

Insight

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Special Alert

In a special alert circulated in April this year, we provided an overview of a ruling of the Supreme Commercial Court of the Russian Federation ("SCC") dated 9 January 2013 No. 14828/12 on case No. A40-82045/11 (the "Ruling") and its review by the SCC Presidium on 26 March 2013. On 26 July 2013, the full text of the SCC Presidium's resolution on this case (the "Resolution") was published on the SCC website. In this alert, we will inform you about the legal positions adopted by the SCC Presidium in relation to disputes involving offshore companies, which were previously proposed in the Ruling and have been mirrored in the Resolution.

Approach to cases involving offshore companies

From the moment that the Resolution was published, the following may be deemed to be the established approach of the SCC:

- To prove that offshore companies are acting in good faith against third parties, such offshore companies must disclose information on their ultimate beneficial owners to the Russian courts,
- Facts established in a judgment of a Russian court may, under certain circumstances, have a res judicata effect on offshore companies affiliated with a party to the relevant case,
- It shall be treated as an abuse of legal rights for a party unwilling to voluntarily comply with a court order to establish an affiliated offshore company, aiming, *inter alia*, to initiate new court proceedings and submit new evidence, and
- The fact that an offshore company affiliated to a party unwilling to voluntarily comply with a court order has acquired the disputed assets shall be considered to be evidence of an acquisition in bad faith.

Such an approach to the consideration of court cases involving offshore companies indicates that the doctrine of "piercing the corporate veil" is gradually being developed in Russian law. It was first mentioned in a resolution of the SCC Presidium in the case of *Olimpia LLC v. Parex Bank JSC*¹.

The conclusions of the SCC Presidium on whether actions may be considered to have been performed in bad faith and to constitute an abuse of legal rights such as to enable the court to apply procedural sanctions, for example by imposing on the abusive party a duty to prove that no adverse consequences resulted from its actions, follow recent trends in Russian court practice².



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Facts of the case

We have provided the facts in detail in our alert of April this year.

To summarize, Russian entity TSJ Skakovaya 5 (“TSJ”) filed a lawsuit against offshore company Arteks Corporation (“Arteks”) to repossess non-residential premises (the “Premises”) registered to Arteks. TSJ filed this claim as it was unable to enforce a judgment (the “Judgment”) in its favor to transfer the legal title of the Premises from their previous owner KomEx LLC (“KomEx”) to it. That Judgment could not be enforced because KomEx had since sold the Premises to Arteks.

The courts of lower instance acknowledged Arteks’ title to the Premises, arguing that the findings made in the Judgment did not have a *res judicata* effect on Arteks since Arteks was not a party to the previous case. The courts decided that the respondent had a right to submit new evidence in its favor and eventually issued a new judgment dismissing TCJ’s lawsuit, based on that evidence.

Findings of the SCC Presidium

The SCC Presidium reversed the judgments of the lower courts. The case was remanded to the court of first instance for reconsideration.

Having concluded that Arteks’ acquisition of the disputed assets was gratuitous and that no consideration had been paid, the SCC Presidium could have avoided considering other aspects of the case, based on the principle of procedural economy. However the SCC Presidium did analyze other aspects of the case and came to the following legal conclusions which will be of great importance for dispute resolution in the future.

First of all, the SCC Presidium developed its legal view on *shifting the burden* of proof as to whether an offshore company has acted in good faith in its relations with third parties.

Under the Resolution, it is not illegal per se to register rights to immovable property located in Russia in favor of an offshore company. At the same time, such ownership of Russian assets should not be permitted to lead to an abuse of the rights and legal interests of third parties. To this end, if an offshore company is used to own assets, taking into account the special rules on the disclosure of information about its beneficial owners, the offshore company shall be the party who bears the burden of proof that it has acted in good faith in its relations with third parties.

Overall, this decision of the court to shift the burden of proof to the respondent follows recent trends in SCC practice. The measure shall be applied if the respondent abuses its procedural rights, in particular, when it fails to submit evidence which only it can provide and which is unavailable to the claimant³. This is exactly the case when an offshore company does not provide information on its structure and beneficial owners.

Secondly, the SCC Presidium developed its position regarding the *res judicata* effect of findings made in a judgment in respect of a person affiliated to the disputing party.

The respondent’s affiliation with the previous owner of the Premises and a respondent to the previously heard case, indirect evidence proving links between the persons representing Arteks and those representing KomEx at different times, and the abuse of third party rights owing to the offshore company’s failure to provide information on its beneficial owners led to the SCC’s perception that the sale of the Premises to the offshore company were potentially aimed at evading the rules on a *res judicata* effect and, thus, to extend the application of such rules to the offshore company.

A third notable conclusion of the SCC Presidium is its finding that there was a *bad faith acquisition* of property by the offshore company. The SCC Presidium emphasised that, in the context of this case, an assumption of the affiliation of the seller and the buyer of the Premises may be made by the courts on the basis of indirect evidence submitted by the claimant which had not been disproved by the respondent who was obliged to disclose its corporate structure and had failed to do so. In such a case, the offshore company purchasing the property may be found to have known about the title defects of the property it acquired which should have been known to the seller, and, may therefore be treated as a bad faith purchaser of the property.

In this case, the conclusion of the SCC Presidium on the courts’ shifting the burden of proof to the responding offshore company complies with the existing legal position⁴, whereby the burden of proof shifts where a petitioner submits certain evidence proving that relevant circumstances do or do not exist, the other party does not submit evidence to the contrary, and the petitioner may not, for objective reasons, submit further evidence.

Fourthly, the SCC Presidium made an important conclusion on the potential for *the abuse of rights through the incorporation of a legal entity*, if the incorporation of an offshore company is aimed at what is contradictory to a legitimate purpose of setting up a legal entity. In this case the SCC assumed that there could have been an abuse of legal rights by way of incorporation and the use of an entity to create factitious grounds to legitimize the title to the Premises and the defence raised. As a legal consequence of the finding that the actions of the persons controlling the offshore company were abusive, certain adverse ramifications may extend to the offshore company, such as the extension of the *res judicata* effect of previous judgments or a finding that it was a bad faith purchaser, as discussed above.

Significance of the case

Given the precedential effect of the SCC resolutions, as provided for in the Arbitrazh (Commercial) Procedure Code of the Russian Federation⁵, the Resolution will have significant legal consequences for similar cases, particularly in the context of combating abusive behavior in corporate relations and property disputes regarding title to assets involving offshore companies.

We believe that the conclusions envisaged by the Resolution will be predominantly applied in disputes which seek to invalidate interested-party transactions, recover damages from controlling persons and recognize title to assets.

At the same time, given the universal nature of the legal views established by the Resolution, as well as the possibility for parties to refer separately to any of the four findings of the SCC, we cannot exclude the possibility that the significance of the Resolution will go beyond these types of disputes.

Further steps for court practice

When considering this case, the SCC left the following matters untouched:

- The extent to which information on beneficial owners should be disclosed, given the possible existence of multiple levels of offshore structures;
- How to verify that the information disclosed by an offshore is complete and correct;
- Specification of the possible abusive and non-abusive purposes behind the incorporation and use of entities⁶; and
- Other legal consequences which may be imposed on an offshore company and its beneficial owners in the event that a court finds that there has been an abuse of legal rights, e.g., the liability of beneficial owners for an offshore company's debts or vice versa.

Future cases will need to develop the legal position in respect of these matters.

¹ Resolution of the SCC Presidium dated 24 April 2012 No. 16404/11 on case No. A40-21127/11-98-184.

² Please refer to the Resolution of the SCC Presidium dated 6 March 2012 No. 12505/11 on case No. A56-1486/2010 (*Doroga CJSC v. G.P. Semenenko* ("the *Kirovsky plant case*")).

³ Please refer to the Resolution of the SCC Presidium dated 6 March 2012 No. 12505/11 on case No. A56-1486/2010 (*Doroga CJSC v. G.P. Semenenko* ("the *Kirovsky plant case*")), the Resolution of the SCC Presidium dated 20 March 2012 No. 14989/11 on case No. A21-2060/2006 (*YunitPrestige LLC v. Uyut-Story LLC* and others ("the *System case*")).

⁴ This conclusion was made in Resolution of the SCC Presidium dated 29 January 2013 No.11524/12 on case No. A51-15943/2011 (*Bankruptcy receiver of Primorsky Neftegazovy Complex CJSC v. Egida LLC*).

⁵ Articles 170 (4(3)) and 311 (3(5)) of the Russian Arbitrazh (Commercial) Procedure Code.

⁶ In the context of developing a legitimacy criterion in relation to the purposes of a company's incorporation and activities, it is worth mentioning the Resolution of the SCC Presidium dated 9 April 2013 No. 15570/12 on case No. A60-40529/2011 (*Metallurgservice LLC v. Inter-District Inspection of the Federal Tax Service No. 26 for Sverdlovsk region*), in which the SCC confirmed that it is legitimate to use an entity and "separate business" in order to obtain a special tax regime.