

Civil Code: New Risks and Opportunities

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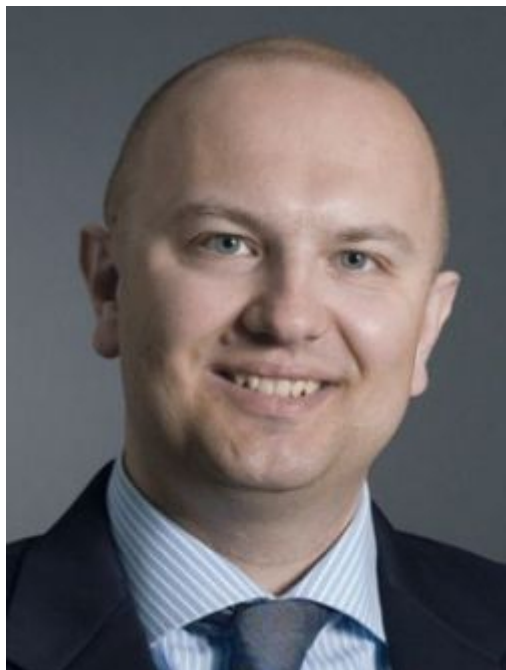
Andrey Goltsblat
Managing Partner
Goltsblat BLP

On April 3 this year, a draft amending the Civil Code of the Russian Federation — one of the cornerstones of Russia's legal system — was introduced into the State Duma. The draft represented the work of more than 4 years for teams of legislators and lawyers, running to 461 pages, encompassing the most significant revision to civil legislation in a generation, with the introduction of new institutions and rules, as well as amending and updating many existing ones.

Against a backdrop of numerous observations, criticisms, and perceived gaps in Russian legislation, from all quarters, including business, and countless vested interests, it was remarkable that just over three weeks later, on April 27, it was passed on the first reading with almost no change.

These amendments come into effect from September 1 this year. Despite the hours of work which have gone into creating the draft few people understand both the nuanced specific provision changes, as well as the fundamental changes to legal concepts and approaches that the amendment represents. That leaves only a Russian summer to wrap the minds of legal practitioners and business around what the changes mean in practice.

After these amendments come into force, we have several years ahead of us during which law enforcement practice will develop. We, as lawyers, need to start working straight away to explain the new rules to our clients and the professional community, in order for law enforcers to be able to predict precisely how a given new institution works. The judicial system in a civilised society must be truly independent. Judges must be irreproachably professional and enjoy an impeccable reputation. Unless these fundamentals of public life are achieved, any legislative initiatives will be still-born. People and their basic values must, of course, constitute the fulcrum of any state ideas. Yet it should not be forgotten that business, its needs and requirements are, in exactly the same way, ultimately orientated on improving our lives. Commercial relations in Russia today require a greater degree of discretion. If freedom of contract is artificially restrained, the result is precisely formal bad faith and sham transactions, which in our society have always provided the broadest scope for the authorities' judicial whim.



Anton Sitnikov

Partner, Head of Corporate / M&A
Goltsblat BLP

By the proposed amendments to the Civil Code lawmakers, probably for the first time in modern history, follow quite a revolutionary approach. They don't simply introduce cosmetic changes to certain wording but focus upon the launch of a number of new legal institutes, such as option agreements, representations and others that in one form or another have been known to the legal world both in common and civil law countries for many years but have yet not been properly materialized in Russian realities.

The amendments suggest a more vigorous contractual freedom, fewer imperative norms and wider room for court judgments.

In line with proprietary interests and law of contract, the new Civil Code provides for greater distinction of corporate rights, attempting to ensure their better protection in complex shareholder and alike arrangements.

So there will be a lot to see and learn in the not too distant future, in particular once one can observe how these new provisions would work in a quite rigid court system.

Fundamental Changes – Good Faith



Alexander Smirnov

Head of Commercial Practice
Goltsblat BLP

Amongst the changes, one of the most fundamental is the emphasis on bargaining in good faith. The new legislation enshrines the principle of good faith conduct as being a duty of all participants in the civil system, with liabilities now envisaged for bad faith negotiations. Parties acting in bad faith will bear the costs of losses incurred stemming from failed contracts as well as the costs of negotiations.

Indeed loss recovery becomes effectively a liability. Currently, the courts often dismiss claims for losses out of hand where the precise amount involved cannot be proven. The plan is to stipulate directly that lack of reasonable confirmation of an amount lost is not grounds for a court to refuse to recover losses, and that it is a court's responsibility to establish loss amounts proceeding from the principles of fairness and proportionality. The undefined concept of 'circumvention of the law' also becomes an abuse of rights.

It is expected that parties will be more diligent when negotiating, also yet there is no understanding on the amounts that could be recovered based on the bad faith negotiation rule. Pre-execution stage will apparently become more formalized as the amendments allow the parties to mutually alter the discussed rule.

Acting in good faith becomes a self-standing obligation of the parties, breach thereof could entail adverse consequences. Also the failing to act so might become a separate line of defence in civil proceeding.

The new code will strengthen the rights of corporate players and participants, clarifying corporate activities and minimizing potential for corporate disputes. It promotes the recovery of damages as a legal responsibility, imposing property liability on management and related parties where they act improperly in the discharge of their duties. It is also now expressly permitted to stipulate break fees for unilateral withdrawal from an agreement.

The current three-year maximum term for a Power of Attorney has been abolished, as has the notarized form of Powers of Attorney delegated by legal entities, heads of branches and representative offices. A party is now entitled to reject a transaction and claim recompense for losses if the counterparty's representative exceeded his authority.

The amendments should allow more flexible contractual mechanisms to be used and loss recovery to be made an effective sanction. These are positive factors. Much will, of course, depend on how the courts perceive the proposed innovations.

Companies – Their Structures and Operations



Anton Vashkevich
Senior Associate, Corporate / M&A
Goltsblat BLP

One of the most notable features of the new code is the end of differentiating between two types of AO, a joint stock company (which were ZAO and OAO). Instead companies will now be either public (AO only) or non-public companies (AO and OOO). The unpopular registration type of ODO was removed from the Code.

Public companies are those that may issue shares or other securities to the public. Non public companies may be more flexible in the manner how they are managed or the pre-emptive right is used. For example the non public companies' shareholders may choose to transfer functions of an executive body to a board of directors, or vice versa, or to change routines for

assembly and stakeholder meetings. Shareholders' agreements may now include third parties and creditors.

Companies existing prior to the new code do not need to be re-registered. Reflecting the fact that the vast bulk of companies are the OOO type (limited liability companies) the registration process for them remains as it is. ZAO's can be transformed as OOO's or just continue as ZAO's but after July 1, 2013 they will be treated as non public-companies.

Affiliation, Subordination and Liability

The criteria for affiliation have been determined, with a court entitled to recognise entities as being affiliated or not (irrespective of whether the grounds set by law exist or not) depending on the perceived possibility of influence.

Criteria for the existence of control, and of controlling or controlled entities, are defined in the amended code. Cases are now envisaged of a controlling entity bearing joint and several liability for the obligations of an entity under its control, with entities through which control is exercised also being joint and severally liable. Management and those who can instruct management will be liable for losses incurred by the company through wrongful acts.

Charter and Equity Capital

A charter is the only document a company is required to have, with other documents optional and functioning as business tools. Equity Capital remains the same for OOO's at 10,000 rubles, but has been increased to 100,000 rubles for public and non-public stock companies.

Reorganization

A simultaneous combination of various forms of reorganization and participation by legal entities of different legal types (e.g. OOO and AO) are now permitted. The implications of a reorganization decision being invalid and the reorganization being recognized as not having taken place have been determined.

Corporate Transactions



Anton Rogoza

Partner, Corporate
Goltsblat BLP

The amended code affects the areas of pre-contractual relations, some contingent transactions and some aspects of liability. In particular, a party that, during or after conclusion of an agreement, provides the other party with incorrect warranties significance to an agreement is required to reimburse the other party for any resulting losses. A party that negotiates or terminates negotiations in bad faith is also required to reimburse the other party for any losses it might incur. The draft clarifies the meaning of the concept of "bad faith." Pre-contractual liability will be stipulated as liability for bad faith negotiations or termination of negotiations in respect of an agreement to be executed.

Only a voidable transaction infringing upon the rights of a contesting party may be invalidated. If a party approved a transaction or expressed its intention to uphold it, then it can not later contest it. This means the presumption of voidability will be established in respect of: resolutions passed by meetings; transactions executed in breach of a law; transactions executed without the required consent of a third party, corporate authority, government authority, local authority. It also means that invalidation of resolutions passed by meetings, transactions void from the outset relating to property where disposal is restricted or limited, and invalidity of transactions executed in error will be regulated comprehensively.

Representations and Warranties

If one party provides incorrect information of key importance to a transaction, the other party relying on this is entitled to withdraw from the contract (or, in some cases, to recognize it as invalid) and to claim damages. Even if the seller was unaware that the information was untrue, this does not release it from liability.

Compensation for Losses Not Connected with Breach of Contract

The parties may agree that, for instance, if any claims are lodged under previous obligations after a company is sold, the seller will compensate the buyer for all relevant losses (connected with the transaction subject losing value).

Creditor Agreements and Indemnity

Creditors will be able to enter into agreements regarding demands for their debtors to perform obligations, and the priority of these demands. In business relations, parties will be able to provide for one party to demand indemnification from another party for pecuniary losses incurred in connection with performance, amendment or termination of obligations, including misconduct by third parties. Indemnity will be permitted under Russian law.

New Types of Agreements

New contractual structures introduced include framework agreements (agreements with open terms), option agreements (an agreement with an unconditional right to enter into a specific agreement), subscriber agreements (agreements with performance on demand), and escrow agreements.

The proposed amendments provide an opportunity for the business to get rid of artificial corporate structures created only because of a rigid legal system which does not correspond with the best practices of the modern business world. This opportunity still has to be supplemented with case law, but the ball is already rolling. The amendments may also become a huge step forward in establishing Moscow as a new global or regional financial center as many foreign investors consider undeveloped Russian legislation an impediment on their desire to invest in Russia. It would be however wrong to say that these proposed amendments alone may completely change our lives. To keep up the momentum the government would need to take further steps to make our country attractive for investors, including further development of tax legislation, denationalization of the economy and to combat corruption.

Property and Real Estate



Maksim Popov

Associate Director, Real Estate and Construction, Goltsblat BLP

With real estate the new code also brings in some significant changes. These include the mandatory notarization of all real estate transactions, neighbors rights and limited new forms of property rights, and a prohibition on the separate sale of buildings and grounds in the same location.

Mandatory Notarization of Real Estate Transactions

After the adoption of new laws on notary activities mandatory notarization of real estate transactions will come into force. This will outline the notary function of verifying the lawfulness of transactions, and underline the liability of notaries for losses to parties, with notaries in private practice having full financial liability for unlawful acts.

Prohibition on Separate Disposal of Land and Buildings Where a Building is on a Particular Site

The Civil Code has previously permitted both the sale of buildings without the sale of the underlying plot of land, and the sale of plots of land without the sale of buildings constructed upon them, with the Land Code setting out the principle of unity of land and buildings constructed upon it at a particular site. This contradiction has been ended by an amendment which sees land and buildings constructed on it, which are owned by the same entity, being treated as a single entity for sale purposes.

Premises as a Separate Type of Real Estate

The new Civil Code also identifies premises as a separate form of immovable property. This kind of property exists after it has been duly separated from a building. The current Civil Code previously recognized apartment owners in an apartment building as having common shared ownership of premises in a building. With the new Civil Code, all owners of premises

(residential or non-residential) will have a share in the ownership of a building's common areas, including the underlying land.

The Rights of Neighbors

Land owners will need to be aware of 'neighbors rights' when exercising their property rights, with these rights potentially applying to both adjoining and non-adjoining land plots. These restrictions include: erection of buildings or structures that create impermissible effects on neighboring land plots or premises; the placement of plant which causes deterioration or degrading of neighboring land or buildings and structures on it; undertaking earthworks on a plot of land which causes subsidence on neighboring land plots; building wells which prevents water reaching neighboring wells; and installing sewage systems that contaminate neighboring land plots.

New Forms of Limited Property Rights

The amended Civil Code will see the introduction of limited property rights including: perpetual tenancy; land plot development right; personal usufruct; preferential acquisition of immovable property; pecuniary benefit; and limited title of a building owner to underlying land.

New Encumbrances on Real Estate

Among the newly introduced encumbrances are personal usufruct (individual benefit) and pecuniary benefit (similar to rent). The right of individual benefit (personal usufruct) is a right to hold and use something provided by the owner of an immovable thing for payment. A pecuniary benefit may also be created by a rent agreement or permanent maintenance agreement with a dependent.

New Form of Mortgage

The new Civil Code introduces the non-accessory, transferable form of mortgage used in Europe, providing a creditor a much stronger legal position concerning obligations secured by mortgage.

In general the amendments relating to real estate and property are what the Russian real estate sector has been looking for and will bring the Russian property sector generally into line with the best developed international standards.

The changes are dramatic, indeed. Some of them I also perceive as a change for the worse, especially those pertaining to mandatory notarization of real estate transactions. I am afraid that, once the new laws on notary services are enacted, it will be a long time before there are enough qualified notaries capable of handling complex real estate contracts.

Many revolutionary changes may be viewed as positive from the theoretical viewpoint (land development right, for instance) but, given the objective conservatism of realty market participants, including state and municipal officials, there is no doubt we have a difficult transitional period ahead of us, during which we will have to learn by practice how apply the new rules.

Financial Transactions



Oleg Khokhlov

Partner, Banking & Finance
Goltsblat BLP

The proposed amendments to the Civil Code introduce a number of changes to the rules on the assignment of claims and factoring, as well as to other provisions of the Civil Code that would be likely to impact on the securitization market.

Assignment of Claims

The new Civil Code will expressly provide for the possibility of the assignment of future claims, where these are made on the basis of agreements entered into by parties engaged in commercial activities. It expressly permits the partial assignment of monetary claims, except where specifically prohibited by law.

The assignment of monetary claims generated under agreements entered into by parties in connection with conduct of commercial activities is permitted, even if the underlying agreement restricts or prohibits such an assignment.

Factoring

The claims that may be transferred under factoring agreements include any monetary claims (including claims under loan and consumer loan agreements). A new requirement is introduced for the factoring agreements insofar as they must now provide for additional services relating to the trade receivables, which may limit the ability of factoring businesses to refinance in structured products markets. The amendments also contain rules on the time when a future claim passes to the factor, as well as alter the principle of allocation of risks associated with the failure by a client to perform obligations under contract with a debtor —

debtors will not be entitled to claim back from the factor any amounts previously paid to the factor.

Securitization of Consumer and Residential Mortgage Loans

New special rules are introduced for consumer loan agreements and these expressly provide for a walk-away right of a borrower where the borrower has not been provided with information on the terms of the loan (including the terms which affect the cost of borrowing), and for any reason during the first two weeks from the beginning of the availability period. It is currently unclear how the envisaged procedure of transferring mortgage certificates will operate with the legislation currently applying, and particularly with the law on mortgage backed securities.

The new amendments introduce a so-called "social" usufruct, which may potentially hamper the enforcement of mortgages over residential property securing residential loans. They also extend voidability on transactions concluded individuals under extremely disadvantageous conditions, to include transactions concluded where an individual is unknowledgeable of business or of unsound mind. This could have a significant impact on some areas of the consumer lending market.

The institution of a non-accessory revolving mortgage (independent mortgage) is introduced. This provides a mortgagee with the right to determine independently what obligation of the debtor-mortgager or a third party is deemed secured by such a mortgage, advising the mortgager and the third party to this effect. An independent mortgage mortgagee may be a bank or other credit institution, and if the mortgage is certified by a mortgage bond, then any commercial organization may be the mortgagee. The draft introduces the requirement for special (increased) diligence on the part of a bank in performing banking operations for a client: the provisions on the bank's liability have been specified in more detail. New types of bank account are envisaged: precious metals accounts, joint accounts, escrow accounts and others.

Security

Provisions for pledges have been extended to include rights under a bank account agreement and corporate rights. Those acquiring pledged property without knowing or being required to know about a pledge are deemed to acquire such property free of encumbrances. However, original pledgers will still be liable to the pledgee for unauthorized transactions with the pledged property.

The new role of security manager is proposed to introduce equivalent of security agent role in English law structures, where such security agent is not necessarily one of the lenders and holds security for the benefit of the lenders' syndicate.

The concept of bank guarantees has been broadened to independent guarantees issued by any commercial organization.

The proposed amendments will help to make Russian law on syndicated facilities and Russian ISDA more enforceable, and that will increase use of these instruments and the confidence of international banks and financial institutions in Russian legal structures.

Intellectual Property / Dispute Resolution



Elena Trusova

Partner, IP Dispute Resolution
Goltsblat BLP

The interesting innovations of the amended Civil Code include, in particular: a complex of rules connected with relations on the Internet (basic definitions, group of respondent parties), amendments concerning the conditions and procedure for registering agreements on alienation and transfer of intellectual property rights, and others.

It should be noted that, while the new provisions of the Civil Code have been under development, in recent years courts have made several attempts to impose liability not on the user but the Internet provider, i.e., the company providing the user with access to the Internet. The courts have developed certain criteria on the basis of which Internet providers can, indeed, be held liable.

It should also be noted that amendments have been introduced into the Civil Code's provisions on recovering losses and penalties (Article 333 and Article 393 of the Civil Code of the Russian Federation). In general, these amendments may be described as being to the benefit of creditors. In particular, the new rules envisage that inability to prove the precise amount lost does not constitute grounds for dismissing a claim for recovery of losses and that the losses will be calculated by the courts proceeding from the principle of fairness and in consideration of all the circumstances of the case. The opportunities for applying article 333 of the Civil Code for reducing a penalty have been restricted. Procedurally, this is only possible given a relevant application from the respondent at the first instance. In general, penalties will be reduced only in exceptional circumstances.

The main goal of the amendments to the Civil Code concerning intellectual property is to

make the regulations more detailed and provide greater compliance between modern business and the law. It is a good sign that the legislators are trying to come to grips with the information environment. The new norms concerning the internet are interesting. I am sure there will be further development, but it is the beginning.

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