

To Russia with love

Russia and its neighbouring states are attracting major investment and increasing numbers of international law firms are establishing operations there. *Legal Business* assesses the challenges and asks how this eastern enigma can be cracked

JULIAN MATTEUCCI



'Russia is flavour of the month again,' Brian Zimble, cross-border investment specialist and managing partner of Dewey & LeBoeuf's Moscow office, enthuses. 'CEOs are asking their boards why they aren't in Moscow.' Russia's foreign capital inflow for 2008 is estimated at between \$40bn and \$50bn. Meanwhile, its insurance market is set to double between 2006 and 2010, and international funds are buying into property all over the country.

Financing has become more difficult to obtain, but Hogan & Hartson's Moscow managing partner and corporate lawyer Peter Pettibone says Russia may not be hit hard by the financial crisis.

'Russia is sitting on a great deal of oil and gas,' Pettibone explains. 'A lot of money is coming in and, although it primarily goes to the state, it also trickles down into the economy.' As for a Russian sub-prime crisis, few home mortgages exist there and were only given to people with exceptional credit.

But those who know the Russian market well have a word or two by way of warning. Winston Churchill, let's not forget, described the country as 'a riddle wrapped in a mystery inside an enigma'. John Balsdon, Russia expert and London-based finance partner at Herbert Smith, cautions: 'It's a tooth and claw environment. But you can make an



RUSSIAN BEAR GIVES PAUSE

The third CIS Local Counsel Forum saw over 200 lawyers and corporate counsel descend on St Petersburg this summer. Having been 'driven together by the common idea of a common market', – as eloquently put by Ilya Nikiforov, local managing partner of host firm Egorov, Puginsky, Afanasiev & Partners (EPA&P) – the event was designed to showcase the strength and unity of the legal market across the region, and present a valuable opportunity for garnering future referral work.

However, the first session – an introductory overview of Russia – prompted an unexpected bout of nationalistic chestbeating. 'I don't know why people are talking in English,' the managing partner of one Russian firm commented. 'It's a CIS forum, so people should be talking in Russian, Ukrainian or one of the other CIS languages. Not English.' That the message was delivered via a translator through a highly conspicuous UN-style earpiece made it all the more uncomfortable. It was a surprising start, especially following the warm greeting from chairperson Irina Paliashvili – president of Ukrainian firm RULG – who had promised that the group was 'a family in which all should feel welcome'.

Another panelist highlighted the relatively poor performance of Russian firms compared to their Chinese counterparts in *The Legal 500*, perhaps not realising that the restrictions on international firms practising Chinese law necessitates the domestic firms having a section to themselves (which, of course, they dominate).

Although a lot was said with tongue pressed firmly in cheek (old Soviet propaganda imagery was used as a backdrop to presentation slides by EPA&P's chairman Dimitry Afanasiev), the sense of frustration and resentment was palpable. It was enough to prompt Nick

Eastwell, Linklaters' regional managing partner, to interject. 'I find this emphasis on nationality strange. We are an international firm, but we see ourselves as a local firm in each country that we operate in,' he said, pointing out that of the firm's 100 lawyers in Moscow, 70 are Russian. At this point, Paliashvili actually had to re-emphasise that all 'international' colleagues were welcome.

Thankfully, this somewhat tense opening proved not to be an indication of the rest of the weekend, which fell during St Petersburg's stunning White Nights Festival.

In addition to presentations on key developments in a range of CIS countries and market sectors, and an interesting debate on the relative merits of globalisation versus best-friend networks (unsurprisingly, support for Slaughter and May's format was unanimous among the domestic firms), delegates were treated to a number of spectacular events.

Most memorable of all was dinner at Peterhof – the imperial palace of Peter the Great – which featured an amusing speech from special guest Igor Artemyev, head of the Russian Federal Antimonopoly Service. 'Our new antitrust law is so complicated that companies will definitely need lawyers to explain it to them,' he said, to widespread cheers and applause. However, the once-in-a-lifetime event was unable to compete with another rare occasion. Upon completion of the main course, forum delegates rushed back to the hotel bar to watch Russia fall to Spain in the Euro 2008 semi-finals.

That loss aside, the event was an overwhelming success, with many attendees already talking about a potential return to Kyiv – home of the inaugural forum two years ago – in 2009. Roll on next year.

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► awful lot of money if you do things properly.'

GO EAST

'Russia is not for the faint-hearted,' Balsdon warns. Nevertheless, UK firm Simmons & Simmons recently took the plunge, establishing a Moscow presence last September. Others such as SJ Berwin are also looking at the potential for opening there, as are various leading offshore firms; Conyers Dill & Pearman did so in January. Indeed, Balsdon's own firm is planning to double the number of partners there over the next three years.

Derivatives expert and Simmons' Moscow managing partner Tony Smith used to run the London capital markets group. Relocating such a senior person to Moscow demonstrates Simmons' commitment to the country. Smith describes the move as part of a conservative, carefully planned strategy. 'Clients would not accept anything less than the same Simmons approach they are used to in other jurisdictions,' he says.

The legal market in Russia remains extremely competitive, and local offices of some international firms have struggled in the past. 'A Russian office can only be successful when it is clear and focused on the product service offered,' Ashurst corporate partner Sergei Ostrovsky, who co-heads the Russia/CIS group from London, says.

With years of in-depth Russia experience, Dewey's Zimble is alert to the dangers and wishes Simmons luck. 'You cannot fool clients with a small office,' he says. 'They want to be served by sizeable resources.' Balsdon adds bluntly: 'If you get it right you can be very profitable, but get it wrong and you can lose pot-loads of money.'

When Bermuda law firm Conyers Dill & Pearman opened in Moscow, it became the first offshore law practice to establish a physical presence in Russia. ►

► Banking and international finance specialist Caroline O'Hare runs the Moscow office. 'The move was driven by a strong business flow from Russia and CIS, clients appreciating the fact that not only are we now in the same time zone but we are also dual language,' she explains.

Harneys is the largest firm in the BVI. It realised from 2000 onwards that Russia was becoming an increasingly important market. London-based global banking and finance head Peter Tarn expects the firm to have a Moscow office within the next five years. But he says: 'London is still regarded as being a sensible environment to do deals, and when events occur like last year's raid on PwC's office, it seems a good idea to be outside of Moscow.'

FUTURE IMPERFECT

'Russia is probably the world's most buoyant legal market at present,' Jason Horobin, a director at international legal recruitment agency Laurence Simons, says. 'There are relatively few expats in the market, and it's a goldmine of opportunity for western lawyers hoping to make a career-defining move.'

Yet, attrition and a shortage of quality lawyers are problems repeatedly cited, with partners receiving half a dozen headhunter



Wilkie: Russia's legal market is white hot

'You cannot fool clients with a small office. They want to be served by sizeable resources.'

Brian Zimble, Dewey & LeBoeuf

calls a day. 'I have never seen any market so white hot.' Akin Gump Strauss Hauer & Feld's Moscow managing partner Richard Wilkie declares. 'Associates are being offered partnerships to change firms. In some cases salaries are being doubled.'

As the economy is largely dependent on oil and gas and other natural resources, partners such as Wilkie think there is no reason to believe the situation will change as long as commodity prices remain high. 'The market has not been taught a lesson yet,' Oleg Riabokon, managing partner of CIS-based Magisters, warns. 'Lawyers are switching firms too easily, and it is not healthy for lawyers or law firms to be playing this game like the stock market.'

Czech firm Brzobohatý Brož & Honsa opened in Moscow in 2006. Jan Petřík is the firm's international managing partner. 'One of the most painful parts of opening an office in Moscow is the attrition,' he explains. 'The Russian market is overheated now, and it is tough for law firms to implement standards of internal growth.' Constantine Lusignan-Rizhinashvili, regional managing partner at DLA Piper, believes the key to retention is providing lawyers with 'proper direction as to where their future lies'.

Herbies' Balsdon explains his firm's approach to attracting the best new talent in Russia. 'We pretty much recruit from two universities,' he says. 'Only 250 graduates come out of them each year. Of those, probably 100 have the skill-set we need, and all the international firms and Russian entities

with international ambitions fight over them.'

At Russian law firm Pepeliaev, Goltsblat & Partners, managing partner Andrey Goltsblat will only interview around one in 15 of the candidates offered by agencies. Meanwhile, Andrey Zelenin, managing partner of Russian practice Lidings Law Firm, observes: 'Russian education is often too theoretical, and Russian law graduates don't always understand the business side to legal issues.'

This leaves the domestic firms in an interesting position. 'Only a couple of Russian firms like Pepeliaev, Goltsblat & Partners and ALRUD can compete with the foreign firms on certain deals,' Harneys' Tarn believes, and, therefore, attrition remains a problem for them. 'Working at an international law firm is just too attractive a proposition for Russian law graduates.'

Vassily Rudomino, senior partner of ALRUD, believes the playing field is levelling as far as M&A and financing work are concerned. Networks and affiliations (such as ALRUD's with Slaughter and May) help domestic firms compete with international practices on global assignments. He points out that certain Russian outfits already lead the way in IP, competition and litigation. 'Foreign firms are still doing mainly international work,' Rudomino says, 'and are mostly staffed at partner level by expats.'

As for profit levels, Balsdon explains that domestic firms 'have higher leverage levels and can afford to pay the high salaries because they have different equity structures and can keep

► fees down (relative to international firm rates). So they end up being just as profitable.'

STATE OF PLAY

Another challenge for lawyers and investors will be getting their heads around this year's key piece of Russian legislation: the new Foreign Strategic Investment Law (FSIL). To acquire control of strategic investments, foreign investors will need to go before a special committee. 'The intention is positive as you now understand when governmental approval is required,' Hogan's Pettibone says.

The new law will come into play when a foreign acquirer attempts to take a controlling interest of generally more than 50% of a strategic sector company or 10% of a mineral resources entity. 'But there are 42 strategic sectors covered,' Pettibone explains, 'and it is not easy to know whether your activity falls into one of the categories.'

Ashurst's Ostrovsky believes the legislation sends a strong message. 'The Russian state wishes to maintain control over certain assets,' he says. Balsdon agrees, saying: 'Russia is protecting itself because it has huge tracts of unexplored land. It is saying "bring your money, but don't try to run the show". They're fighting for the



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Oleg Riabokon, Magisters

future of their country, but what's wrong with that? Westerners must stop thinking they are doing Russians favours by investing there.'

'It's no surprise,' Ostrovsky adds. 'As far as defence and natural resources are concerned, the governments of the past were too relaxed. This is an attempt to balance some of the events of the '90s. Only time will tell whether it makes sense to invest in strategic sectors, but by no means is every asset class covered by the Act.' Dewey's Zimble does not believe the new law will affect existing investments, though. 'There may be problems if shareholders need to restructure or try to increase their holdings,' he says. 'It is always a good idea to talk to the government first before embarking on the acquisition of a strategic asset.'

Of course, talking to the government is exactly what BP did back in 2003 when it

announced its \$6.15bn investment in Russia. In the first three years, BP earned enough in dividends to cover its initial investment in TNK-BP. But cut to the end of July this year and events had taken a dramatic turn. TNK-BP CEO Robert Dudley had his work visa renewal application denied by the authorities after his local oligarch partners (at Alfa-Access-Renova (AAR)) refused to extend his work contract. As *LB* went to press, Dudley had left Russia but was determined to retain control over the joint venture.

BP and Dudley have spoken of an orchestrated campaign of harassment by the authorities, including frequent raids on TNK-BP's offices, suggesting that these disturbances were carried out at AAR's prompting. AAR complained that BP treats TNK-BP as its subsidiary, not a joint venture, and that BP has no plans ►

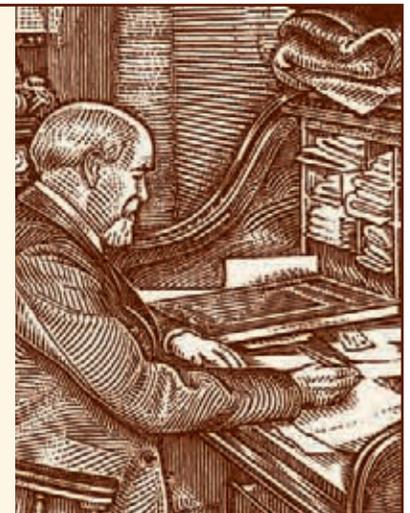


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BUILDING MOMENTUM

Russia's rapid rise to become one of the world's most important emerging legal jurisdictions has been fuelled by big-ticket M&A, capital markets and real estate deals. However, an important new area is emerging as Russia seeks a solution to its extensive infrastructure requirements: the oft-maligned public private partnerships (PPP).

Speaking shortly before his formal election in March, Russia's new president, Dmitry Medvedev, said: 'Russia in the next four years should focus on four 'I's: institutions, infrastructure, innovations and investment.'

Although the PPP model made its first appearance in Russia in the mid-'90s, the market is set for significant boost following the passing of a new concession law in 2005. 'It was a very important step for the PPP market in Russia,' Innokenty Ivanov, head of the Moscow infrastructure and projects team of Freshfields Bruckhaus Deringer, explains. 'It's one of the most important sectors in Russia right now; the pipeline of deals is huge.'

The firm recently won an instruction to advise St Petersburg on the €5bn Western High-Speed Diameter (WHSD) motorway: the largest PPP project ever in Russia, and the first in the transport sector. Allen & Overy is advising the private sector consortium that won the construction contract, ZSD Nevsky Meridian, which is being headed by Basic Element, the investment vehicle of Russia's richest man, Oleg Deripaska. The contract is a successful outcome of Deripaska's attempts to target projects work, with Basic Element strategically boosting its road-building expertise through the \$1.6bn acquisition of a 30% holding in Austro-German construction giant Strabag in April 2007. The company also owns a 10% stake in UK construction firm HOCHTIEF, another member of the WHSD consortium.

Deripaska also benefited from the first wave of PPP projects to be announced in June 2006 by the Kremlin following the passing of the new concession law, with £800m of state money going towards RUSAL's construction of a £2bn hydropower plant and aluminium smelter in Siberia.

Although Deripaska's position as Russia's richest man means that his regular appearance on projects is unsurprising, the WHSD tender raised concerns as ZSD Nevsky

Meridian was the sole remaining consortium at the final bidding stage. 'The approach of the Russian government is, probably for the first time in Russia, to start these concessions with a transparent and truly competitive tender,' Ivanov says. 'I have seen a lot of tenders in Russia that are not well structured, but that is not the case with PPP; there is no preference for any of the bidders.'

The Russian PPP model has one fundamental difference from the more conventional formats used in western Europe, with the private sector consortium negotiating the contract terms *after* being named the winning bidder, not before. 'The process has received a lot of criticism from the market,' Ivanov explains. 'It's been structured in a rather simplistic way, with the technical and financial proposals submitted at the same time. But the government has shown a genuine willingness to enter into dialogue with the market in order to improve things, which is a real positive.'

One less obvious benefit to the law is that it allows for the implementation of concessions without a change in ownership, meaning that PPP projects can be developed in strategic sectors that are otherwise closed to private investment. Federal roads, for example, have to remain under state ownership. This protective stance over public sector assets makes PPP a surprising choice for infrastructure procurement in Russia, even ignoring the fact that having the private sector profit from public sector projects flies in the face of the country's communist past.

'The idea of PPP is currently incredibly popular in Russia,' Ivanov says. 'Everybody, including the President, sees it as an excellent tool to develop infrastructure. I've never heard of any opposition to the use of PPP for infrastructure projects, but if it was oil and gas, it might be a different matter.'

Then again, with the TNK-BP saga looking increasingly fraught, it's likely that prospective international investors will already be thinking twice before leaping into Russia's lucrative resource sector. chris.johnson@legalease.co.uk

▶ to expand the JV abroad. The Russian shareholders want TNK-BP to become a global force and suggest that BP plans to expand its Russian presence but has scant intention of creating a global rival.

Prospective investors in Russia are following the ongoing clash with interest. Russian law firm Egorov, Puginsky, Afanasiev & Partners has been acting for BP in the shareholder dispute. The firm's chairman, Dimitry Afanasiev, told *LB*: 'Prospective investors in Russia are following the ongoing clash with interest. Many observers do believe there are legitimate shareholder issues to be resolved but are troubled by the manner in which the dispute is unfolding.'

Magisters' Riabokon has not been involved with the case but is concerned that it will discourage other international ▶

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► investors. At Russian firm Liniya Prava, managing partner Andrey Novakovskiy argues that the state has not intervened in the dispute but that both parties have genuine concerns as to the future direction of the JV, which need addressing.

COMING CLEAN

Apart from concerns over what the outcome of major business disputes such as that between BP and AAR may signify for investors in Russia, there are also more general worries relating to the perception of corruption in the country. Investors will regularly hear of both Russians and westerners being shaken down and asked for bribes. 'Retailers are visited every day by fire, sanitary and other inspectors,' Rudomino reveals. 'The rules are unclear, and even if the shop is in the right, it will be closed if it does not pay off these inspectors.'

President Medvedev has established a new commission to fight corruption. Akin Gump's Wilkie believes the government is serious about its eradication, but recognises that there's a long way to go. 'Corruption is so embedded within the culture that a government cannot change things quickly,' he says. 'The changes must also work their way down to the lower levels of government and the judicial system.' DLA's Lusignan-Rizhinashvili is even less optimistic. 'Promises to curb red tape, stamp out corruption and implement the rule of law remain to be delivered on, and state interventionist tactics at various levels compound the difficulties faced by both local and foreign investors.'

Moscow managing partner and project finance lawyer Jacky Baudon of Freshfields Bruckhaus Deringer explains that in Russia 'some of the technical prerequisites of the rule of law are painfully missing: the independence and competence of judges; access to well-drafted court precedents; and



'WTO entry will help Ukraine's GDP growth, and harmonising standards to international requirements will create favourable conditions for investors.' Ilona Zekely, Schönherr

the enforcement of judgments by the police.'

As a result, much outbound investment is made through off-shore holding companies, as clients seek isolation from Russian legal risks and the freedom to structure investments in accordance with international law. The Cyprus route to investing in Russia is especially popular. Zimbler explains: 'Western banks feel comfortable there. The time zone is the same as Moscow and the double tax treaty works well. An ideal structure for investing in Russia would be a BVI holding company at the top with a shareholders agreement governed by English law and a 100%-owned Cyprus holding company below it, which in turn owns Russian shares or assets.'

Nevertheless, Harneys' Tarn doesn't altogether buy into the hype. 'To a certain degree,' he says, 'the UK press is responsible for propagating the notion that Russia is an unsafe environment in which to conduct business.' Goltsblat likewise believes that examples of federal bureaucracy involvement are exaggerated.

On the flipside, there are 110 billionaires in Russia and the country's newly enriched investors are expanding globally. 'Russian clients have governmental approval to go forth and multiply,' Zimbler says. 'Russians are jumping into Africa but lagging behind in the Middle East. They like to invest in Europe and especially into the US because of the weak dollar.'

'They are used to high risks and high returns,' Balsdon adds, 'and will pick up undervalued assets.' Pettibone describes the sort of reception Russian investors receive in the west. 'There is still a suspicion about Russian businesses buying abroad as the west tries to understand whether the operation is state controlled, but once they get beyond this there are no problems,' he says. The ►

► Russians are pretty sophisticated about how they go about things, reassuring local communities that they will be good citizens and that job numbers will increase. SeverStal is known to have made several acquisitions in the US and passed the CFIUS [Committee on Foreign Investment in the US] tests without any difficulty.'

WIDER HORIZONS

The action isn't entirely limited to Russia. Ukraine's infrastructure, energy, telecoms and real estate sectors are currently underdeveloped and are attracting interest. The country is entering the European mainstream both culturally and economically: it will be cohosting the 2012 UEFA European Football Championship and foreign direct investment reached \$29.5bn as of January 2008. It also formally acceded into the WTO in February. With world food prices spiralling and possible land reforms coming up, Balsdon believes: 'Ukrainian land values could rocket in a very short time.'

Vladimir Sayenko is an M&A and antitrust partner at Ukrainian firm Sayenko Kharenko. He regards the impact of WTO accession on deal flow as 'almost irrelevant'. However, Ilona Zekely, managing partner of Austrian firm

'Kazakhstan may have had its day. It suffered the heaviest blow caused by the credit crunch of all the CIS economies.'

Constantine Lusignan-Rizhinashvili, DLA Piper

Schönherr's Kyiv office, views it more positively. 'WTO entry will help the country's GDP growth, and harmonising standards to international requirements will create favourable conditions for investors,' she says.

As for the upcoming football championships, progress has been slow. 'The Ukrainian government

has done little to advance matters ahead of 2012 and UEFA president Platini has given the country until September to get its act together,' Riabokon complains. 'We need railways, roads and airports but we haven't seen any tenders. It's all just talk, and the Taiwanese company that won the tender to build the stadium had the contract cancelled by the government. The government is now being sued and none of this does much to promote investor confidence.'

Arzinger & Partners Ukraine's co-senior partner Timur Bondaryev strikes a note of caution. 'Ukraine is a country where corruption starts with the traffic police and goes right up to high-ranking politicians, and the judicial system is famous all over Europe for its venality.' This is the reason that Sayenko prefers transactional matters and is selective about the disputes work it takes on. 'The counterparty might have a bad reputation, and I



Sayenko: red tape is stifling in Ukraine

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► would prefer to lose the work to firms with lower ethical standards,' Sayenko explains.

Meanwhile, potentially stifling bureaucracy remains a bitter hangover from Soviet times. As far as transactional work is concerned, Sayenko sees bureaucracy as a bigger problem than corruption. 'You can't just buy currency or wire money out of the country,' he says. 'You need a raft of documentation explaining the transactions, and excessive rules impede business.'

As for the legal market, Ukraine is accustomed to foreign firms. Baker & McKenzie arrived in 1992 and Chadbourne & Parke, DLA Piper and Salans all run



Baldson: Russia isn't for the faint-hearted

Kyiv offices. Schönherr opened in 2006 and Squire Sanders & Dempsey has reopened there after closing four years ago. 'The legal market is still immature,' Sayenko explains. 'You can do interesting things. A new firm with a good team of lawyers can become a market leader in a year or two, which would be impossible in any developed market, but the lack of qualified lawyers is a problem.'

Sayenko elaborates on the situation. 'Because the number of Ukrainian lawyers able to handle major transactions is so limited, it is difficult for foreign firms to enter the market, so most law firms have grown steadily. But an aggressive entry with the right budget can shift the balance.'

He continues: 'Last year, when CMS Cameron McKenna raided Chadbourne & Parke, Baker & McKenzie and others to form its 20-30 lawyer office, many firms responded by raising salaries for lawyers and fees for clients. These wars will continue as headhunters are desperately trying to fulfil orders from new-entrant firms, but because existing practices can evaluate and promote their own lawyers better than outsiders, it is difficult to persuade the best lawyers to move. Well-known US and UK

'Belarus is going to be a paradise for those who were too late coming to Russia and Ukraine.'

Dimitry Afanasiev, Egorov, Puginsky, Afanasiev & Partners



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► firms entering the market are likely to end up with mediocre teams.'

BLACK GOLD

Kazakhstan is causing tongues to wag and with good reason. Denton Wilde Sapte opened its Almaty office back in 1998. Speaking of the firm's arrival, managing partner and energy/infrastructure specialist Marla Valdez says: 'We recognised that if we wanted to be a serious energy practice, we needed to be where the oil and gas was.'

Aside from huge oil fields, agriculture and infrastructure projects are expected to take off, and it has a tightly controlled, relatively stable government. DLA's Lusignan-Rizhinashvili is unconvinced, though. 'Kazakhstan may have had its day,' he says. 'It suffered the heaviest blow caused by the credit crunch of all the CIS economies.' At the time of the crunch, the

banks were too highly leveraged; a wave of consolidation within the banking industry was expected, but is yet to happen. Dewey's Zimble comments: 'The country's spending outstripped the oil money receipts: it should be in much better shape than it is considering all the money coming in.'

Bakers, Dewey, Salans and White & Case are all present, but Akin Gump's Wilkie says: 'We won't open in Almaty unless we have the right group.' Meanwhile, Valdez believes: 'It is difficult for foreign law firms to come here because the learning curve is so steep. All industries in Kazakhstan are suffering from labour shortages, including law firms.'

Headhunting does not occur in Kazakhstan as it does in Russia and elsewhere, as the market is too small. 'We do not poach from other firms but spend time nurturing and training our lawyers,' Valdez says.

LOVE SPREADS

'After Kazakhstan the most important destination is Belarus,' Arzinger's Bondaryev states. Egorov's name partner Afanasiev agrees. 'Belarus is going to be a paradise for those who were too late coming to Russia and Ukraine.'

Privatisations are planned and the IT industry is already relatively well developed. However,



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senior partner Anna Rusetskaya of Belarus firm Beljurbureau knows that investors and law firms will encounter what she describes as 'confusing and unstable legislation'.

Austrian firm Cerha Hempel Spiegelfeld Hlawati and Arzinger are already in Belarus, but some view the political situation as unfavourable to most investments. 'It's insane for a foreign law firm to open an office in Minsk,' Zimpler says.

However undeveloped the rest of the CIS states are, there's no denying the possibilities. Tajikistan, for example, has potential to dominate the world aluminium market. 'Up to 80% of Georgia's electricity

'In Ukraine, a new firm with a good team of lawyers can become a market leader in a year or two.' Vladimir Sayenko, Sayenko Kharenko

production companies already belong to Russians,' ALRUD's Rudomino says.

Armenia and Azerbaijan are rich in natural resources, while Turkmenistan has huge natural gas reserves. 'Other CIS countries are witnessing a steep increase of

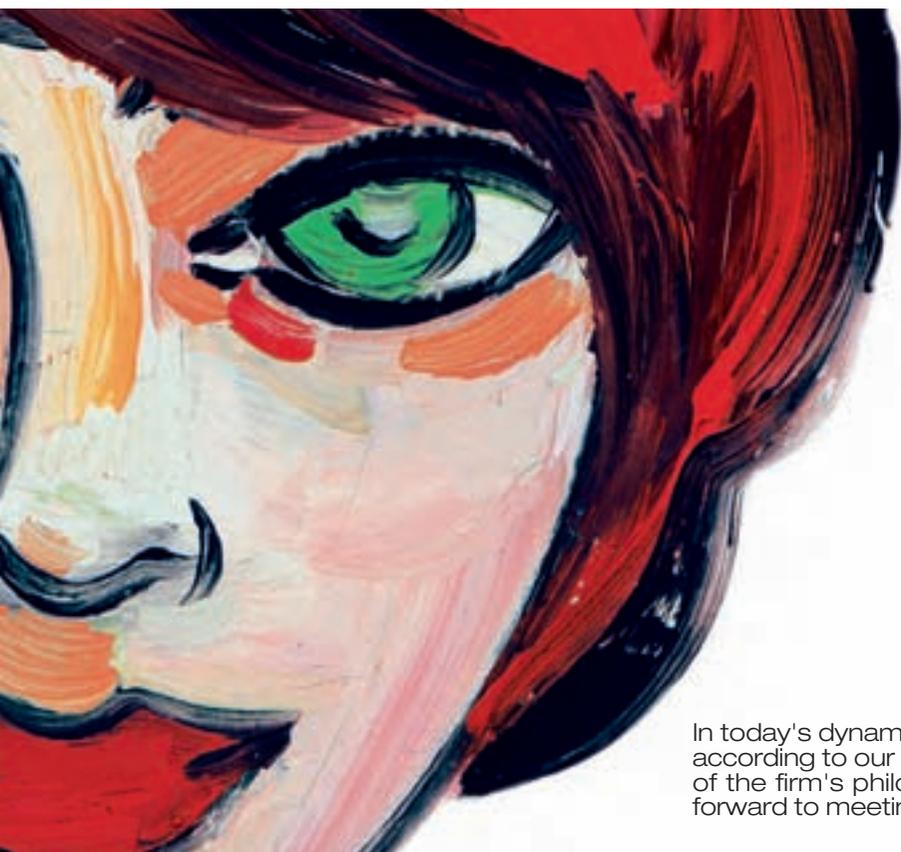
interest from western investors within a range of sectors,' Schönherr's Zekely says. Schönherr is already running a dedicated Moldovan desk from its Bucharest office.

'The Central Asian Republics' infrastructure projects will happen, but for now they remain somewhat behind, with the exception of Kazakhstan,' Ashurst's Ostrovsky says.

Wilkie reminds *LB* that: 'Major American firms tried years ago to set up a network in other CIS states, but that didn't work out.'

A sense of humour and a sense for adventure come in handy for both investors and lawyers conducting business in eastern Europe, but the potential rewards warrant the high risks. 'Russia is endlessly fascinating and gets into your blood,' Balsdon says, adding jokingly: 'like the *Hotel California* song, you can check out any time you like, but you can never leave!' **LB**

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Fuelling fire

Volatile oil prices have led to escalating inflation in Russia. *Legal Business* looks at whether the country's economic stability is in danger

CHRIS JOHNSON

None of the global law firms currently keeping their London transactional teams busy with Russia-related work will need to be told just how hot the country is. The question is whether it's *too* hot. A recent World Bank report claims that all seven indicators of economic overheating are present in Russia today (see box 'Seven deadly sins', below).

'The economy has been expanding rapidly for a number of years, but the spike in oil prices over the last year has really pushed things forward,' David Wack, a corporate partner in Squire, Sanders & Dempsey's Moscow office, says.

Russia's accelerating inflation, which stood at 11.9% in 2007 and is expected to near 15% this year, is fuelling a rapid increase in wages; an issue exacerbated by a fiercely competitive and under-resourced labour market (as any Moscow managing partner will testify).

The country's economy remains heavily reliant on its oil and gas reserves, with GDP growth almost

exactly mirroring global oil price trends (see graph, opposite). Oil revenue accounts for 30% of GDP, and 60% of the country's total exports. This means that the continued rise in oil prices, which peaked at over \$145 per barrel in July, has helped mask a deepening non-oil current account deficit. However, while higher oil revenues allow rentier states more breathing space for public spending, they also foster dependence on a highly volatile and uncertain source of income. Oil prices have since come down by 17% to \$120 per barrel. 'A drop in oil prices would be concerning, as it would certainly have a wider effect and could result in a slowdown,' Wack warns.

The last time that the Russian market suffered a prolonged downturn was during the financial crisis of the late '90s, which saw widespread downsizing among the international firms.

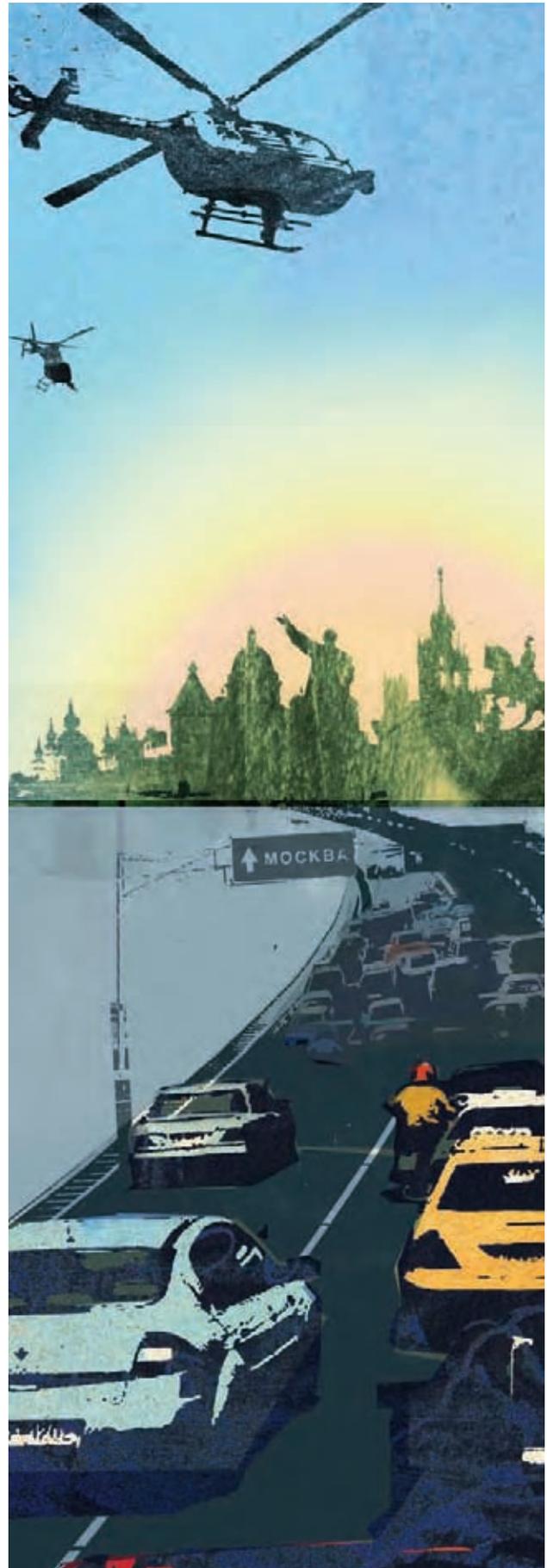
Although Russia is undoubtedly a stronger economy than it was ten years ago, a recent attack on steel firm Mechel by Prime Minister Vladimir Putin served

SEVEN DEADLY SINS

The warning signs of an overheating economy:

- 1** Double-digit or accelerating inflation, seemingly unresponsive to monetary policy.
- 2** High use of factors of production (capital and labour).
- 3** Nominal wage growth significantly higher than productivity growth.

- 4** Real wage growth higher than productivity growth.
- 5** Infrastructure constraints.
- 6** Rapid (above inflation) real estate price growth.
- 7** Rapid import growth and deterioration in the external current account.

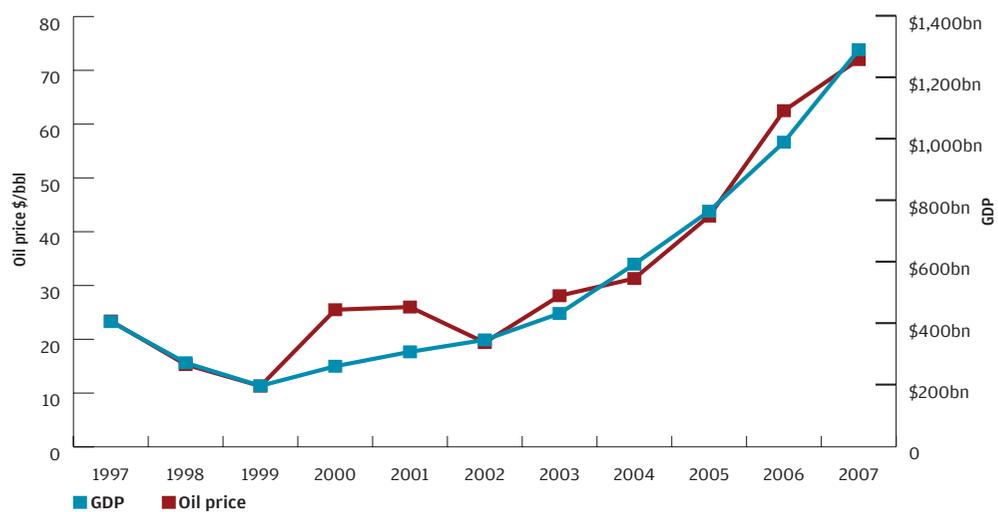


as a stark warning for investors that Russia remains an unpredictable animal. Putin's accusation that the company was evading taxes by selling its products cheaply through offshore holding companies saw its share price drop by 40%, wiping more than \$5bn off its market cap. More worrying was the wider effects: the Moscow Interbank Currency Exchange, Russia's main share index, fell by over 5%.

'It will put a bit of a dampener on investor appetite,' Wack says, 'as it reminds people that Russia is not London or New York. It's an emerging market that has a huge amount of political and legal risk.' **LB**

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RUSSIA'S DEPENDENCY ON OIL



Sources: International Monetary Fund/International Petroleum Exchange

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