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Briefing note May 2015

Changes to the Russian Civil Code: What's new in the regulation of obligations

As of 1 June 2015, the next set of changes to the Russian Civil Code, which were adopted in the course of the first reform of the Civil Code in several years, will come into force. This time the changes affect the law of obligations (including performance, security and termination of obligations, as well as liability for breach of obligations) and general contractual provisions (including entering into, amending and terminating contracts).

Key issues

- Contractual subordination of creditors' claims becomes available
- The suretyship becomes a more robust security
- Guarantees can be issued by non-banking commercial entities
- A form of common law indemnity and a concept of representation are introduced
- General principles for options are established
- Basic rules for the waiver of contractual rights are introduced

Apart from the general changes to the areas mentioned above, the amendments contain the following innovations which are discussed in greater detail in this briefing:

- **A concept of intercreditor agreement has been introduced, permitting a contractually agreed order for the recovery of claims;**
- **Changes to the regulation of suretyships have been introduced to ensure the survival of the suretyship in cases where the underlying secured obligations are amended and to decrease the risk of the security being set aside on formal grounds;**
- **Numerous changes have been introduced to expand the use of guarantees and to strengthen their independent nature;**
- **The taking of security in the form of financial collateral (which was used in practice but lacked any legal framework) is now provided for;**
- **Liability for breach of obligations, such as penalties and payment of default interest, is now regulated in greater detail;**
- **The right to be indemnified for losses incurred upon the occurrence of certain events not related to a breach of obligations has been introduced;**
- **A concept of representation and remedies for misrepresentation have been introduced;**
- **Option agreements are now regulated;**
- **General principles of pre-contractual liability for negotiating in bad faith have been introduced;**
- **There is now a right to amend or terminate a multilateral contract by consent of the majority of the parties; and**
- **There is a general right to waive the exercise of rights under a contract.**

We outline below the most important changes applicable to financing transactions, restructurings and, to a certain extent, corporate transactions.

Intercreditor agreements

The amendments allow creditors with 'claims of a similar nature', to agree between themselves on the order in which their claims will be discharged, *inter alia* allowing claims to be satisfied otherwise than on a *pro rata* basis.

A creditor that recovers more than it is entitled to under the terms of an intercreditor agreement must turn over the excess to the other creditors, but the recovering creditor is subrogated to the rights of the creditors with which it shared the excess. The subrogation right applies whether the recovering creditor received the excess amount by breaching the intercreditor agreement itself or the debtor decided to prefer that particular creditor. The law is silent over whether these rules can be contracted out of by agreement between the parties.

These provisions on turn-over and subrogation may have implications which should be carefully considered. For example, a secured creditor which recovers a payment to which it is not entitled under the terms of an intercreditor agreement may, upon turn-over of the excess amount to another (unsecured) creditor, find that its security has been discharged by the payment from the debtor and that it is left with an unsecured claim instead.

As the insolvency regime has not been changed to reflect the introduction of intercreditor agreements, an insolvency administrator will still repay the creditors according to the statutory order of priority. However, as there is no reason to believe that an intercreditor agreement becomes ineffective on insolvency, it (including the turn-over provisions) will still apply as between the creditors which are parties to it.

Performance by third parties of a debtor's obligations

The rule according to which a third party may, subject to certain conditions, perform another party's obligations has been amended. Until now, a creditor was obliged to accept performance by a third party only if performance had been authorised by the party obliged to perform the obligation. The only exception to this was when the third party's recourse to the original obligor's property as a result of any enforcement proceedings against such property might be prejudiced by non-performance, when it was entitled to perform the obligation to protect its own position.

Another exception has been added by the amendments, allowing a third party to discharge another party's obligation, without being expressly authorised to do so, when the party obliged to perform the obligation is in payment default. The third party will then acquire a right of subrogation against the debtor, with the caveat that if less than the full amount of the obligation was discharged by the third party and the creditor retains a claim against the debtor, the third party's claim will not be allowed to prejudice the priority of the claim of the creditor for the balance (for example if the creditor had security for the claim).

It is unclear whether a third party may perform a debt obligation which is in default in full or only in the amount in default, without the debtor's consent. This may be important since the subrogation right which arises on performance could conflict with a prohibition on assignment by the creditor in the agreement under which the debt arose, depriving the debtor of the right it would have had to claim damages from the creditor for breach of the prohibition on assignment.

Obligations subject to conditions precedent

The amendments have resolved a long-standing uncertainty over whether it is valid for the obligations of one party to be subject to the satisfaction of conditions which are under the other party's exclusive control (such as conditions precedent under a loan agreement which are generally under the control of the borrower). The amendments expressly provide that this is valid, and that the exercise, amendment and termination of contractual rights may also be dependent on action taken or not taken by the other party, or the occurrence of events which may be within the other party's control.

Security of obligations

Important and long-awaited changes have been made to general principles of Russian security, the regime for suretyships and guarantees and the ability to take security in the form of financial collateral, which was commonly used in practice but was not formally regulated.

General principles of security

Changes have been made to mitigate the accessory nature of Russian security and to reflect the position developed earlier in clarifications of the Supreme Arbitrazh Court. From 1 June 2015, a security interest will not terminate if the secured obligations become invalid, but it will continue to secure the obligation to return any property received by the debtor under the agreement which evidenced the secured obligations. This will apply whether or not the security documents so provide (as opposed to the position under the approach supported by the Supreme Arbitrazh Court, where the security documents needed to stipulate this expressly).

Suretyships

The regulation of suretyships has been revised to emphasise their accessory nature and to decrease the risk of challenge by bad faith debtors on technical grounds.

Ability to secure non-monetary obligations

One of the key changes is to allow a suretyship to secure non-monetary obligations. It was previously accepted in clarifications of the Supreme Arbitrazh Court that damages and other monetary sanction arising from the non-performance of non-monetary obligations could be secured by a suretyship. However there is a risk that, in the absence of any specific provisions dealing with this, securing obligations to supply property *in specie* or to perform certain actions (such as rendering services or performing work) may not work in practice.

Description of secured obligations

As with pledges, instead of describing the secured obligations in detail, it will be sufficient for the suretyship to refer to the agreement evidencing the secured obligations for it to be valid.

In addition, a surety engaged in commercial activity will be able to grant a suretyship securing all existing and future obligations of a debtor without reference to a particular agreement evidencing those obligations. However a cap on the liability of the surety must be specified in the suretyship.

Restriction of the right of subrogation

The position has been made more favourable to creditors with the introduction of the principle that a surety that acquires secured rights against a debtor by way of subrogation is subordinated to the claims of the original creditor until the original creditor's claim has been satisfied in full.

Consequences of loss of security

From 1 June 2015, if a security interest existing at the time a suretyship was entered into becomes invalid or is impaired as a result of circumstances for which the creditor is responsible, the surety may be released from its liability under a suretyship to the extent it could have recovered amounts from the debtor by way of subrogation under that security interest. However, to avail itself of this exoneration the surety must prove that at the time the suretyship was granted it would have been reasonable to rely on recovery through enforcement of such security interest. There is an argument that when a surety is engaged in commercial activity, the parties may agree other consequences of the invalidity or impairment of a security interest.

The right of a surety to raise defences

The amendments expressly provide that a surety may suspend payment under a suretyship until the creditor has had an opportunity of discharging its claim against the debtor by way of a set off against any claim the debtor may have against it. There is a strong argument that this right of a surety cannot be contracted out. Similarly the right of a surety to raise defences which can be raised by the debtor cannot be waived; any restriction of this right will be invalid.

These provisions reinforce the accessory nature of a suretyship as opposed to an independent guarantee.

Termination of a suretyship

The amendments confirm the position expressed earlier by the Supreme Arbitrazh Court that a suretyship does not terminate when the secured obligations terminate as a result of the debtor being wound up, provided that such winding up occurs after a claim under the suretyship has been made.

Another approach of the Supreme Arbitrazh Court which has been adopted in the Civil Code is that if secured obligations are changed without the surety's consent in a way that increases the surety's liability or has other adverse consequences for the surety, the suretyship will not terminate but will continue to secure the secured obligations as if no change had been made to them.

Consistent with previous court practice, under the amendments a suretyship may contain the consent of the surety to amend the secured obligations, but such consent must specify the limit of the surety's liability. In our view, in the context of facility agreements the limit may extend to the overall liability as well as limiting the interest rate, the tenor or other material terms.

Transfer of debt

According to the amendments, in the event of a transfer of the debtor's obligations, the consent of the surety must make it possible to determine the identity of the obligors in respect of which the surety agrees to be liable. This resolves a debate over whether a suretyship could just refer to the obligors in a generic rather than specific way.

Independent guarantees

The changes made to the regime for guarantees (as opposed to suretyships) have extended the list of entities that may provide guarantees and at the same time emphasised the independent nature of this type of security from the obligations it secures.

Essential terms of a guarantee

From 1 June 2015, a guarantee may be used more in practice because guarantees may be issued not only by banks and other credit institutions, but also any other legal entities involved in commercial activity. Although the requirement to specify the limit of a guarantor's liability is retained, it is expressly provided that such requirement is

considered to have been satisfied if the provisions of the guarantee relating to the guaranteed amount should enable the guaranteed amount to be determined as of the date when the guarantor has to pay under it.

As previously, the guarantee should contain an expiry date, describe the guaranteed obligations and any conditions to be satisfied for the guarantor to pay thereunder upon request of the beneficiary (such as documents to accompany the claim).

The amendments specifically state that the rules regulating guarantees should apply to security arrangements under which a security provider is obliged to transfer shares, bonds and fungible assets.

Independent nature of a guarantee

Under the amendments, the status of a guarantee has changed to make it more independent of the guaranteed obligation by comparison with a suretyship which is clearly an accessory obligation. Under a guarantee:

- The guarantor is not entitled to raise any defences arising from the guaranteed obligations or any other obligations;
- The guarantor's defences are limited to the express terms of the guarantee and the guarantor may only refuse payment if any documents presented to obtain payment do not conform to the requirements of the guarantee, or if the guarantee has expired. Payment may only be suspended (and in any event for not more than seven days) on very limited grounds specified by law, and as previously, the invalidity of the guaranteed obligations constitutes a ground for suspension of payment, but not for refusal to pay;
- The guarantor is not entitled to set-off its obligations against any claim which it may have against the beneficiary, which it acquired from the primary obligor, unless otherwise provided in the guarantee or agreed between the guarantor and the beneficiary.

Assignment of rights under a guarantee

As previously, the beneficiary may only assign its rights under a guarantee if assignment is expressly permitted by the terms of the guarantee and only if the rights to the guaranteed obligations are assigned simultaneously to the assignee. Even if assignment of the guarantee is permitted in principle, the guarantor's consent is required for a specific assignment unless the guarantee provides otherwise.

Financial collateral

The amendments introduce regulations for financial collateral which is recognised as a new type of security under Russian law, although it has been widely used in practice for some time (e.g. under lease agreements). According to the rules, under a financial collateral arrangement a monetary obligation (including a claim for losses or penalties) can be secured by way of a transfer of a sum of money by the party which owes the secured obligations to its counterparty. This sum can be applied to discharge the secured obligations on the occurrence of certain events. An equivalent sum is to be returned to the collateral provider on discharge of the secured obligations or expiry of the agreed term for which the collateral was provided.

It is expressly provided by the amendments that shares, bonds, other securities and other fungible assets may be used as collateral under similar rules.

It is unclear at this stage to what extent the collateral provider takes a risk on the counterparty for return of the assets transferred, especially in an insolvency of the counterparty.

Assignment of rights

From 1 June 2015 the assignment of a monetary claim may not be set aside on the grounds that it violates a prohibition on assignment in the agreement evidencing the claim (including in a situation when the claim is unconnected with the commercial activity of the parties). However, the debtor will still be entitled to claim damages from the initial creditor as a result of a breach of such prohibition.

As previously, the assignment of rights under a non-monetary claim may be prohibited by agreement and may be challenged if it is proved that the assignee was aware of or should have been aware of such prohibition.

Injunction for breach of a negative covenant

The amendments entitle a creditor to seek an injunction from the court to restrain a counterparty from breaching a negative covenant. It is not clear in practice how this will apply, particularly if the breach has already occurred (such as a disposal of assets or incurring additional financial indebtedness) or even with respect to a possible future breach, as there is no concept of contempt of court in Russian law, and the law on execution has not been amended to reflect this new remedy.

Interest on funds

When payment is delayed or funds are otherwise unlawfully withheld, interest is payable by operation of law. From 1 June 2015, the applicable rate of interest is the average rate on deposits of individuals for the relevant period at the

place of location of the creditor, as published by the Russian Central Bank. This rate has replaced the earlier refinancing rate set by the Russian Central Bank. As previously, as a general rule the rate of interest above applies unless the parties have agreed on a different rate.

The rate of default interest agreed by the parties may be decreased by the court on application of the debtor if the amount is not commensurate with the consequences of the breach, but in any event will not be lower than the statutory rate referred to above.

In the context of commercial transactions, the amendments also permit a creditor to claim statutory interest on funds at the refinancing rate of the Russian Central Bank, unless the parties have agreed another rate or that no interest is payable.

As an exception to the general prohibition on compound interest and in addition to those cases where compound interest is expressly permitted by law, the amendments allow compound interest to be provided for in agreements relating to obligations performed by the parties in the course of their commercial activity.

Indemnity for losses not connected with a breach of obligations

A new concept has been introduced according to which parties to an obligation which is connected with their commercial activity may agree that one party will indemnify the other against any actual losses incurred upon the occurrence of events not related to a breach of obligations (such as losses incurred as a result of a claim of a third party or the tax authorities). The intention is to introduce some features of the common law indemnity into Russian law.

For a Russian law indemnity to be effective, it is essential that the amount of actual losses is specified, or that the agreement provides how the amount is to be determined. It is not clear at present how exactly the agreement should provide for the amount to be determined, and it is likely that this will differ according to the circumstances.

The court may decrease the amount payable under the indemnity if it is proved that the party claiming under the indemnity deliberately contributed to its loss.

If losses are incurred as a result of the unlawful action of a third party, upon paying under the indemnity, the indemnifying party has a right to be indemnified by the third party responsible.

The amendments expressly provide that this form of indemnity can be used in shareholders' or participants' agreements and agreements on the disposal of shares or participatory interests to which an individual is a party.

Preliminary agreements

The requirements for preliminary agreements have been relaxed. It will no longer be necessary for a preliminary agreement to contain all essential terms of the main agreement, but it will be sufficient for the parties to agree on the subject matter of the main agreement and those terms which one or other of the parties wants to have included.

There is now an effective remedy against a party to a preliminary agreement which subsequently fails to enter into the main agreement. As previously the court may order the defaulting party to enter into the main agreement, but according to the amendments the main agreement will be treated as binding on the parties as soon as the court decision enters into force. In the event of disagreement over the terms of the main agreement, the court will determine them and include them in its decision. The right to apply to the court for an order for the defaulting party to enter into the main agreement may be exercised within six months of the date on which it was proved to be in default.

Options and option agreements

Two concepts have been introduced to regulate option agreements.

Under the first (**an option to enter into an agreement**), one party makes an irrevocable offer to the other to enter into an agreement on terms previously agreed. By accepting the offer the other party effectively exercises the option and becomes bound by the agreement. The offer can be made valid for one year or such other period as the parties agree, and can be accepted at any time until expiry.

The option may be granted for a fee or other consideration which, unless the parties agree otherwise, is not returnable if the option is not exercised, and the option should include all the main terms of the agreement with respect to which the option is granted.

The agreement containing the option must be entered into in the same form (that is to say notarised or not notarised) as the agreement to be entered into on exercise of the option.

Under the second concept (**an option agreement**) one party has a right to require performance by another party of specified obligations.

As with the first concept, there is a fixed period during which the option is exercisable, and there may be non-returnable consideration for granting the option.

Circumstances precluding a party from challenging or repudiating a contract

As a general rule, in the context of commercial transactions, a party that accepted performance of a contract by its counterparty, but failed to perform its own obligations in whole or in part, will not be entitled to challenge the validity of the contract. This rule is intended to prevent a party seeking in bad faith to avoid performance of its own obligations.

By way of enhancing the principle of freedom of contract, in the context of commercial activity the parties to an agreement may agree on the consequences of a voidable contract being held by a court to be void (which may include remedies other than mutual restitution). The law expressly provides that this agreement may only be entered into after the contract has been held void and may not affect the interests of third parties or be contrary to public interests.

If a party entitled to repudiate a contract nevertheless affirms the contract, its right to repudiate the contract subsequently is restricted by the amendments. According to the amendments, a contract is deemed to be affirmed if, for example, the party has accepted performance by another party. Following affirmation, the affirming party is deprived of the right to repudiate the contract on the same grounds. In this context it is not clear how the prohibition on repudiation on 'the same grounds' would be interpreted in practice, for example if 'the same grounds' arose a second time.

Concept of representation

The amendments introduce a concept of representation and specify the remedies for misrepresentation. If a party relied on a representation given by another party which was relevant for the entry into, performance or termination of the contract, and such representation proves to be untrue, that party which relied on the representation is entitled to:

- claim damages or the payment of an agreed penalty from the representing party; and/or
- rescind the contract, provided that the representation was material for the party which relied on it; or
- request the court to declare the contract to be invalid if the misrepresentation was fraudulent or a material misrepresentation or mistake was made by the other party, by seeking to apply the relevant Civil Code provisions on the invalidity of transactions.

The first two remedies (damages and rescission) can be claimed against a party which made a misrepresentation in the context of its commercial activity, in connection with a shareholders' or participants' agreement or an agreement for the disposal of shares or participatory interest even if made innocently, unless the contract provides otherwise.

A claim for damages can be made even if a contract is held invalid.

It is not clear whether the remedies listed above are exhaustive. In particular it is not clear whether the new concept of indemnity for losses incurred not connected to a breach of obligations could be applied, or whether it would be possible to provide for acceleration of the principal outstanding under a loan agreement as a result of a misrepresentation, since the relevant Civil Code provisions on acceleration of loans have not been amended to provide for this.

Liability arising from pre-contractual negotiations

A concept of liability arising from pre-contractual negotiations has been introduced. The following are presumed to be done in bad faith and may give rise to a liability to the other party to negotiations:

(a) providing insufficient or untrue information or not disclosing material facts to the other party in the course of negotiating a contract; or

(b) sudden and unreasonable termination of contractual negotiations when the other party could not reasonably have expected such termination; or

(c) disclosure of confidential information received in the course of negotiations or inappropriate use of such information by the other party for its own purposes.

Damages in the cases referred to in (i) and (ii) are limited by law to the amount of costs and expenses incurred in connection with conducting negotiations and arising from the loss of opportunity of entering into a contract with a third party. The damages for inappropriate use of confidential information are unlimited. It should be noted that damages caused by bad faith in the course of contractual negotiations cannot be limited by contract.

Majority parties' decision

In a multilateral agreement where the obligations of the parties relate to their commercial activity, the parties may agree that the agreement may be amended or terminated with the consent of the majority of the parties, and provide what majority is necessary.

However, it is unclear whether this concept may be applied to exercise of the rights under an agreement such as a syndicated loan agreement (for example the right to accelerate the loan) where the 'majority lenders' represent only one set of interests under the agreement.

Waiver of contractual rights

A concept of a waiver of contractual rights has been introduced and applies where the parties are engaged in commercial activity. This permits a party to an agreement to waive contractual rights and rights arising by operation of law, so that exercise of those rights is not permitted unless grounds for their exercise arise on a subsequent occasion.

It may also be provided by law or by contract that rights are waived if not exercised within a specified period of time.

Conclusion

Although most of the changes outlined in this briefing are positive developments (especially those which have introduced into the Civil Code approaches previously developed by the courts or used in practice), some new concepts, including those where the draftsmen have tried to replicate common law principles (such as representations and indemnities), give rise to numerous issues of interpretation and need to be tested in practice and in particular, in the Russian courts. In the meantime it is difficult to derive any general principles about how the new concepts will apply and a unified and universal approach for the application of some of these new provisions will only develop as they are tested in practice and applied in the courts.

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