

Client Update

Options, Representations, Indemnities, and Other Innovations in Russian Contract Law

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Even though the principle of freedom of contract is enshrined in the Russian Civil Code (the “Civil Code”), Russian law and the Russian courts have for many years taken a hostile or equivocal approach towards the inclusion in Russian contracts of many instruments often used in international business deals. This issue is particularly keenly felt in situations where the absence of a foreign element means the parties cannot choose foreign law to govern their contract.

On March 8, 2015 the President of Russia signed into law a new bundle of amendments to the Civil Code,¹ which should resolve some of these issues and make Russian law more user friendly and flexible. From June 1, 2015, when these amendments will take effect, the Civil Code will directly govern such institutions as:

- representations in respect of facts;
- indemnification of losses;
- option agreements;
- conditions precedent;
- security payments;
- inter-creditor agreements;
- independent guarantees (in addition to the already existing bank guarantees);
- framework agreements;
- fees for termination of contract (*break-up fee*);
- general provisions on *culpa in contrahendo*.

¹ Federal Law No. 42-FZ on Amendments to Part One of the Civil Code of the Russian Federation dated March 8, 2015.

Many other provisions of the Civil Code on obligations have also been amended, making them more flexible and sensitive to the needs of business, such as:

- a further narrowing of cases where a contractual penalty may be reduced by a court;
- the clarification that a security may apply to the consequences of termination or invalidity of secured obligations;
- the inclusion in the Civil Code of many legal positions enshrined in the Decision of the Plenum of the Higher Arbitration Court No. 42 on Certain Issues of Dispute Resolution Related to Guarantee dated July 12, 2012;
- the establishment of rules on approximate, abstract and concrete losses;
- an allowance of compound interest in commercial relations; etc.

We set forth below a brief summary of some of them.

REPRESENTATIONS IN RESPECT OF FACTS

Art. 431² of the Civil Code now expressly provides that one party may make representations to another party about circumstances relevant to the execution, performance or termination of a contract. In the event of any misrepresentation, the party giving the representation must compensate the other party for any losses or pay the damages stipulated in the contract. If a contract in respect of which representations have been made is found to be invalid or not concluded, this in itself does not affect the validity of the representations.

In contrast to French or German law, where representations essentially constitute ordinary obligations, Russian law has separated representations into a separate concept in a similar way to English law. But Russian representations constitute a strange combination of English *representations* and *warranties*. For example, as with *representations*, but in contrast to *warranties*, in general the party that has received a false representation may rescind the contract, and the fact that the recipient knew that the representation was misleading does not affect the right to compensation (in fact, in contrast to English law, in the Russian Civil Code what is important is not whether the recipient of the representations relied on their accuracy, but whether the party giving the representation knew of such reliance). Given these differences, the question arises as to how damages from misleading representations will be calculated:

- in accordance with the liability in contract model, i.e., reinstatement of the party to the same position in which it would have been if the

representation had been accurate (protection of a positive interest which is typical for English *warranties*); or

- in accordance with the liability in tort model, i.e., reinstatement of the party to the position that existed prior to conclusion of the contract (protection of a negative interest which is typical for English *representations*).

The Russian Civil Code does not provide a clear answer to this question.

INDEMNIFICATION OF LOSSES

In accordance with Art. 406¹ of the Civil Code, the Parties to an obligation have the right to enter into an agreement providing for the obligation of one party to compensate the other party's losses defined in the agreement and not related to a breach thereof in the event of occurrence of certain circumstances (inability to perform obligations, claims asserted by third parties, etc.). In general, only commercial entities and individual entrepreneurs may enter into such agreements, whereas individuals who are not entrepreneurs may only assume such obligation in a shareholders agreement or an agreement for the disposal of shares or participation interests.

It must be noted that a claim for indemnification of losses is not a charge of liability, and the creditor is therefore not required to prove the wrongfulness of the actions or the guilt of the debtor, etc. For the same reason, a court may not reduce the amount of the losses to be indemnified, other than where the creditor has deliberately played a part in inflating the amount of the losses.

In essence, this provision represents the Russian analogy of the English *indemnity*. In contrast to earlier versions of the draft Civil Code, the final version of this article turned out to be considerably more flexible. Possibly the principal unclear issue is the reference to the fact that an agreement on indemnification of losses is entered into by the "parties to an obligation." This provision may be interpreted to mean that the obligation to indemnify losses may only be assumed by the party to the principal obligation; this was the rule that was most clearly articulated in the first draft of the amendments and, unfortunately, the final wording does not completely dispel all doubts. It should also be noted that the Civil Code contains no default method of calculation of indemnified losses and requires that the agreement provide for the amount and method of calculation of losses to be indemnified, thus it is desirable that the parties specify this in as great detail as possible in the agreement.

CONDITIONS PRECEDENT

Russia has seen a contradictory practice develop in relation to the possibility of making a transaction conditional upon the will of one of the parties. In academic circles the prevailing view allowed for the possibility of using conditions dependent, among other things (but not exclusively), upon the will of one of the parties. However, the courts sometimes took the opposite view, that any conditions dependent, to a greater or lesser degree, on the will of the parties should be deemed invalid. These conflicting positions were based on a divergent reading of Article 157 of the Russian Civil Code, which has not been redrafted as part of the reform of the Civil Code.

At the same time, the new bundle of amendments (Art. 327¹ of the Civil Code) now expressly provides that certain rights and obligations of the parties under a transaction may be made subject to any conditions, including those that are completely dependent upon the will of one of the parties. It is anticipated that these provisions will finally put an end to the absurd problem of drafting conditions in a contract.

In addition, the amendments to Art. 314 of the Civil Code provide that the period for the discharge of obligations may be tied to the point in time at which the second party discharges its obligations. Previously, the courts would often deem that such period had not been established, since it did not contain any references to a specific date or an event that must necessarily occur. This amendment will be of crucial significance for contractor agreements and other agreements where the period is a material term of the agreement, but the parties would like to tie it to events dependent upon the will of one of the parties.

OPTIONS

Since an option agreement by nature assumes the possibility of the exercise of an option at the discretion of one party, in Russia such agreements have come up against the risks described above in respect of conditional transactions.

In an attempt to resolve this issue, the amendments to the Civil Code introduced two new instruments (in many areas duplicating each other): an option to conclude a contract under Art. 429² (the subject of the option is the right to conclude a contract), and an option agreement under Art. 429³ (the subject of the option is the right to require that certain actions be performed under a previously concluded contract). In both cases the contract may provide for a fee for granting of the option.

NEW MEANS OF SECURING OBLIGATIONS

The bank guarantee is replaced by an “independent guarantee” that may now be issued not only by a lending institution, but by any other commercial organization. An independent guarantee constitutes an on-demand guarantee that is independent of the principal obligation. The Civil Code now also expressly provides that an independent guarantee may include a condition concerning an increase or reduction of the amount of the guarantee on a certain date or upon occurrence of a certain event. Furthermore, the guarantor now has the right to suspend payment under a guarantee for a period of up to seven days if he has reasonable doubts concerning the validity of the principal obligation, correctness of the documents presented, or failure to perform the principal obligation.

A new method of securing obligations is also introduced: the security bond payable to secure monetary obligations, including those related to compensation of losses or to any future obligations (Art. 381¹ of the Civil Code). In addition to being able to secure obligations that do not yet exist, an important difference between the security bond and earnest money is that the creditor does not bear the risk of repayment of double the amount if the obligation is breached not by the debtor, but by the creditor.

RULES FOR CONDUCTING NEGOTIATIONS

The previously adopted general principle of good faith, which took effect from March 1, 2013, is developed further, and the procedures for the good faith conduct of contract negotiations are clarified. In particular, it is prohibited to enter into or continue negotiations if there is a lack of intent to reach agreement, to remain silent about material conditions, to cease negotiations abruptly and unreasonably, and to use information provided by the other party to the negotiations in an improper fashion (Art. 434¹ of the Civil Code).

The requirement to conduct negotiations in good faith did not apply prior to March 1, 2013, and is not provided for in English law, which is often used to govern transactions in respect of Russian assets; therefore, in Russia negotiations have traditionally been viewed as a stage that does not give rise to any legal consequences for the parties. However, with the introduction of the new rules, it is worth being more attentive to behavior at the pre-contractual stage.

INTEREST UNDER A MONETARY OBLIGATION

For commercial organizations Art. 317¹ of the Civil Code introduces the obligation of the debtor to pay interest under any monetary obligation at the Central Bank of Russia refinancing rate, unless the parties exclude this

obligation in their agreement. In contrast to Art. 395 of the Civil Code, the new requirement applies even if there has been no delay or other violations on the part of the debtor, i.e., the interest essentially constitutes a mandatory payment for a trade credit. Since such payment is often already factored into the price, the parties ought to take into account the new provision of the Civil Code when drawing up contracts and exclude it from applying to the contract.

PAYMENT FOR TERMINATION OF CONTRACT

The Civil Code now expressly permits the inclusion in a contract of a specific fee (similar to a *break-up fee*), which must be paid in the event of the unilateral change of an obligation or unilateral termination of an obligation (Art. 310.3 of the Civil Code).

AMENDMENT OR ASSIGNMENT OF A CONTRACT CONCLUDED BY TENDER

For contracts that may only be concluded through conduct of a tender, Article 448, paragraphs 7 and 8 establish a new rule, pursuant to which the winner of a tender may not assign its rights or transfer the debt under such contracts, and any amendments to such contracts may not affect the terms of the contract of material importance for determining the price at tender.

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Please do not hesitate to contact us with any questions.