



DIVESTING RUSSIAN INTERESTS ISSUES FOR COMPANIES

Louise Nash, Jeremy Wilson, Tom McGuire, David Lorello and William Lowery of Covington & Burling LLP discuss the challenges for companies in divesting their interests in Russia following Russia's invasion of Ukraine.

The consequences of Russia's invasion of Ukraine and the ensuing international sanctions against Russia are forcing multinational entities (MNEs) to make critical strategic decisions about their Russian operations that will inevitably have long-term consequences for their businesses. Many MNEs are feeling pressure from investors and regulators to limit or terminate their operations in Russia and the first half of 2022 bore witness to an unprecedented phenomenon, with many MNEs announcing that they would suspend or terminate business operations in the country. However, as this article explains, exiting Russia is not as straightforward as it may have seemed in February 2022 and many companies have struggled to fully abandon their presence in Russia.

INTERNATIONAL SANCTIONS

Russia has been subject to international sanctions since 2014, after Russia unlawfully

annexed Crimea and occupied parts of Eastern Ukraine. Following Russia's full-scale invasion of Ukraine in February 2022, many countries, including the US, the EU, the UK, Japan, Singapore, Australia and Ukraine, have imposed a wide range of additional sanctions restrictions against Russia, as well as Belarus, which has supported aspects of the Russian war effort (see *News brief "Russian sanctions: responding to a complex situation"*, www.practicallaw.com/w-035-3181).

These sanctions have the aim of:

- Isolating Russia from the global financial system.
- Reducing the profitability of Russia's industrial sectors.
- Decoupling Russia from the European economy.

- Curbing exports of high-tech products that might be used to support Russian military capabilities.

Extent of sanctions

Whether issued by the UK, the EU, the US or other jurisdictions, sanctions typically comprise a combination of measures targeting individual sanctioned persons or entities, as well as broader sanctions that restrict certain types of transactions with any person or entity in, or from, a given sanctioned jurisdiction (see box "*The impact of sanctions*").

The UK, EU and US sanctions regimes carry a broad extra-territorial scope and can apply, for example, to the worldwide conduct of persons of UK, EU member state or US nationality, or entities established under the laws of the UK, any EU member state or the US. Moreover, aspects of US sanctions, known conventionally as US secondary

The impact of sanctions

Following the introduction of international sanctions, direct trade between Russia and the jurisdictions that have imposed sanctions has dropped dramatically. For example, in January 2023, the UK Office for National Statistics reported that, by November 2022, UK imports of goods from Russia had decreased by 98.2% in comparison with the monthly average over the 12-month period up to February 2022, and UK exports to Russia decreased by 77.4% in the same period (www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/articles/theimpactofsanctionsonuktradewithrussia/november2022).

According to the European Commission, by March 2023, measures imposed by the EU had placed sanctions restrictions on the import of goods that accounted for more than €90 billion worth of imports from Russia into the EU in 2021; trade that represented 58% of the EU's imports from Russia in 2021 (https://eu-solidarity-ukraine.ec.europa.eu/eu-sanctions-against-russia-following-invasion-ukraine_en#trade-restrictive-measures-export-and-import-bans). While Russia has looked to replace its trade with sanctioning jurisdictions, the International Monetary Fund has reported that Russia's total volume of imports of goods and services fell 15% in 2022 compared to 2021, and its total volume of exports dropped 8.7% in the same period (www.imf.org/en/Publications/WEO/weo-database/2023/April/weo-report).

sanctions, can apply to any legal person, anywhere in the world, that engages in certain transactions involving parties or jurisdictions that are targeted for US secondary sanctions measures.

In addition, while sanctions regimes focus primarily on business activities that have some connection to the jurisdiction that is the target of sanctions, in practice, they can apply to transactions that are far removed from any sanctioned jurisdiction. For example, UK, EU and US sanctions include measures blocking transactions involving the property of designated sanctioned persons or entities and prohibiting transactions relating to those parties. These sanctions can also extend to transactions involving businesses located anywhere in the world that are, directly or indirectly, owned or controlled by designated parties, including businesses that are established in countries that are not a target of sanctions.

Varying sanctions regimes

The response to Russian military action in Ukraine has led to increased co-ordination between different regimes imposing sanctions against Russia, but there are nonetheless wide-ranging differences in the ways in which even theoretically similar restrictions imposed under different sanctions regimes operate. This has created, and continues to present, significant challenges for many international businesses that were engaged in operations and activities related to Russia before February 2022 and have jurisdictional

touchpoints that bring them within the scope of more than one of the various sanctions regimes that impose restrictions on business activities involving Russia.

EXITING RUSSIA

For companies doing business in Russia, Russia's invasion of Ukraine has created both business and ethical dilemmas as they consider whether to:

- Exit the market completely.
- Partially divest operations in Russia.
- Relocate operations to third countries.
- Continue to engage in Russia-related business activities that are not subject to sanctions restrictions.

Wide-ranging challenges

A complete exit from the Russian market may mitigate sanctions risk and satisfy shareholders' ethical concerns, but the path to exit requires exiting companies to navigate a complex web of challenges. In the months after Russia's invasion of Ukraine, a number of MNEs saw a window of opportunity to exit the market and moved swiftly to terminate joint ventures or sell their businesses. These exits can be challenging and, while the financial terms of these transactions tend not to be in the public domain, reports suggest that deals are being done at significant discounts to value.

Back in spring 2022, some observers questioned the wisdom of exiting the market and writing down significant investments in Russia, potentially for little or no financial return. The financial terms of those deals may have been hard for MNEs to swallow but, with hindsight, a full market exit with no future liability for operations in the region looks like quite a prize. Those companies may be quietly congratulating themselves, with a report from the Yale Chief Executive Leadership Institute in May 2022 suggesting that MNEs that incurred significant write-downs of assets on exit have been rewarded by investors with a rebound in stock performance which more than compensates for the financial hit that they were forced to take on exit (<https://ssrn.com/abstract=4112885>).

It is also clear that the path to exit has in some instances become harder to navigate as the Russian government has taken steps to protect its economy and punish MNEs that are looking to exit the market. For example, companies from countries that the Russian government deems to be linked to "unfriendly" states face a constantly evolving and increasingly restrictive regulatory environment that imposes regulatory prerequisites to leaving. The list of "unfriendly" states currently consists of about 50 countries, including all 27 EU member states, the UK and the US. In order to sell Russian assets, companies from these countries frequently need approval from the Russian government's Commission on Control over Foreign Investments.

Companies operating in strategically important enterprises, including the energy and banking sectors, face heightened restrictions on exiting the market and frequently require express approval from the office of the President. In recent months, the Russian government has also introduced standards for mandatory valuation of assets for sale, a potential discount of at least 50% on the valuation price and "voluntary" contributions to state budgets in the region of 10% of the total deal value. Pursuing these alternatives may be viable from the standpoint of applicable international sanctions regimes, but international sanctions compliance issues can arise at various stages of the divestment process and must be closely evaluated on an ongoing basis.

Buyer complexities

Aside from the regulatory obstacles, there are practical challenges for Western businesses

that are looking to find a buyer. Some companies are seeing their way through these challenges, particularly in divesting assets in strategic sectors, such as energy and technology, where there is a cohort of willing buyers from Russia and “friendly” states. However, in some instances, these potential buyers have links to sanctioned persons, which presents challenges from a sanctions compliance standpoint that need to be analysed carefully.

In other sectors, exit deals frequently involve the sale of the Russian businesses to local management teams that are not subject to sanctions, through a management buyout. This option enables the Western business to transfer its operations to a team with the knowledge necessary to operate the business and to retain employees in order to protect the value of the asset for the longer term. It also mitigates the risk of intervention from Russian authorities, which are keen to preserve businesses and jobs, and to cause the minimum disruption to supply chains and customers in the Russian market. Sales to local management teams nevertheless require close scrutiny from a sanctions compliance standpoint, including to ensure that the sale process does not result in the transfer of restricted goods, software, technology or services to those buyers or other third parties and that the transaction does not involve sanctioned third parties, including sanctioned Russian financial institutions.

Sales to non-Russian third parties attract more scrutiny from Russian officials who are concerned about the potential impact of a “disorderly” exit and have been less common. However, some MNEs have negotiated deals to sell businesses to buyers from third countries that do not appear on Russia’s list of “unfriendly” states, such as the sale by Reebok of its Russian business to Turkey’s FLO Retailing, or the sale by Inditex of its Russian business to UAE-based Daher Group.

A LONG GOODBYE

For some MNEs, an early exit was never on the cards. Many MNEs have geographically dispersed operations but are highly integrated globally, with cross-border flows of technologies, products and services that cannot be easily severed without significant disruption to the global supply or manufacturing chains. For others, particularly

Added complexities for franchisors

In a typical franchise model, the franchisor grants an entity the right to operate the brand in the local market and provides products, equipment and services from outside of the market. Therefore, in many cases, a franchisor does not have its own direct presence in Russia and, although it will retain some control over marketing and branding, the business is “owned and operated” by the local franchisee.

In the face of pressure from investors, many big consumer brands announced shortly after the invasion of Ukraine that they would exit the Russian market. However, franchisors that want to terminate the arrangement and exit the market may find that the contractual termination provisions do not cover the current situation. Franchisors frequently insist on wide-ranging rights of termination but these do not usually extend to termination at will, which is understandable given the level of investment that the franchisee is required to make in the business. In addition, franchisees will argue that they have done nothing to merit termination; the war is a government act. Force majeure clauses have proven difficult to enforce in the current situation, as the Russian government is not trying to prohibit the operation of global brand franchisees in the Russian market.

The complexity of navigating the franchise system is leaving franchisors in a quandary. They could either allow the franchise to continue to operate in accordance with its contractual terms and risk the wrath of consumers in the West who want to see these big brands exit the Russian market, or take a unilateral decision to terminate and risk a substantial claim for damages from the franchisee. Even if they decide that one of these courses of action is better than the other, they are of course also faced with the possibility that the franchisee simply continues to operate the business in the knowledge that the franchisor will receive scant support from the Russian authorities. This is evidenced by the Russian Presidential Decree of 27 May 2022, which prohibited Russian citizens from paying businesses for the use of trademarks and patents in countries that imposed sanctions on Russia.

In addition to navigating the challenges of the Russian market, global franchisors also need to manage their global franchise networks. Many are feeling the pressure from franchisees in other jurisdictions to exit the Russian market in order to uphold the reputation of the brand internationally, opening another potential avenue for litigation.

those involved in the provision of essential goods and services such as medicines, medical devices and baby products, and food producers or retailers, ethical considerations weighed heavily in the mix and led to a decision to continue to service the market, in some cases with a more limited scope of operations.

Many MNEs operating in the Russian market also have ongoing contractual and legal obligations to suppliers, manufacturers, retailers, customers and employees. A sudden withdrawal would risk counterparties resorting to legal action for breach by the MNE of its contractual obligations to them, potentially with the Russian counterparty having recourse to Russian courts with little reassurance available to the MNE that the outcome of any legal action will be fair or proportionate.

Increasing sanctions

However, remaining in Russia is not without its challenges. The constantly evolving international sanctions restrictions against Russia continue to create complexity for businesses operating in the country, especially given the expanding scope of goods and services that are subject to restrictions, and the growing list of Russian persons and entities that are designated for sanctions. For example, a large number of Russian banks are now subject to European and US sanctions, which have been construed by regulators to extend to routine payments to or from non-sanctioned parties through bank accounts held at sanctioned banks.

The growing list of Russian oligarchs that are subject to sanctions also presents increased risks for companies that remain in Russia. Asset-freezing sanctions against

oligarchs, and other designated parties, generally extend not only to listed persons and entities, but also to non-listed entities that the sanctioned parties hold a 50% or greater interest in or otherwise control, whether directly or indirectly. For companies that are affected by UK, EU or US sanctions, continuing to engage in business in Russia requires ongoing efforts to conduct sanctions-related screening and due diligence on any Russian parties with whom they interact.

Practical challenges

The hostility of the Russian government to Western companies, and its increased focus on economic nationalism, is also making the operating environment challenging. At a practical level, Western companies operating in Russia are facing growing labour shortages as a result of emigration and mobilisation, including of Russians who have fled Russia to avoid mandatory military service. Perhaps even more challenging is the emergence of policies favouring domestic companies over their foreign counterparts, leaving companies concerned about possible quotas for domestic products in retail stores, the potential for new or higher taxes and tariffs, selective enforcement of Russian laws against international companies and other forms of economic nationalism.

The decisions that MNEs are facing are difficult enough, but there are added complexities for some brands that operate in Russia through franchise models, such as Burger King, as they may not be able to control the operation of their brands in the Russian market (see box "Additional complexities for franchisors").

DISPUTE RESOLUTION

Given the complexities both of remaining in, and exiting, the Russian market, it is no surprise that companies both inside and outside of Russia are considering their dispute resolution options.

Contractual obligations

There is ample scope for disputes between MNEs that are seeking to exit the Russian market and their counterparties in Russia. First and foremost, there is the question of whether or not the new sanctions regimes prevent the performance of already agreed contractual obligations. For example, in the context of an oil and gas joint venture agreement, there may be obligations to contribute capital to exploration and development activities that ultimately benefit state-owned enterprises

Force majeure and sanctions

Whether a force majeure clause will excuse the non-performance of a contract will depend on the applicable law and how the clause is drafted. One example of this is found in the Court of Appeal's decision in *MUR Shipping BV v RTI Ltd*, which related to whether sanctions imposed by the US in April 2018 against a number of Russian individuals and entities amounted to a force majeure event under a shipping contract ([2022] EWCA Civ 1406; www.practicallaw.com/w-037-7125).

Shipping firm MUR had an ongoing contract with RTI, which was a subsidiary of one of the sanctioned entities. MUR argued that the continued performance of the contract would be a breach of US sanctions, in particular because the contract required payment in US dollars. However, the force majeure clause offered relief only to the extent that the relevant event could not be overcome by the affected party's reasonable endeavours. RTI offered to pay in euros and to absorb any costs in relation to currency conversion.

The Court of Appeal held, by a majority, that the force majeure clause should be applied in a commonsense way that achieved the underlying purpose of the contract. The word "overcome" was a broad and non-technical term, which did not necessarily mean that the contract must be performed in strict accordance with its terms. MUR's acceptance of RTI's alternative payment proposal would have "overcome" the force majeure event, as it would have achieved the same result as performance of the contractual obligation to pay MUR in US dollars, with no detriment to MUR.

MUR demonstrates that the contractual interpretation of force majeure clauses is not always straightforward, as highlighted by Lord Justice Arnold's dissenting judgment in which he disagreed with the majority view that the force majeure event could be overcome by an offer of non-contractual performance. He argued that MUR was entitled to insist on its strict contractual right to receive payment in US dollars and that if the parties had intended the force majeure clause to extend to a requirement to accept non-contractual performance, clear express words stipulating this would be needed.

of the Russian government, either directly or indirectly, which could trigger EU or US sanctions restrictions against investments in Russia.

An MNE seeking to divest its Russian operations will need to take advice to understand the impact of sanctions on its obligations, as well as whether any provisions of the contract afford it an easy way out. Notably, some contracts include provisions that provide a party with the right to trigger a sale to its Russian counterparty in circumstances where sanctions prevent the investor from holding its interest in the investment or participating in the activities of the investment vehicle. In addition, there may be a force majeure clause in the relevant contract, but whether the imposition of sanctions will be a force majeure event will depend on the specific drafting of the clause (see feature article "Force majeure in a changing world: predicting the unpredictable", www.practicallaw.com/w-019-2821) (see box "Force majeure and sanctions").

If a party does not have an easy way out contractually, it will be necessary to also consider legal doctrines that allow the MNE to effectively terminate or avoid its arrangements in Russia. The applicable legal doctrines will depend on the law applicable to the relevant contract at issue. Under English law, this would include the doctrines of illegality and frustration (see feature article "Terminating for breach of contract: look before you leap", www.practicallaw.com/w-016-9676).

In any event, even if there are provisions that allow for an easy way out, it is common for there to be disputes about the value of the underlying asset or agreement. In these cases it will be necessary to obtain advice about the value of the asset and put forward a well-reasoned analysis that demonstrates the value of compensation that should be paid to the MNE in the relevant circumstances.

Arbitration

As is the case with most dispute resolution, but especially in these circumstances, the

parties will need to consider the forum for any dispute and how that forum affects the prospects for success and the ability to recover value. It will help if contractual rights are supported by a well-drafted international arbitration clause that clearly sets out the seat of the arbitration, the governing law and the applicable arbitration rules, and allows for the enforcement of the right to arbitrate disputes without needing to rely on the Russian courts.

The arbitral forum and strategy for enforcement will be crucial in these circumstances because the Russian government and Russian courts have taken efforts to undermine the enforceability of international arbitration agreements. In particular, one of the countermeasures employed by the Russian government against “unfriendly” states has been to invalidate the arbitration clause where the seat of arbitration is in an “unfriendly” jurisdiction and give the Russian courts exclusive jurisdiction in respect of the dispute. For example, in May 2023, the Russian court reportedly granted an anti-arbitration injunction to halt arbitration proceedings brought by Airbus against Avia Capital Services under an arbitration agreement that required all disputes between the parties to be referred to ICC (International Chamber of Commerce) arbitration seated in Paris. Despite the existence of the arbitration agreement, the Russian court concluded that it was the competent forum to hear the dispute.

For an MNE, obtaining a fair hearing in a Russian court on the impact of foreign sanctions on the performance of its contractual obligations will obviously be problematic, so it is essential to try to obtain a forum outside of Russia in which a dispute may be fairly adjudicated and enforced.

Expropriation

In addition, there are numerous examples of Russia taking countermeasures to retaliate against foreign assets that amount to an expropriation of assets or violation of other obligations that the Russian government owes to foreign investors. Indeed, the refusal to honour a previously agreed arbitration clause may provide a basis for such a claim. In these cases, an MNE may consider relying on protections afforded by investment treaties to protect their rights and preserve claims for the value of expropriated assets against the Russian government.

CHALLENGES AND OPPORTUNITIES

Even if an MNE has found a buyer for its Russian assets, negotiated a deal and avoided a dispute, challenges remain. As a practical example, sanctions restrictions may mean that MNEs cannot make payments through accounts that are held with sanctioned Russian banks. To the extent that a divestment involves actions subject to sanctions-related restrictions, it may be possible to secure licensing from sanctions regulators to engage in the activities that trigger sanctions restrictions, or an exemption or general licence may be available. These options would need to be evaluated carefully on a case-by-case basis.

Preserving value

Against the backdrop of the constantly evolving political situation and sanctions landscape, sellers have an eye on how the future will judge them; that is, whether or not a transaction will be viewed as a good deal. It is clear that deals are being negotiated in a distinctly buyer-friendly market in which sellers have limited leverage, either with respect to price or deal terms. Some Western businesses have tried to preserve future upside in an exit transaction, perhaps with an eye to facilitating a longer-term return or future economic benefit.

Creative attempts to preserve upside participation have included future call options, such as the sale by French car manufacturer Renault of its majority stake in Avtovaz, reportedly for the sum of one rouble, but with a six-year buy-back option, rights of first refusal on future sales of the business and price adjustment mechanisms that seek to enable Renault to benefit from any future sale of the business. The effectiveness of these provisions remains to be seen, although the longer the Russian invasion continues, the less likely it seems that these provisions will have meaningful value. These provisions also would need to be carefully considered from a sanctions compliance standpoint.

Another option for preserving value has been to negotiate transition services arrangements under which the Russian business continues to provide certain support or other services on commercial terms, assuming that this can be structured in a way that is compliant with applicable sanctions and associated export controls regimes. There too, challenges abound in light of the Russian legal environment. Russian countermeasures

against companies from “unfriendly” states restrict payments of royalties for the use of intellectual property to companies that have made public remarks about leaving the Russian market, or that are deemed to have breached contractual obligations to Russian counterparts, with payments diverted to special accounts from which payments can be made only with the prior approval of the Russian government. Russian officials view these restrictions as necessary to try to stabilise the market, and these accounts could also create a pool of funds from which Russian companies can enforce Russian judgments against overseas companies.

The scale of exits

In the face of these challenges, experts disagree about whether there has been a meaningful corporate exodus from the Russian market. In January 2023, Simon Evenett of the University of St Gallen and Niccolo Pisani of the IMD Business School published a working paper suggesting that, as at the end of November 2022, less than 9% of Western businesses operating in Russia, and only 120 in total, had divested at least one of their Russian subsidiaries (<https://ssrn.com/abstract=4322502>). This paper triggered a blistering response from Jeffrey A Sonnenfeld from Yale University School of Management, whose research indicates that 1,300 multinationals have either exited the Russian market or are in the process of doing so (<https://som.yale.edu/story/2022/over-1000-companies-have-curtailed-operations-russia-some-remain>).

While these two reports may seem contradictory, the critical difference between them is that Evenett and Pisani’s report measures only completed exits, while Sonnenfeld’s report includes companies that are in the process of exiting, which can involve a prolonged effort. Given the challenges outlined in this article, the significantly lower number of fully completed corporate exits is unsurprising.

The long-term view

The full-scale Russian invasion of Ukraine is now well into its second year, and there is little confidence that the situation for MNEs operating in the Russian market is going to get easier any time soon. Early predictions that the war would last only a period of months, with Russia’s relationship with the West returning to the status quo ante shortly thereafter, have evaporated. MNEs that had hoped to ride out the storm until they could go back to business as usual are realising

that the path is likely to be a longer and more challenging one than they had anticipated. Perhaps the greater challenge is for those companies that made early statements of intention to leave the market but have been unable to complete an exit.

In an article published on 3 April 2023, Peter van Veen, Head of Corporate Governance at the Institute of Chartered Accountants in England and Wales, noted that “where there is a discrepancy between customer expectations, previous bold pledges to leave and the reality that they are still operating more or less as before, this could be a ticking reputational time bomb” (www.icaew.com/insights/viewpoints-on-the-news/2023/apr-2023/russia-exit-failures-put-businesses-on-the-back-foot). Van Veen acknowledges that the challenges of exiting the market are significant and espouses transparency as critical to maintaining the confidence of investors, not just with respect to strategy for exiting the Russian market, but to maintain confidence in statements on other claims that businesses are making, such as on environmental, social and governance issues.

Perhaps the only thing that is clear is that the need for long-term critical strategic planning for MNE’s Russian operations is going to stay on the C-suite agenda for the foreseeable future and sophisticated advice will be needed to navigate the challenging, and constantly evolving, legal, regulatory and policy landscape.

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