

# CLIENT UPDATE

## ENTRY INTO LAW OF BUNDLE OF AMENDMENTS TO RUSSIAN CIVIL CODE - SECTION ON PRIVATE INTERNATIONAL LAW

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On September 30, 2013, the President of Russia signed into law Federal Law No. 260-FZ on Amendments to Part Three of the Civil Code of the Russian Federation. The amendments introduced by this law are part of ongoing reforms of the Civil Code of the Russian Federation (the “Civil Code”) and take effect from November 1, 2013.

- This update examines the most important changes introduced by this law to Part Three of the Civil Code, Section VI - Private International Law.
- In particular, the changes affect the concepts of “overriding mandatory norms” and “public policy”, and determination of the law governing the liability of founders/members for the debts of legal entities, and the law applicable to joint stock companies, proprietary interests, the form of a transaction, rights and obligations under a contract, power of attorney and other agency, and obligations arising from infliction of harm (tort) or obligations arising from unjust enrichment.
- The amendments apply to legal relations arising after the law takes effect. Thus, as a general rule, these amendments do not change the law as it applies to relations arising prior to November 1, 2013.

Below we provide a brief review of the key new provisions envisaged by this law.

## GENERAL PROVISIONS OF PRIVATE INTERNATIONAL LAW

The special term “norms of immediate application” has been introduced to Art. 1192 of the Civil Code to designate a special group of mandatory norms in Russian law that must be applied regardless of which law applies generally to a particular set of relations (and regardless of the choice of governing law set out in a cross-border transaction).<sup>1</sup> This will make it easier to distinguish the set of “norms of immediate application,” or overriding mandatory provisions, from other (regular) mandatory norms of the Civil Code in the usual accepted meaning of the term (*see, e.g.,* Art. 422, Art. 1210.5, paragraphs 1 and 4 of Art. 1212, and Art. 1223.1.2 of the Civil Code).

The import of this special class of overriding mandatory provisions was recently brought into focus by paragraph 16 of the Digest of Case Law on Certain Matters Related to the Consideration by *Arbitrazh* Courts of Proceedings Involving Foreign Persons (approved by Information Letter No. 158 of the Presidium of the Higher *Arbitrazh* Court of the Russian Federation dated July 9, 2013). This Digest cited certain provisions of Federal Law No. 57-FZ on Foreign Investment in Commercial Entities with Strategic Importance for National Defense and National Security dated April 29, 2008 as an example of Russian overriding mandatory provisions. At the same time, the court of highest instance noted that not all mandatory norms in Russian law may be deemed overriding mandatory provisions and noted, in particular, that the provisions of Arts. 196 and 198 of the Civil Code on the statute of limitations are not classified as such.

Art. 1193 of the Civil Code has been supplemented to state that, in interpreting the concept of public policy, the nature of relations involving a foreign element must be taken into account. This places an emphasis on the distinction found in the legal systems of many countries between public policy as it applies to purely domestic relations (so-called “domestic public policy”) and public policy in the context of private international law (so-called “international public policy”).

## STATUS OF LEGAL ENTITIES

The scope of the *lex societatis* of a legal entity as defined by the place of incorporation of the legal entity has been supplemented to include issues of the liability of the founders/members of the legal entity for its obligations (Art. 1202.2(9) of the Civil Code). This issue

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<sup>1</sup> The term “overriding mandatory norms” is also widely used in Russian case law and legal doctrine when discussing this set of norms.

is becoming more and more relevant in Russian court practice as part of the lively discussion of application under Russian law of the concept of piercing the corporate veil.

However, the new Art.1202.4 of the Civil Code emphasizes that if a legal entity incorporated outside Russia conducts its business operations predominantly in Russia, then the issue of liability for the obligations of the legal entity of its founders/members or other persons entitled to direct its business activities may – at the option of a creditor – be governed either by the *lex societatis* or by Russian law.

In the new wording of Art. 1214.1 of the Civil Code, for the first time ever parties will have the statutory right to choose the governing law of an agreement on the establishment of a legal entity and an agreement on the exercise of the rights of participants in a legal entity. Previously, Russian courts had taken the view that the governing law of shareholders' agreements and participants' agreements was not a matter of the parties' choice.<sup>2</sup>

At the same time, it is worth mentioning that, regardless of the choice of governing law by the parties, the mandatory norms of the law of the country of incorporation of a legal entity will still override that choice on the matters set forth in Art. 1202.2 of the Civil Code (i.e., on matters included in the scope of the *lex societatis*). It should be noted that pursuant to Art. 1202.2(7) of the Civil Code, the scope of the *lex societatis* of a legal entity includes, *inter alia*, regulation of internal relations, including the relations of the legal entity with its members. An example of such internal relations could be the procedure for managing the activity of the legal entity (composition, formation, competence and decision-making of the corporate bodies). This gives rise to the complex issue of the extent to which any foreign law chosen by the parties to a shareholders' agreement/participants' agreement may apply to matters related to such internal relations if Russian court practice continues to deem a major portion of the provisions of Russian corporate law as mandatory norms.

If the parties have not agreed on the law governing an agreement on the establishment of a legal entity or an agreement on the exercise of the rights of participants in a legal entity, the law of the country in which the legal entity is or will be incorporated applies.

## PROPRIETARY INTERESTS

The rule stating that the parties to a cross-border transaction may agree that, in respect of the creation and termination of title or other proprietary interests in movable property, the

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<sup>2</sup> See, e.g., Ruling of the Federal *Arbitrazh* Court for the West Siberian District dated March 31, 2006 in Case No. A75-3725-Г/04-860/2005; Ruling of the Federal *Arbitrazh* Court for the Volga District dated May 25, 2011 in Case No. A57-7487/2010.

law governing the transaction will apply rather than the law of the place where the property is located, has been moved from Art. 1210.1 of the Civil Code to Art. 1206.3. The intent of this change is to emphasize that this matter relates to the scope of the law applicable to proprietary interests rather than the law governing the contract. This change could mean that in the event that the parties to a cross-border transaction wish to extend their choice of law to also include the creation and termination of proprietary interests under the transaction, they should set this forth expressly in the governing law clause.

A new article 1205.1 has been included in the Civil Code, clarifying the scope of the law that applies to proprietary interests, including, *inter alia*, the negotiability of the objects of proprietary interests, and the types, scope, exercise and protection of proprietary interests.

## FORM OF TRANSACTION

Art. 1209 of the Civil Code requirement no longer includes the norm whereby previously it was imperative that any cross-border transaction where at least one of the parties was a Russian legal entity or a Russian sole entrepreneur be in a form (e.g., written) consistent with Russian law. The deletion of this provision is a logical consequence of the fact that, from September 1, 2013, the requirement in Art. 162.3 of the Civil Code that a “foreign economic” transaction be in written form became inoperative.

These rules have been replaced by a liberal approach, whereby a transaction cannot be deemed invalid for not being made in the proper form, so long as the requirements of at least one of the following legal systems have been complied with:

- the domestic law governing the transaction itself. Under Art. 1210 of the Civil Code the parties to a cross-border transaction generally may agree to choose such law;
- the domestic law of the country where the transaction was entered into. In accordance with Art. 444 of the Civil Code, if a contract does not specify the place of its conclusion, the contract is considered concluded at the place of residence of the person or location of the legal entity that made the offer;
- Russian law, if at least one of the parties to the transaction is a person whose *lex personalis* is Russian law.

However, for practical reasons and in order to comply with the provisions of Russian public laws on currency, customs and tax control, it is recommended that Russian parties to cross-border transactions continue in the future to execute international transactions in writing.

Special rules have been established to determine the applicable law governing the formal validity for the following types of transactions:

- for consumer contracts, the consumer may choose to apply the law of the country of residence of the consumer, subject to the provisions of Art. 1212.1 of the Civil Code;
- special requirements apply to agreements on the establishment of a legal entity and transactions in connection with the exercise of the rights of participants in a legal entity that are laid down by the law of the country of incorporation of the legal entity;
- if either the transaction itself or the creation, transfer, restriction or termination of rights thereunder requires mandatory registration in Russia, the form in which such transaction is drawn up must comply with Russian law; and
- transactions involving immovable property are governed by the law of the country where the immovable property is located, and those involving immovable property registered in the Russian state register are governed by Russian law.

## LEX CONTRACTUS

In the previous version of the Civil Code, considerable difficulties were caused by Art. 1210.5 of the Civil Code, under which, for any contract that was genuinely connected with only one country, the parties' choice of the law of another country could not affect the application of any mandatory norms of the country with which the contract was genuinely connected. In Russian case law this rule was also sometimes applied to contracts containing an objective foreign element (such as contracts involving foreign companies).<sup>3</sup>

The new wording of Art. 1210.5 of the Civil Code stipulates that such implications may only take effect if at the time the parties to the contract chose the governing law, all substantive elements of their contractual relations were connected to only one country. Thus, it is clear that the drafters of the law sought to narrow the scope of this norm.

The new wording of Art. 1211 of the Civil Code establishes a more precise mechanism for determining the law applicable to a contract in the absence of a choice-of-law agreement between the parties. In determining the governing law the court must start by applying the precise criteria set forth in Art. 1211, paragraphs 1-8 of the Civil Code (e.g., establish that as a general rule a sale and purchase agreement is governed by the law of the country

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<sup>3</sup> See, e.g., Ruling of the Federal Arbitrazh Court for the Far Eastern District No. Ф03-792/2010 dated August 3, 2010 (shipbuilding contract between a Russian contractor and a German client; the parties chose English law); Ruling of the Third Arbitrazh Appeals Court dated January 12, 2011 in Case No. A33-4642/2010 (loan agreement between a Russian borrower and a lender from the British Virgin Islands; the parties chose BVI law).

of residence or principal place of business of the seller). The court may only depart from the legal precepts of Art. 1211, paragraphs 1-8 of the Civil Code and apply the law of another country in exceptional circumstances, when it establishes that the law, the terms and conditions or the essence of a contract or the circumstances of the case in their entirety clearly imply that the contract is more closely connected with the law of another country than that set forth in Art. 1211, paragraphs 1-8 of the Civil Code.

There have been substantive changes to the norms on determining the law applicable to contracts for the exercise of exclusive rights to intellectual property and means of individualization:

- for franchising agreements, the applicable law is the law of the country on whose territory the franchisee is permitted to use the set of exclusive rights owned by the franchisor or, if such use is permitted within the territory of several countries simultaneously, the law of the country of residence or principal place of business of the franchisor (Art. 1211.6 of the Civil Code);
- for agreements on the alienation of exclusive rights to intellectual property or means of individualization, the applicable law is the law of the country on whose territory the exclusive right granted to the acquirer operates or, if it operates within the territory of several countries simultaneously, the law of the country of residence or principal place of business of the owner of the rights (Art. 1211.7 of the Civil Code);
- for licensing agreements, the applicable law is the law of the country on whose territory the licensee is permitted to use the rights to intellectual property or means of individualization or, if such use is permitted within the territory of several countries simultaneously, the law of the country of residence or principal place of business of the licensor (Art. 1211.8 of the Civil Code).

The amendments also clarify the conditions under which the choice of law in a consumer contract cannot result in the consumer being deprived of protection of his or her rights as granted by the mandatory norms of the law of the country of residence of the consumer. Such mandatory norms of consumer protection apply in all cases where the trader operates its business in the country of residence of the consumer or otherwise directs its activity in any way to the territory of that country or the territories of several countries, including that of the consumer's residence. Among other things, this means that the rule contained in Art. 1212.1 of the Civil Code may be used in situations where goods are distributed or services rendered by foreign enterprises through websites based abroad and aimed at Russian consumers. In addition, the new Art. 1212.4 of the Civil Code provides that even where the provisions of Art. 1212.1 of the Civil Code do not apply (e.g., it cannot

be proven that the vendor is directing its activity to the territory of the country of residence of the consumer or that the consumer contract in question is not connected with the actions of the vendor aimed at the market in the country of residence of the consumer), the choice of law in a contract involving the consumer cannot result in the consumer being deprived of the protection of his or her rights as granted by the mandatory norms of the country whose law would have been applicable to the contract had there not been a choice-of-law agreement between the parties (i.e., in most cases, the law of the country of the principal place of business of the trader).

The new Art. 1216.1 of the Civil Code determines the law applicable to subrogation (i.e., the assumption of the legal rights of a person for whom a debt has been paid). An example of subrogation under Russian law would be where a surety that had discharged the obligations of a debtor assumed the rights of a creditor, or an insurer that had paid out a claim assumed the rights of the policyholder in respect of the party responsible for causing harm. In general, issues of subrogation are governed by the law applicable to the relationship between the original creditor and the new creditor (i.e., for example, the law applying to the suretyship agreement, or the law applying to the insurance policy). However, this is not prejudicial to any legal provisions that serve to protect the debtor and that govern the obligation between the debtor and the original creditor (i.e., for example, the right under the original obligation secured by the suretyship, or the right under the obligation in tort between the policyholder and the party responsible for causing harm).

The new Art. 1217.2 of the Civil Code provides that unilateral set-off is governed by the law applicable to the original obligation that gave rise to the claim for set-off. In other words, in using set-off to reconcile mutual obligations governed by different *lex contractus*, the law applicable to the underlying obligation in respect of which the creditor is the “passive” party which received notice of set-off from the other party should be applied.

Art. 1215.2 of the Civil Code now includes an important new rule that explains that the law applicable to a contract does not affect other special conflict of law rules, including the scope of the *lex societatis*, the law applicable to proprietary interests, and the law applicable to agency.

## **AGENCY**

The new Art. 1217.1 of the Civil Code provides detailed regulation on determining the law applicable to agency (e.g., acting under power of attorney). That law will determine such things as whether the agent has authority and the scope of that authority, what the power of attorney is required to contain, the validity period and termination of the power of

attorney, whether a substitute power of attorney may be issued, and the implications of concluding a transaction without authority or beyond the limits of authority granted by the principal.

The law applicable to these matters may be chosen by the principal and set forth in the power of attorney, provided that the third party and the agent were informed of such choice. If the principal does not choose the governing law in the power of attorney or the choice is invalid, then the relationship between the principal or the agent and a third party is determined in accordance with the law of the country of residence or principal place of business of the agent. If a third party was not aware and should not have been aware of the place of residence or the principal place of business of the agent, the applicable law is the law of the country where the agent primarily operated in the circumstances in question.

Special norms have been established for determining the law applicable in respect of the authority to complete transactions involving immovable property (the applicable law is the law of the country where the immovable property is registered in the state register), and the authority to conduct proceedings in a court of law or arbitral tribunal (the applicable law is the law of the country where the court or arbitration proceedings are being conducted).

The conflict of law rules described above differ substantially from the rules previously in existence, pursuant to which the validity period and grounds for termination of any power of attorney were determined in accordance with the law of the country where the power of attorney had been issued, while all other matters fell under the law of the country of residence or the principal place of business of the principal (Art. 1217 of the Civil Code in its previous version).

It is also important to note that, under the 2nd paragraph of Art. 1209.1 of the Civil Code, the above general rules on the form of a transaction apply to the form of a power of attorney.

Art. 1217.1.6 of the Civil Code includes another important rule under which, unless a power of attorney specifies otherwise, the scope of the agent's authority is deemed to include determination of the procedure for resolution of disputes (execution of arbitration and prorogation clauses) and execution of agreements on the choice of governing law. Thus, should principals issuing powers of attorney under Russian law wish to limit any such authority of the agent, they should expressly include the relevant limitations in the power of attorney.



## NON-CONTRACTUAL OBLIGATIONS

The new version of the Civil Code significantly expands the ability of the parties to choose the law applicable to obligations arising from infliction of harm (torts) or obligations arising from unjust enrichment. Where previously the parties could only agree to choose the law of the court (i.e., Russian law), this restriction has now been lifted (Art. 1223.1.1 of the Civil Code). At the same time, the new version of the Civil Code has retained the rule that an agreement on the choice of governing law may only be reached after the tortious action that gives rise to the infliction of harm or unjust enrichment has been performed. The law chosen by the parties is applied without prejudice to the rights of third parties. In all other respects agreements between the parties on the choice of applicable law are governed by the general provisions of Art. 1210 of the Civil Code.

The ability of the parties to have a say in determining the law that will govern their non-contractual obligations is also extended by the new Art. 1219.3 of the Civil Code, which states that, if the circumstances of the case show that liability in tort is closely connected with the contract between the injured party and the party that caused the damage, then the law governing such contract will apply to that tort liability. However, this rule applies only if the contract was concluded by the parties in the course of their conduct of business.

If the country of residence or principal place of business of the parties to a liability in tort are one and the same, the law of that country will apply. If the country of residence or principal place of business of the parties to a liability in tort are different countries, but the parties are nationals or legal entities incorporated in one and the same country, the law of that country will apply (Art. 1219.2 of the Civil Code). Contrary to the previous version, these rules also apply if the tort is committed on the territory of the Russian Federation.

The new Art. 1220.1 of the Civil Code determines the law to be applied in establishing whether an injured party may claim directly for indemnification for any loss from the insurer that insured the liability of the party that caused the harm. In order to protect the interests of the injured party, such direct claim is permitted if this is permitted either under the law governing the liability in tort or under the law governing the insurance contract.

The new Art. 1222.2 of the Civil Code stipulates that similarly to obligations arising out of unfair competition practices, obligations arising as a result of restriction of competition, as a general rule, are governed by the law of the country whose market was or may be compromised by such restriction of competition. It also points out that the parties to such liability in tort may not agree to change the governing law, unless the unfair competition practices solely affect the interests of a particular injured party.

The new Art. 1222.1 of the Civil Code relates to determining the law applicable to obligations arising as a result of *culpa in contrahendo*. In this case, the law applicable to the contract applies (including the law chosen by the parties to govern the contract if they have already made a choice-of-law agreement) or, if a contract has not yet been concluded, the law that would have applied to the contract if it had been concluded applies. General conflict of laws provisions for tort (Arts. 1219 and 1223.1 of the Civil Code) need only be applied if the above rules are unable to determine the applicable law.

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We would be happy to answer any questions you may have regarding the above matters.

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