Russian Civil Code reform - Aligning Russian contractual instruments with international practice

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As part of the ongoing reform of the Russian Civil Code, significant amendments to the Russian law of obligations (the “Amendments”) came into force on 1 June 2015. The key changes relate to the introduction of a number of mechanisms into Russian law which have for a long time been common international practice in the corporate and general commercial fields but which have rarely if ever been recognised by the Russian courts.

From this perspective, the most important innovations include:

- the regulation of relations between parties in connection with the conditional performance of obligations;
- the concept of warranties (in Russian – “zavereniya ob obstoyatel’stvakh”) (an equivalent of warranties as used in contracts under English law);
- the concept of the reimbursement of losses arising from the occurrence of certain circumstances specified in a contract (the equivalent of the English law concept of indemnity);
- new types of civil law contracts such as options, framework agreements and subscriber agreements;
- rules for the conduct of negotiations to conclude a contract and
- new mechanisms to secure the performance of contractual obligations by the parties.
Conditional performance of obligations

New Article 327.1 of the Civil Code allows conditions within the control of a party. The performance of obligations as well as the exercise, variation and termination of certain rights under a contract may be made conditional upon a certain act being done or not done by one of the parties, or upon the occurrence of any other circumstances as provided for by the contract, and such actions or circumstances can be, in particular, within the control of one of the parties to the contract.

This will allow parties to use more complex transaction formats, so that in M&A deals the parties’ respective closing obligations may now be made subject to their fulfilment of so called conditions precedent that can include performing or alternatively refraining from certain actions. Conditions precedent are commonplace in international contracts but the Russian courts up until now, often failed to enforce such conditions unless they were completely outside the control of the parties.

Warranties (in Russian – “zavereniya ob obstoyatel'stvakh”)

New Article 431.2 of the Civil Code introduces the concept of warranties in connection with the conclusion, performance or termination of a contract and provides a remedy for breach of a warranty, entitling the aggrieved party to damages from the warrantor or, if stipulated in the contract, a penalty.

If there is a breach of a warranty that is of substantial significance to the party who has relied on such warranty, such other party is also entitled to terminate the contract, unless the right to terminate has been expressly excluded.

According to the Amendments, the fact that the contract is held as non-concluded or invalid will not itself release the breaching party from liability for breach of warranties.

Warranties and the related English law concept of representations, have proven a vital and enduring feature of foreign law governed corporate and commercial transactions and the fact that Russian law has had such a narrow and restricted concept of warranties has been a major reason for avoiding Russian law in all but the simplest transactions or where it cannot be avoided. The acceptance by Russian law of the concept of actionable statements of fact concerning more than just the specific nature of the goods sold but now including general facts relevant to a buyer’s decision, is a most important step for Russian law to gain general acceptance.

Reimbursement of losses (indemnity)

New Article 406.1 of the Civil Code introduces a new concept into Russian law which is similar to what is known as an ‘indemnity’ in many legal systems. According to this Article, parties acting in the course of business may agree that one of them will reimburse the losses incurred by the other party in relation to particular matters specified in the contract and not connected with any breach of the contract (e.g. losses caused by an impossibility to perform an obligation, by claims made by third parties or state authorities against the other party or a third party specified in the agreement, etc.). The amount of reimbursement or the procedure for its determination must be set out in the contract between the parties.

Like warranties, indemnities are an enduring feature of international transactions – addressing risks that arise
from known events that have been discovered or disclosed before the contract. So again, the inclusion of this concept into Russian law is a most important step for Russian law to be accepted for sophisticated transactions.

New types of civil law contracts

Option agreement

The addition of specific Civil Code Articles regulating option agreements helps to remove the previously existing doubts as to the validity of Russian-law option agreements. In particular, before the Amendments introduced the concept of option into the Civil Code, option agreements were at risk of being invalidated by the Russian courts that would often hold them to be conditional transactions on the basis of a narrow interpretation of Article 157 of the Civil Code (transactions concluded under a condition).

The introduction of free-standing concept of option contracts in the Civil Code resolves the contradiction and enshrines this concept in Russian law. The lawmakers have defined two option agreement models, which are to a large extent regulated in the same manner, namely:

- an option to enter into a contract whose subject-matter is the provision of a right to enter into one or more agreements (Article 429.2 of the Civil Code), for example, an option to enter into a lease agreement by way of which the lease agreement is entered into upon exercise of the option by the rightsholder; and
- an option agreement whose subject-matter is the right to require the performance of actions contemplated by the agreement (Article 429.3 of the Civil Code), for example, an option to buy or sell assets without execution of a separate sale and purchase agreement.

Framework agreement

Based on the freedom of contract principle, framework agreements have been extensively used in Russian commercial law despite the fact that this type of contract was not previously defined in the Civil Code. If an agreement lacked the material conditions required to give effect to a specific transaction, such an agreement was at risk of being held by court as either invalid or purely declarative (i.e. non-binding).

Article 429.1 of the Civil Code not only defines framework agreements as a separate type of contract, but also establishes that a framework agreement may set out the general terms and conditions of the parties' contractual relationship, while details are to be reflected in separate agreements to be concluded by the parties in pursuance of the framework agreement.

Subscriber agreement

A subscriber agreement is defined as an agreement under which one party undertakes to make regular payments or provide other consideration to the other party for the right to require the performance of contractual obligations by the other party. If the subscriber fails to require such performance, the money paid or other consideration provided by the subscriber is non-refundable.
Although this type of contract was not previously codified, it has been widely used in practice (for the organisation of all-you-can-eat buffets, for fitness club subscriptions, etc.).

**Rules for the conduct of negotiations to conclude a contract**

The Amendments introduce important provisions regulating pre-contractual relations between the parties. Article 434.1 of the Civil Code establishes a duty on those entering into contractual negotiations to act in good faith and not to enter into negotiations frivolously. This Article also introduces the notion of bad faith negotiations and defines the concept of bad faith as where one party to the negotiations provides the other party with incomplete information or conceals certain facts, or unexpectedly breaks off the negotiations without due cause. If a party breaches the requirements of Article 434.1 of the Civil Code, it will have to reimburse the aggrieved party's losses, which are defined as the expenses incurred by the good faith party for the conduct of the negotiations and any expenses related to the lost opportunity to conclude a contract with a third party.

The new rules for the conduct of negotiations to conclude a contract have some parallel with the German law principle of "culpa in contrahendo". Even though Russian practice in this field will no doubt develop with time, it would be prudent for counterparties involved in projects or transactions with Russian partners to refer to best practices commonly used in Germany to minimise the new risks. Liability under the culpa-in-contrahendo concept arises only if in the course of negotiations and prior to the conclusion of a final contract, one party acts in a way that causes the other party to incur costs and effort in reliance on the future conclusion of the contract and which are lost later on when the first party terminates negotiations.

To limit liability in the German law context, our general recommendation is to enter into a document clearly defining the negotiations as non-binding and does not give rise to any obligation on the parties to conclude an agreement and the termination of negotiations does not make either party liable for the other's costs incurred in the course of negotiations. This recommendation, however, would not be appropriate for Russia. Although it is now possible to enter into an agreement regulating procedures governing the conduct of negotiations and setting out penalties for breach of obligations under such agreement, any limitation of liability is deemed invalid. It is therefore important (and is yet to be seen) what criteria Russian courts will apply to determine whether a party that terminated negotiations was acting in good or bad faith.

The new rules will clearly apply to negotiations carried out between Russian individuals and entities. We assume they would also apply to negotiations on agreements that shall mandatorily be governed by Russian law. Application of the new rules to cross-border negotiations is a more complex issue which will remain uncertain until the relevant court practice has been formed.

To minimise the risks, we would recommend that negotiating parties establish the time when negotiations have formally started. This could be achieved by way of execution of an LOI or any other document that could be used as evidence if a claim for reimbursement of expenses related to termination of negotiations (as described above) is filed.

In order to have an argument that Russian rules on pre-contractual negotiations do not apply to the parties and rules of a foreign jurisdiction apply, it is further advisable that the LOI or any document that evidences the commencement of negotiations contain applicable law provisions to avoid automatic application of the conflict of rules principle.
New mechanisms to secure the performance of contractual obligations by the parties

The Amendments introduce additional mechanisms for securing the parties' performance of their respective contractual obligations and for safeguarding their commercial interests. Among the new mechanisms, some will be useful in the context of corporate, commercial and financial transactions, such as break-up fee arrangements (Article 310.3 of the Civil Code), independent guarantees from a credit institution or commercial organisation (Article 368 of the Civil Code), and security deposits (Article 381.1 of the Civil Code).

Comment

These are highly significant changes to the Civil Code: they mean that Russian law is now theoretically capable of regulating sophisticated corporate, commercial and financial transactions and provides many of the tools that are needed by practitioners to protect their clients and bring deals to a successful closing. The market may remain a little under-confident until the approach of the Russian courts is known and that will undoubtedly take a little time. Nevertheless, Russian law is becoming less easy to avoid and so it is very welcome that steps have now been taken that appear to make it very much more practical and aligned to international practice.

The market's response to the new rules for the conduct of negotiations to conclude a contract will no doubt be more mixed.

Please find links to our previous Alerts on the Civil Code reform below:

- Russian Civil Code reform in the field of corporate law
- Russian Civil Code reform – A new pledge regime
- Exclusive rights to intellectual property caught in the Russian Civil Code reform
- Transactions and torts with a foreign element – impact of the Russian Civil Code reform

Changes to regulation of shareholders agreements in the context of the Russian Civil Code reform – Will they make a difference?

- Third set of amendments to the Russian Civil Code
- Russian Civil Code reform: changes ahead for transactions
- Amendments to the Russian Civil Code have been adopted in relation to the registration of rights to property
- The State Duma adopted in 3rd reading amendments to Sections 1, 2, 3 and 4 of Part I of the Civil Code of the Russian Federation (CC RF)
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