Challenging the Competence of Arbitration Courts by Parties to M&A Transactions in the Russian Federation*

*Yuri E. Monastyrsky***

Introduction

Dear Participants,

Providing legal advice on mergers and acquisitions is the most profitable aspect of provision of legal services, and is of particular importance for clients. It is rightly noted that the most complex legal matters dictate the use of flexible legal structures which were first evaluated by lawyers with close professional links to representatives of the financial worlds of London, New York, Hong Kong and Singapore and by legal advisers from the USA and Great Britain who were working under English Law and the laws of certain American states.

Our Russian law was more-or-less able to regulate these complex operations for the sale of material and intellectual assets of a business – an "enterprise". However, it is generally acknowledged that over 15 years this subject of civil rights has only been in demand to a negligible extent. In accordance with the Concept for the Development of Civil Legislation, the enterprise, as an object or property, will cease to be a legal category. The inclusion of "business", or (for whom this term is unattractive, which has been brought into use everywhere apart from civil law) "undertaking", which was formerly known as "household", the separation of which was caused by the manufacture of a single product, being the material result of goods or services, would be very useful for our legal system and jurisprudence. But it has not happened yet, and this sphere of relations, which has an economic effect in Russia, is governed by English law.

For the sake of fairness it must be noted that it is not only because the business structure is not provided for by RF civil law as a whole that M&A transactions are usually constructed subject to English law. There is an independent and important significance to optimising structures/operations so that transfer of rights is carried out by transfer of relevant shares

---

* 1st Russian and CIS Mergers and Acquisitions Conference of the International Bar Association. Session 6 "Post-acquisition litigation", Moscow, November 19, 2009.

** Yuri E. Monastyrsky – partner of the law firm «Monastyrsky, Zyuba, Stepanov & Partners». www.mzs.ru.

not to a Russian company, but to offshore companies because of considerations of tax efficiency and preservation of commercial secrets. And for as long as it is permissible to use companies in tax havens no rational variations to this model will emerge.

And for the same period M&A transactions will be purely an exotic for Russian law and science, which is reinforced by the Russian translation, 'Junction and Uptake.' I would like to draw your attention to the conjunction 'and' in the phrase 'Junction and Uptake' as if the aim of this well known transaction is either simultaneous junction and uptake, or a junction followed up by uptake. Allow me to point out that neither the first nor the second is possible. In Russian law this is a type of reorganisation of legal entities with mutual or single termination of juridical personality, an organisational procedure of the same kind as incorporation or winding-up of a company and not a civil law transaction.

It is not difficult to see that should the English notion "merger & acquisition" be subject to a translation of the relevant concepts, then it would be rendered as "engagement and purchase". "Merger" also has the sense of transformation and combination. This sounds unusual, but all the same it is correct. We are faced with a terminological oddity, and it is unlikely that anything will happen in either Russian or civil legislation until this nomenclature is corrected, since the fundamental concepts inherent in the civil law context - is the basis of regulation. And for as long as M&A transactions in terms of provision and operation of a given legal structure are in the hands of non-Russian advisers, large English and American firms and their foreign offices, disputes over such transactions will be submitted for resolution to those international arbitration courts which have long and extensive experience of working with these legal products. Specialists in Russian law usually complete the due diligence of a given business, but its regulatory influence is manifest not only in the evaluation of assets, but also in the use of rules which express the public (that is general) interest, and not only the rules of competition law but other mandatory rules as well. In certain diverse situations parties to M&A may effectively protect the public good by challenging in the RF the competence of the chosen tribunals, and I would like now to discuss this matter in more detail.

Under certain circumstances a foreign entity which is a party to a transaction may file a claim in the courts against the other party (likewise a non-Russian organisation) where it is able to show, firstly, that the court has jurisdiction to hear the dispute, and secondly, that the relevant arbitration

clause has no effect of derogation which excludes the competence of the courts, the possibility of which, as discussions show, is often not analysed.

The Competence of the Russian Courts

The state courts, when hearing cases under the rules of international jurisdiction prescribed in the Commercial Procedure Code, will accept claims against foreign defendants where the claim relates to a contract to be performed within the Russian Federation (article 247.1.3 of the RF CPC). We assert that whatever organisational structure may exist over Russian assets in the form of subsequent holding of shares in a Russian subsidiary company on whose balance sheet they are recorded, the transfer of control always indicates performance of a contract within the Russian Federation.

Having elected foreign arbitration for the resolution of future disputes, the parties deprive the Russian courts of control functions since pursuant to the provisions of international conventions, an arbitration award may only be set aside by the courts in the place where the arbitration proceedings were held. At the same time, it will not be without interest to those present today to learn that in addition to refusing the recognition and enforcement of foreign arbitration awards on specific incorporeal grounds within the Russian Federation, when a case is lost and the chances of protecting the rights of a party to a M&A transaction in Russia are limited to an exhaustive list of breaches of arbitration procedure, and an award may be enforced in other countries, there are other means of legal protection which may be effected by filing a claim with the Russian state courts, where substantive arguments may be advanced, depending on the legal position.

There are two circumstances under which it will be prudent to submit claims to the Russian state courts: the decision of a Russian court may be successfully enforced against the other party, and the relevant arbitration clause has no legal force. It must be kept in mind that in the Russian Federation, a court which accepts a claim for hearing as regards invalidity or failure in conclusion of a main contract, is not entitled by its own initiative to send the parties to arbitration, but is bound, provided that the defendant has been duly notified, to attend court and makes submissions on the merits plus disregards the arbitration procedure, which might begin later. However, where such procedure has already commenced, the hearing of a dispute on the same grounds and subject matter is impossible in view of article 148.1 of the RF CPC (*lis pendens*).

Even so, as we are aware, in serious disputes it is rare that a defendant, for whom arbitration is more convenient, would fail to take advantage of an arbitration clause and fail to make application that the action be stayed pursuant to article 148.6. In deciding whether to grant such application by a defendant, a Russian court will be guided not only by the CPC but also the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards (1958) and the European Convention on International Commercial Arbitration (Geneva 1961), which give different prescriptions for resolving the question of whether an arbitration clause in a given case should lead to excluding the jurisdiction of the state courts to hear such a case. The Geneva Convention is applied in preference to the New York Convention, but only where the arbitration proceedings have already been started, the parties are within states which are signatories, and the dispute arises out of a foreign trade transaction in the broadest sense of that phrase. Does an M&A transaction fall within foreign trade? This is a question which the Russian courts are yet to resolve. Also, whether a foreign trade transaction should include transfer of property (that is, goods) across the state customs border, remains unclear. However, if disposal of shares and other types of performance under an M&A transaction are declared to be foreign trade, then the courts will stay an action until the award of the foreign arbitration court has been made, but if, nonetheless, they have adequate grounds to consider that the arbitration clause is invalid or unenforceable, then pursuant to article VI.2. a, b of the Geneva Convention, it will have to decide, under the relevant foreign law, the place for arbitration (*lex arbitri*). An interim award of an arbitration court as to its own competence may create a *res judicata*, if the same grounds as have been lodged in the state court are considered.

However, the Geneva Convention, which restricts the possibility of challenging an arbitration clause in state courts, is inapplicable not only in the situations where arbitration proceedings have not yet begun and the dispute has not arisen out of foreign trade, but also where the parties are not from countries signatory to the Convention. The United States and Great Britain, for example, are not signatories to that convention, and if organisations from those countries are involved in a dispute the corresponding rules should not apply.

The New York Convention is universal, and its applicability depends on the venue of the hearing, and not on the countries to which its participants belong. The court has greater ability to conclude that an arbitration

clause is not binding, since in the court's opinion, it may be void, without effect, or inoperative, and clarification of the meaning of this provision must proceed on a total analysis of the texts in all languages of the United Nations, in accordance with article 33.4 of the Vienna Convention on the Law of Treaties, and not only on the Russian text. The difference is clear from the slide, and in practical terms it is substantial because in foreign languages instead of "termination" there is a subjective unenforceability of the clause, an inability to enforce it not because of absence of arbitration courts, but because of difficulties for the parties. The Russian courts should be guided by the sense prevailing in all the languages and have regard to this subjective impossibility.

In principle, it is established in the New York Convention that an application may be made as to invalidity or lack of legal effect of an arbitration clause. However, such means of legal remedy cannot be regarded as optimal. Firstly, in the standard model of structuring of transactions where shares in a foreign company are bought and sold by two non-Russian organisations, the court may declare itself incompetent due to lack of jurisdiction. An arbitration clause is not performed in Russia, and there is no element in relation to the parties which could connect the situation with the Russian Federation. Secondly, the court's finding does not raise *res judicata* for a foreign arbitration court, which may begin the case and make an award which is enforceable in all countries which are signatories of the New York Convention, while the claim that a M&A transaction is inconsistent with Russian law should undoubtedly be taken into consideration if not as *res judicata*, then as information as to the necessity of including it in the analysis of mandatory rules of Russian law applied by the Russian courts.

In our opinion, arbitrators should not be disrespectful of parallel proceedings being heard in another jurisdiction, unless they have a destructive urge to monopolise the dispute resolution functions. International contracts signed within the Russian Federation give significant advantages and preferences to arbitration: they are not bound by the principle *lis alibi pendens*, a simplified notification, the right to be broadly guided by practices and a conflict of laws system which they consider necessary, and the legislation of the country where the case is heard is not binding. Even so, it is surprising when arbitrators regard parallel court hearings not only with intolerance but even with hostility. Well known arbitration courts in Great Britain and Switzerland have developed the practice of prohibition of filing of claims and continuing proceedings (the anti-suit injunction). In one dispute an order

was received by a party to the case, its managers at the office address, and its representatives at their home addresses indicated in the powers of attorney, and personally by the judges hearing the case at first instance. In reply all the parties to the case received a summons from the judicial authorities to attend proceedings in Russia, and were bound to answer to it.

Arbitrability in M&A Disputes

There is a legal description of claims arising out of M&A transactions which even makes it necessary to hear such claims in the Russian state courts, and not by arbitration. This description neither depends on applicable law, nor on the validity or enforceability of an arbitration clause, not even on the legal capacity the parties to sign an arbitration agreement, and relates not so much to the contract or part thereof (an arbitration clause), its unenforceability, but to the dispute per se, which because of the great importance of the public element may be declared not arbitrable even irrespective of whether the arbitration procedure has been started.

In the broadest sense, not being subject to arbitration, as follows from the semantic of this English phrase, is the inability of an arbitration court to resolve a dispute or hear a claim. The criteria for non-arbitrability are themselves quite often disputed. Members of the Russian arbitration community, which is not as numerous or as active as in the West, but which consistently champions the ideology of arbitration, say that the criterion should be the nature of legal relations between the parties; that even if the dispute relates to rights over a forest or waterway, and the claims are property claims, then the matter should be subject to arbitration. According to other experts, a more correct view is to be found not in the legal relations, but in the rules of law which fall to be applied to a given dispute. The provisions of anti-monopoly, environmental and other administrative laws not only can be, but should be, applied by the courts in commercial cases. If it is left to the discretion of an arbitration court, a claim in breach of numerous important public RF standards will be completed, evading the mandatory regulation of the Russian Federation.