is Russian money being repatriated through offshore channels. However, this fails to account for the fact that other jurisdictions use the BVI to structure their financial transactions as well as to effect investment into Russia. For instance, a report by the Carnegie Moscow Centre noted that 'Chinese companies often invest abroad through the British Virgin Islands. The investment from the British Virgin Islands is quite substantial in the post Soviet space including Russia. It can be assumed that part of these investments in fact come from China.'

Additionally, it should be noted that other studies have examined the use of offshore jurisdictions (particularly in the Chinese context) and observed that round-tripping is not a significant or sole explanation for the use of offshore structures in FDI patterns. Instead, it has been observed that '[t]ax minimisation through the Caribbean offshore thus seems to be less a motivating factor than property rights, investment seeking and institutional arbitrage.' These other factors are important to bear in mind because offshore jurisdictions perform other roles than tax structuring. As Vlcek notes, '[t]he common portrayal of the [offshore jurisdiction] today as a tropical island "tax haven" fails to acknowledge that it provides other forms of regulatory arbitrage beyond taxation. It may be the home to mutual (hedge) funds, captive insurance and re-insurance firms, trust companies, and shipping registries, as well as an international business company (IBC) registry.' As a result, consideration needs to be given to other factors rather than relying upon undeveloped notions of round-tripping. It will be seen later in this paper that these same motivating factors of property rights, investment seeking and institutional arbitrage, apply equally in the Russian context.

2.2. Corruption Claims

Aside from the round-tripping argument, another common assumption that underlines many studies is that offshore structures are used in Russia for the purposes of laundering the proceeds of corruption.

A number of papers approach this topic through the lens of criminality and assume, as their starting point, that offshore companies are used by Russian investors for corrupt purposes. A good example of this perspective can be seen in a paper by Ledyeva, Karhunen, Kosonen and Whalley, who assert that the drivers for the use of offshore jurisdictions in Russian capital outflows 'mainly include tax avoidance / evasion, laundering the proceeds of corruption and securing the secrecy of an investor's identity from Russia's corrupt and autocratic authorities.' These are strong charges, and the crucial point to note is that, after making sweeping claims as to the nature of offshore transactions, no source or authority is provided for such assertions. Instead, these claims are posited as an assumed starting point for analysis, on which

the research is based, rather than a conclusion reached through neutral research and, consequently, no attempts are made to analyse and test these assumptions.

Similarly, Ledyeva, Karhune, Kosonen and Whalley assert that given 'the persistently high-level of corruption in Russia, it is reasonable to suggest that corrupt public officials in Russia utilize round-trip schemes via offshore centres for laundering the proceeds of corruption.' Again, no specific source, authority or foundation is provided for such claims. This approach is therefore troubling, as it operates to ascribe a character of criminality to offshore jurisdictions by association rather than through fact, and is based upon supposition rather than analysis. Without hard facts, it is not 'reasonable to suggest' that offshore structures are used for the purposes of laundering the proceeds of corruption. Suggestion is not a sufficient ground on which to conduct analysis or perpetuate myths.

If serious claims are going to be made about the nature and role of offshore jurisdictions, they need to be supported by fact and reasoned analysis. The question then arises as to how, if these types of assertions are accepted, we can test and verify such claims.

One answer is to look to the courts as a source of fact. If offshore structures are used, as some authors suggest, for the purpose of laundering the proceeds of corruption, then these structures, and any claims or evidence of impropriety in respect of such structures, will ultimately come before the courts. As a result, the courts would also provide a key source of factual evidence to support such assertions. If these assertions are correct, then one would expect to see a significant number of court judgments concerning allegations of corruption and criminality.

In order to test these theories, research was conducted on all the judgments available at the Eastern Caribbean Supreme Court, where such judgments were made by the BVI courts and either concerned Russian parties or related Russian business or assets. The BVI was used as a sample jurisdiction given that it is the leading offshore jurisdiction within Russia in terms of FDI flows. In addition, the BVI has a robust legal system and a dedicated commercial court, ensuring that there would be a wide and easily available selection of judgments to review.

This research found that there were 41 relevant judgments concerning Russian parties or enterprises located in Russia. Of these judgments, there were 7 cases in which fraudulent, dishonest or unlawful conduct was alleged, amounting to 17% of all judgments. Of these 7 cases, there were no judgments in which fraudulent, dishonest or unlawful conduct was proven to the satisfaction of the court. What this research clearly shows is that corruption is not a significant issue before the courts in terms of the use of offshore structures in Russia, given that only 17% of cases alleged such issues and that in no case was any allegation of fraudulent, dishonest or unlawful conduct proven. Based on this review of BVI cases, there is simply no grounding in proven fact or law to justify the corruption allegations raised by some academics and journalists.

The question then arises as to why some authors persist in ascribing notions of criminality to offshore structures in Russia, when there is clearly a lack of analysis underlying such assumptions and an absence of factual grounds to support these assertions. It would tend to suggest that some of the existing studies and journalistic reporting on this topic are unsound. It would also suggest that many studies may be tainted by an inherent bias on the part of the observer.

The question of bias is important, as the fact that these claims are made on the basis of assertion rather than supported fact suggests that common perceptions on the use of offshore structures in Russia is informed by value judgments. In a sense, it can be seen that many observers of Russian business operate with innate or unconscious anti-Russian bias, where it is assumed (rather than established) that Russian commercial practices must necessarily involve corruption. This bias therefore infects popular perceptions towards the use of offshore structures in Russia as, given the lack of understanding of the legal and commercial rationale behind the use of such structures, an assumption is made that their use must simply be a product of nefarious intent.

It can be seen that this anti-Russian bias has a long history and arises frequently where Russian business practices are involved. To take one example, this bias could be seen in relation to the failed bid by the Russian company *Severstal* for *Arcelor* where *The Wall Street Journal* reported that there was a 'mounting frustration in Moscow at a perceived anti-Russian bias in European business' and *The New York Times* similarly reported that 'many Western investors still look at Russia in "comic book terms, as mysterious and mafia-run"'. Given the narratives concerning the use of offshore jurisdictions in Russian FDI, it would appear that this comic book characterisation also extends into journalism and academic analysis. This frustration is shared by some contemporary observers of Russian FDI. For instance, one paper notes that there were problems with creating 'a positive and attractive image of Russian business abroad [due to] the extendedly created politicised typologies of Russian multinationals' and another paper observed that Russian investors face 'a strong degree of suspicion in most parts of Eastern Europe and in the developed world . . . [even though] Russian investors have frequently transformed bankrupt enterprises into thriving companies and are regarded as effective owners and employers.'

Aside from questions of bias, many studies also exhibit a lack of understanding as to the nature of offshore transactions. For example, many studies fail to address the legal rationale for the use of offshore jurisdictions, despite the fact that offshore structures are created in a legal context (given that offshore companies are creatures of law, created for legal purposes and governed by legal rules). This is an important consideration and, again, an examination of the BVI court judgments gives insight as to the real concerns surrounding offshore structures. An analysis of the court judgments relating to Russia reveals that, rather than criminal enterprise, the main concerns before the courts related to property rights, shareholder disputes and

questions of corporate governance. The types of structures under consideration were joint ventures, holding companies and investment vehicles. In most cases, these were ordinary commercial disputes concerning normal business activities and standard types of investment structures that one would expect to see in a normal and mature legal environment.

The rest of this paper will therefore dispense with the bias and unreliability of common narratives about offshore jurisdictions and instead show how a legal analysis is essential to understanding the role that offshore structures have played, by looking at aspects of the Russian legal system that gave rise to the demand for offshore vehicles and aspects of offshore jurisdictions that made them suitable for use by Russian investors. The Paper will explore how the need for legal certainty has been a key driver of the use of offshore jurisdictions, which has been an issue of key importance given historical deficiencies and uncertainties in Russia's legal and financial infrastructure.

3. The Historical and Legal Context to Property Rights in Russia

In order to understand the circumstances which gave rise to the need to use offshore platforms to structure financial transactions, it is essential to look at the legal context to Russian property rights. By looking at the Russian legal system, it will be possible to have a clearer idea as to what issues created the demand for offshore jurisdictions, and what problems were addressed by the use of offshore vehicles. In order to understand the Russian legal system, it will be useful to consider its recent development.

Following the collapse of the Soviet Union in the early 1990⁵, Russian society underwent a number of changes, which included periods of political and economic instability. Further changes arose in the legal sphere with the development of a new code of law, reflecting the change from a socialist-based economy to a free-market oriented society. These changes had an impact on the investment climate as investors were concerned about uncertain legal protections, unclear property rights, and the threat of expropriation of their assets.

Given the changes in Russian society, new corporate laws were enacted to reflect the development of the new market based model. The changes in Russian law and society 'led to many quick codifications of relatively new concepts. The earliest laws following the collapse reflect this haste.' The swift enactment of new legislation was described as having created 'a conflicted body of corporate law that can often prove unpredictable for entrepreneurs and legal counsel alike, particularly where foreign investment is concerned.'

These changes in Russian corporate law also impacted on investors attitudes towards FDI into Russia, with Karhunen and Ledyeva observing that

a key institution affecting FDI is the legal framework, which includes the legislative system as formal institution and law enforcement as informal institution. The unpredictability and arbitrariness of legislative changes combined with the lack of transparency in law enforcement is one of the key challenges faced by investors in Russia.

Not only did the new legal framework prove unpredictable to investors, there was also uncertainty as to how such laws would be implemented and enforced. This was a legitimate concern for investors, given that Russia had an inexperienced judiciary who were unfamiliar with the new laws and uncertain how to apply them. As Kuzmina observed, although

such countries as the U.S. had a long history of courts regulating the issues of reasonableness of defensive actions in takeovers, fiduciary duties, conflict of interest, Russian lawyers and judges had virtually no practical experience in corporate disputes as private business did not exist as a notion during the Soviet era.

These concerns were also raised by the OECD, which noted that '[t]he main problems are limited experience in interpretation of the law and a lack of guidelines from higher judicial authorities, which could reduce incoherent decisions by lower courts.' As a result, investors were uncertain as to the scope and effect of the new laws and as to their treatment and interpretation by the courts.

Additionally, investors were unclear whether their new rights were actually capable of enforcement. For instance, Dzarasov noted that '[t]he new laws contained some clauses which in theory protect the rights of minority shareholders' such as the rights to take part in meetings, access to information, demand repurchase of shares and initiate civil action against the company, but

[i]n the early 1990⁵, many of these rights in Russia were purely theoretical, because it was impossible to enforce them through the court or by other legal means . . . [for] in Russia, the most pressing problem is not quality of legislation but its practical enforcement. When abused by insiders, shareholders are usually passive and do not try to secure their rights in court . . . For most judicial disputes, the party with greater administrative and financial resources appears to be favoured.

Given the general unavailability of formal legal enforcement, Russian investors often had to rely on informal and extra-judicial enforcement mechanisms when doing business in Russia. For instance, Dzarasov suggested that due to the lack of regulatory enforcement, it was common to have business networks based on family

and clan relationships where '[e]nforcement of contracts were secured by the mutual trust of family relatives . . . [or] by coercion on the part of clans.' However, this was clearly an imperfect means of enforcement and remained the privilege of certain social groups, given that this form of enforcement relied on contact networks and informal relationships rather than standardised and universal codes.

As a result, investing in Russia was not without risk, given the uncertainty of the new laws and the problems of enforcing them. Investors therefore sought legal certainty and the solution could be found offshore. As some observers noted:

In the case of emerging economies, such components of poor institutional environment as corruption, regulatory uncertainty, underdeveloped intellectual property rights protection and governmental interference are commonplace. [Overseas foreign direct investment] to a location with more supportive institutions would provide means to escape those institutional constraints.

Offshore jurisdictions, such as the BVI, could provide these more supportive institutions and were therefore chosen as a platform to mitigate the risks inherent in the Russian legal system. Taking the BVI as an example, there were a number of attributes that made it a suitable venue in which to relocate Russian enterprise. For instance, the BVI is a British Overseas Territory, being a self governing dependency of the United Kingdom, and therefore politically stable. It is a common law jurisdiction, based on English law, whose ultimate court of appeal is to the Privy Council in London. The jurisdiction is noted for the quality of its commercial law and the territory has a dedicated commercial court. Additionally, it offered a zero tax, regulatory light platform with flexible corporate legislation.

The importance of this legal flexibility for Russian investors can be seen in three key ways. Firstly, the BVI could offer a neutral third party jurisdiction with a mature and predictable body of law, thereby ensuring legal certainty in terms of rights and the enforcement of such rights. Secondly, the absence of cumbersome regulation in the BVI ensured that corporate vehicles could be operated with the maximum of flexibility. As a result, the BVI offered a commercial environment which was more permissive than in other jurisdictions, it being observed that the advantages of the BVI was that it generally follows 'the UK legal system for corporate law but [is] not under the FSA or EU regulations.' Thirdly, the availability of common law rights and remedies provided numerous benefits to Russian investors, as this would (as will be examined further in the following section) allow Russian enterprise to rely on Western principles of corporate governance and to structure joint ventures and co-investment in ways that would not be possible under Russian civil law.

As a result, it was for legal reasons, rather than questions of round-tripping or criminal intent, that led to the use of offshore jurisdictions to structure Russian investment.

As Kuzmina notes, 'investors, not satisfied with the rules of Russian corporate law, started searching for a new market for law which eventually resulted in jurisdictional competition between Russia and, not surprisingly, offshore zones.' The next section will consider, in more detail, some of the specific deficiencies in Russian law that encouraged the move offshore, and the various ways in which offshore jurisdictions would provide solutions to such deficiencies in the Russian legal system.

4. The Legal Rationale for Moving Offshore

As previously discussed, most offshore jurisdictions, are politically stable jurisdictions with established legal systems based on English common law. The BVI is the pre-eminent jurisdiction for the establishment of offshore companies, with over 482,000 active companies as of the first quarter of 2014, and is well regarded for its modern commercial law, which is based to a large extent on the Delaware Commercial Code. One of the key attributes of the BVI is the quality of its legal infrastructure, as the jurisdiction has a modern commercial court with particular expertise in shareholder disputes, which was noted by *The Economist* recently, where it was observed that the '[c]ourts in the British Virgin Islands hear a good share of all disputes involving international joint ventures.'

Given the many advantages of jurisdictions such as the BVI, it was a natural choice for Russian investors who sought a legally secure environment from which to conduct business, in distinction with the legal uncertainties inherent in Russia. In addition, an offshore jurisdiction, such as the BVI, would be chosen over other more mature jurisdictions because, aside from legal certainty, it could offer cost efficiencies and greater corporate flexibility than would be available in onshore legal environments.

Offshore jurisdictions were chosen by Russian investors in order to overcome a variety of legal and commercial uncertainties, but chief among these were the need to protect assets, access capital, and rely on common law principles of corporate governance and property rights. These specific concerns will be examined in more detail in the rest of this section.

4.1. Asset Protection

Offshore jurisdictions are often used to protect assets against the risk of seizure, whether from other business partners or from the government by locating ownership in a neutral and legally robust jurisdiction. They are also used to protect family assets from dissipation, such as in private wealth structures which provide succession planning solutions. Assets can be protected by using offshore jurisdictions in a number of ways, whether by locating a business enterprise outside of Russia, to avoid expropriation by the state, by establishing a joint venture in a neutral jurisdiction, to reduce the risk of misappropriation by business partners through utilising the

protections offered by a mature legal environment, or by establishing the private wealth structure offshore, to take advantage of the trusts laws available in common law jurisdictions. The rest of this Section 4.1 will consider why offshore jurisdictions were chosen to protect against political risk or to ensure the integrity of family wealth, whereas the question of joint ventures will be explored further in Sec. 4.3 below.

The question of political risk has always been a key concern for Russian investors. Following the collapse of the Soviet Union, there was uncertainty whether the new free market model would continue and whether private property rights would continue to be protected, and in the first decade of this century, there were fears over possible expropriation by the state following a number of high profile cases by the government against Russian businessmen. These factors, together with the continued uncertainty in the legal system, led one academic to conclude that ‘the main factor of the capital flight from Russia is “chronic multidimensional crisis of society, economy and state”’.

As a result of such political uncertainties, Russian investors turned to offshore jurisdictions in order to protect assets against political and legal risks by locating them offshore and ensuring that any dispute concerning ownership would have to occur offshore, under the protection of a neutral and mature legal system. By locating an enterprise offshore, the investor would gain the ‘ability to “manage institutional idiosyncrasies” including the ability to protect against the “grabbing hand” of government and opportunistic behaviour of local business partners.’ Therefore, by incorporating an enterprise in a jurisdiction like the BVI, a Russian investor would be able to rely on the established laws of the offshore jurisdiction to protect their property rights, rather than under the imperfect and undeveloped laws of Russia, and to rely on enforcement mechanisms provided by the offshore jurisdiction, rather than the informal family or clan enforcement system described by Dzarasov, or the uncertain protections offered by the Russian courts.

This rationale for the use of offshore companies is not only evidenced by the actual use of such companies, but also confirmed by the opinions of the Russian investors who utilised such structures. For instance, a recent article by the *Associated Press* noted that ‘[l]eading businessmen have said they would be willing to drop [incorporating offshore] only after Russia launches tangible reforms of the court system and law enforcement.’ Furthermore, one study noted that ‘[i]nterviews with many Russian entrepreneurs confirm the fact that at least partly capital outflows in 90^s was a trial to escape country risks, the indicator of rational behaviour of new owners.’ As a result, the use of offshore jurisdictions was a rational response to inefficiencies in the Russian political and economic system, and not simply, as some commentators would suggest, a case of round-tripping or the use of such structures for illicit purposes.

Aside from protecting against political and jurisdictional risk, offshore jurisdictions have also been used to protect and maintain assets in private wealth planning

structures. This form of asset protection has become increasingly important as the generation that built their fortunes following the collapse of the former Soviet Union now needs to consider how to maintain and protect that wealth. Offshore jurisdictions provide such solutions given that they allow for the establishment of trusts and foundations, which are commonly used in the West as structures for the preservation of wealth. In contrast, Russian law does not recognise the common law concept of the trust, which explains why offshore jurisdictions were frequently chosen to establish such structures. Trust structures involve a transfer of ownership in assets from a settlor to a trustee, who then holds the assets for the benefit of certain beneficiaries. The advantage of this approach is that they allow the settlor to transfer legal title to assets while allowing some control over the use of such assets and making provision for the future use and enjoyment of such assets. There are various reasons behind the use of trusts and foundations, although these frequently include the preservation of family wealth for future generations, to guard against the fragmentation of family business, to guard against the possibility of divorce, to allow for philanthropy, or to address concerns in relation to political instability and personal safety.

4.2. Access to Capital

Aside from being used to preserve assets, offshore jurisdictions are also used as a platform to access international capital. For instance, *The Economist* noted that investors are drawn to the BVI in particular, as they are 'attracted by the ease of raising funds, cheaper access to capital markets, speed of set-up and access to reliable courts.' Aside from these general advantages, Russian investors also sought to use overseas jurisdictions as a platform for capital raising, given that Russia had a number of structural issues which made raising finance difficult and often led to capital flight. Karhunen and Ledyeva identified a number of these issues, noting that in Russia '[t]he root causes of capital flight consist of an unsettled political environment, macroeconomic instability, a confiscatory tax system, an insolvent banking system, and weak protection of property rights.'

In contrast with the perceived problems with the Russian legal, financial and political landscape, offshore jurisdictions were seen as a stable and mature environment with which to access international finance. For example, in reviewing the rationale for using offshore jurisdictions in international trade, Gordon and Morriss noted:

[E]xpanding trade increases the need for access to deep capital markets and, crucially, to legal systems capable of handling complex business organization and contractual matters . . . to accommodate such needs, a legal system needs both a group of sophisticated decision makers and regulators capable of adding value without imposing excessive costs and a body of law

that allows transaction engineering to structure transactions to predictably accomplish clients' goals. Financial transactions may thus be structured to take advantage of such jurisdictions by legally locating crucial steps (e.g., issuing bonds) in them.

Given the low costs, legal stability and international recognition of offshore jurisdictions such as the BVI, there was a clear legal and commercial rationale for Russian entrepreneurs to locate their business in such jurisdictions. Indeed, even some of the more critical studies on the use of offshore jurisdictions in Russia admit that 'firms establish subsidiaries in such locations in order to enjoy more favourable institutional environment such as better functioning financial markets.'

As a result, Russian businesses began to use offshore jurisdictions to structure their operations and raise finance. As Koroliuk and Rudenko observed, 'very often such jurisdiction is used as staging bases for investment in third countries. For example, leading foreign assets holder, Russian oil and gas multinational "LUKOIL" exercises all its international projects for exploration and extraction of raw material through Limited Liability Company "LUKOIL Overseas Holding" registered in the British Virgin Islands.' In fact, a number of leading Russian enterprises have located their business in the BVI, including *TNK-BP* (which was a joint venture between *Rosneft* and *BP*) and *MTS* (Russia's leading mobile operator). Additionally, the Russian supermarket group *Lenta* is incorporated in the BVI and recently held an initial public offering on the London Stock Exchange, with a market capitalisation of \$4.3 billion at March 2014. It is therefore clear that offshore jurisdictions were integral to the financing strategies of international business structures and that the Russian enterprises using such jurisdictions included Russia's most prestigious and dynamic companies.

This desire to use offshore jurisdictions as a platform for raising international finance can also be seen in practice, with a good source of information contained within the court judgments of the Eastern Caribbean Supreme Court. For example, one BVI court judgment provided insight into the rationale behind choosing to incorporate a company in the BVI, describing how a witness

explained under cross-examination that when the volumes of [the Russian company's] coffee production started to grow, it became necessary to do business with western companies and finance these larger volumes. After the 1998 crisis the western companies refused to give credit to Russia. This was the reason why she decided to incorporate [the BVI company] she said, with the idea that this Company would assist in [the Russian company's] trading and importation of coffee from different parts of the world. [The BVI company] would act as intermediary between [the Russian company] and its coffee suppliers from outside of Russia. This would reduce costs and permit the respondents to better structure their coffee business operations.

Again, we see a need to incorporate in an offshore jurisdiction such as the BVI in order to escape the financial constraints within Russia (in this case occasioned by the 1998 financial crisis). Again, the rationale for doing so is to reduce costs, obtain access to international finance and to ensure the efficient structuring of the enterprise.

The Russian approach fits international patterns of investment through offshore jurisdictions, as Sutherland, Voss and Buckley noted a similar phenomenon in respect of the Chinese experience, observing that Chinese enterprises moved offshore in order 'to exploit offshore capital markets and superior institutional environments' because it is 'offshore jurisdictions alone that allow them to access capital markets and institutions unavailable to them.' We see this approach extend to Russia, with observers of the Russian experience noting that, by incorporating offshore, a Russian business could gain advantages over purely Russian enterprises as 'their access to resources such as foreign banking and financial expertise and managerial know how through the offshore investment puts them in a superior position towards purely domestic firms.'

4.3. Property Rights

Offshore jurisdictions have also been used by Russian investors to take advantage of the property rights available in offshore jurisdictions, in order to overcome specific deficiencies in Russian law. One area in which this can be seen is with joint ventures and shareholder agreements.

Joint ventures are frequently located in offshore jurisdictions as a means of protecting the joint venture from legal and financial risks. One way of achieving this is to ensure that the 'valuable assets of the joint venture might be owned by a legal entity that was bankruptcy-remote from either of the joint venturers.' A second way of protecting against legal risk 'is to choose the law and legal institutions of a jurisdiction other than the home jurisdictions of the contracting parties (to avoid potential bias).' A third way of protecting against risk is to incorporate a BVI joint venture vehicle above the Russian operating company in order to ensure that any sale can occur at the offshore level, thereby avoiding the financial and legal risks involved in a sale at the local level, given that 'the transfer of assets in Russia can be very difficult, mired in red-tap and bureaucracy and time consuming.' In each of these cases, offshore jurisdictions offered simple structural solutions to protect a joint venture against financial and jurisdictional risk. However, joint ventures and other forms of co-investment have also been structured offshore in order to negotiate specific problems arising under Russian law. These specific issues are commonly seen in relation to shareholder agreements.

In establishing joint-ventures or other forms of co-investment, shareholder agreements are an important and commonly used tool. Shareholder agreements commonly provide for a number of negotiated rights given to investors in a joint venture, which can include preferential rights as to voting, distributions or liquidation,

tailored corporate governance provisions, pre-emption rights on any further issue of shares, rights of first refusal on the sale of shares, dispute resolution mechanisms and governing law provisions. The advantages of such provisions are that they allow for differing economic and voting rights to be provided to different investors and provide mechanisms which assist with the effective corporate governance of a business.

However, shareholder agreements were not legally recognised in Russia by the government and the courts, save to the extent that such agreements were consistent with codified law. The problem arose that, up until 2009, Russian law did not recognise contractual provisions relating to share transfers, restrictions on the sale of shares, and tailored corporate governance provisions relating to voting and board appointments. This had the effect that shareholder agreements were void to the extent that they provided for such matters. This problem became pronounced in 2006, when a number of court rulings confirmed that shareholder agreements would be void where they ran counter to provisions of the Russian Civil Code and the Joint Stock Company Law, for example by including pre-emption rights and non-competition clauses. As a result, it was not possible to structure investment in Russia using standard common law shareholder protections, and this had an impact on the willingness of international investors to invest in Russia. It also made it difficult for Russian investors to rely on the sophisticated legal protections that were commonly available in common law jurisdictions.

Given that '[c]ontractual restrictions on transferring shares, "tag-along" and "drag-along" mechanisms, contractual regulation of voting procedures and board formation, and call options and put options were all considered illegal . . . institutional investors traditionally used offshore legal entities' where such provisions were recognised by the law and commonly used. As a result, it was common practice to incorporate the investment vehicle in an offshore jurisdiction, where shareholder agreements would be recognised and enforced, where the provisions of the shareholder agreement could be incorporated within the constitutional documents of the offshore vehicle, where shareholder remedies were available, and where the parties could rely upon the legal certainty provided by a neutral and mature common law jurisdiction.

The Russian government was, of course, aware of these deficiencies in Russian law and, in 2009, steps were taken to address this issue. An amendment to the Law on Joint Stock Companies was introduced which formally recognized the legality of shareholder agreements. However, the amendments were widely considered to be problematic as they 'failed to clarify whether choice-of-law-provisions that allowed for the application of another country's law were now available in shareholders' agreements.' Another issue was the perceived inflexibility of the 2009 amendments, which led one observer to comment:

Russian courts generally interpret codified corporate law as both mandatory and exhaustive. Given that the 2009 amendment sets out what shareholders'

agreements can and cannot include, much of the flexibility inherent to the instruments in other countries is lost, along with much of the value to foreign investors who wish to structure corporate relations in a familiar way.

As a result, and despite the 2009 amendments, there was still a need to incorporate a vehicle offshore and rely on shareholder agreements to structure the relationship between investors, where Russian law was silent or deficient. For instance, shareholder agreements could provide for issues that were not addressed by Russian law, such as shareholder deadlocks, and could provide for negotiated rights to appoint board directors. Whereas under Russian law the right to appoint directors was based on the level of ownership, rather than any negotiated individual rights. Additionally, many shareholders faced an inability to assert their rights under Russian corporate law as '[i]n many cases, foreign or minority investors were conspicuously excluded from voting arrangements, excluded from decisions regarding share dilution that disproportionately affected them, or saw their investments radically decline in value when the courts refused to protect invested assets.'

However, Russian law is not static and a number of further changes were made to the Russian Civil Code in the years since 2009, with the most recent amendments coming into force on November 1, 2013. The 2013 amendments attempted to resolve the foreign law issue by providing that as long as one party to a shareholders agreement is a foreign person, the agreement may be subject to foreign law. However, some observers have noted that issues still remain in using shareholder agreements in respect of a Russian enterprise. One paper noted that issues may continue to arise due to the fact that the agreement may not override mandatory rules (which are wider in Russia as opposed to common law jurisdictions), that a company cannot be party to a shareholder agreement under Russian law, and that the law does not extend to purely Russian co-investments, in light of which the authors 'do not see an immediate change to the tendency to structure Russian joint investments offshore.'

As a result, and despite the changing Russian legal landscape, there continue to be issues in using shareholder agreements under Russian law, particularly given the rigidity of corporate law in Russia which has frequently led to the view that with 'the lack of incentives to attempt structuring a shareholders' agreement under Russian law, and the benefits available to those who establish an offshore holding company, [the incorporation of an offshore vehicle] is the most prudent' approach.

5. Conclusion

The preceding analysis illustrates that when consideration is given to the legal and economic context in which the need for offshore companies has arisen, the reasons for their popularity become clear. When close attention is paid to the function and

employment of offshore companies in practice, the rationale for their use becomes apparent. In each case, it is clear that the legal rationale has been a dominant motivating factor for the use of offshore jurisdictions by Russian investors.

It can therefore be seen that, contrary to the popular myths that offshore jurisdictions are used for the purposes of round-tripping or laundering the proceeds of corruption, they are actually used in practice to negotiate inefficiencies in the Russian legal system. In cases where offshore companies have been used, they have been employed in order to provide practical solutions to technical legal issues. This usage is confirmed by practice, by theory and by context. This usage is also supported by a close reading of the court judgments relating to the use of such vehicles.

What the incidences of such usage tell us is that offshore companies are used as an efficient means of managing legal risk. Offshore jurisdictions have enabled investors to manage risk by allowing Russian investors to protect their assets from governments or unscrupulous business partners, to obtain access to finance in an uncertain economic environment, and to rely upon certain and well defined property rights and legal protections when co-investing with others. Offshore centres are used because it is economically efficient and commercially practical to make use of such jurisdictions, given that the use of common law standards enable investors to structure deals to allow for efficient profit sharing and risk mitigation.

References

Berezkina, Evgeniya. *Recent Developments in Russian Corporate Legislation: Will New Norms Secure the Future for Shareholders Agreements?*, 16 *The Columbia Journal of European Law Online* 31 (2009), available at <<http://www.cjel.net/wp-content/uploads/2010/02/Berezkina.pdf>> (accessed May 18, 2015).

Chazan, Guy, et al. *Moscow Claims Anti-Russian Bias Led Arcelor to Accept Mittal Bid*, *The Wall Street Journal* (Jun. 27, 2006), <<http://online.wsj.com/news/articles/SB115137274678291456>> (accessed May 18, 2015).

Dzarasov, Ruslan. *The Conundrum of Russian Capitalism: The Post-Soviet Economy in the World System* (Pluto Press 2013).

Glossary of Statistical Terms, Organisation for Economic Co-operation and Development (Jan. 4, 2006), <<https://stats.oecd.org/glossary/detail.asp?ID=5988>> (accessed May 18, 2015).

Gordon, Richard, & Morriss, Andrew. *Moving Money: International Financial Flows, Taxes, & Money Laundering*, 37(1) *Hastings Int'l & Comp. L. Rev.* (2014), available at <http://papers.ssrn.com/abstract_id=2348144> (accessed May 18, 2015).

Koroliuk, Timur D., & Rudenko, Dmitry Y. *Russian Multinationals FDI Outflows Geography: The Emerging Dominance of Greater Europe*, 67(1–2) *European Researcher: International Multidisciplinary Journal* (2014), available at <<http://oaji.net/articles/2014/1-1391657820.pdf>> (accessed May 18, 2015).

Kuzmina, Maria. *Jurisdictional Competition in a Developing Economy: Law and Policy Issues of the Offshore Structure Use in Russia*, Ill. Bus. L.J. (Nov. 30, 2009), <<http://www.law.illinois.edu/bljournal/post/2009/11/30/Jurisdictional-Competition-in-a-Developing-Economy-Law-and-Policy-Issues-of-the-Offshore-Structure-Use-in-Russia>> (accessed May 18, 2015).

Ledyeva, Svetlana, et al. *Foreign Investment from Offshore Jurisdictions into Russia: An Analytical Overview*, 2013(140) Russian Analytical Digest, available at <<http://www.css.ethz.ch/publications/pdfs/RAD-140-2-6.pdf>> (accessed May 18, 2015).

Nietzsche, Friedrich. *Beyond Good and Evil* (Oxford University Press 2008).

Pulec, Karina L. *Legal Restraints on the Use of Shareholders' Agreements for Structuring Foreign Investment Deals in Russia*, 45(2) Cornell Int'l L.J. (2012), available at <<http://scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=1795&context=cilj>> (accessed May 18, 2015).

Said, Edward W. *Orientalism* (Vintage Books 1978).

Schneider, Richard C., Jr. *Developments in Soviet Property Law*, 13(4) Fordham Int'l L.J. (1989), available at <<http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=1248&context=ilj>> (accessed May 18, 2015).

Vlcek, William. *Byways and Highways of Direct Investment: China and the Offshore World*, 39(4) Journal of Current Chinese Affairs (2010), available at <<http://journals.sub.uni-hamburg.de/giga/jcca/article/viewFile/359/357>> (accessed May 18, 2015).

Wilson, Kristian. *Seeking Truth from Fact: Rationale and Use of Offshore Jurisdictions in the PRC*, 6 Tsinghua China Law Review 205 (2014), available at <<http://www.bedellgroup.com/siteFiles/resources/docs/insights/Articles/2014/KristianWilson-Spring2014.pdf>> (accessed May 18, 2015).

Information about the author

Kristian Wilson (Singapore) – Senior Associate at *Bedell Cristin* Law Firm (Level 25, North Tower, One Raffles Quay, 048583, Singapore; email: kristian.wilson@bedellgroup.com).