

The Civil Code Reloaded

On 2 April 2012 the Russian President submitted to the State Duma a draft bill on amendments to the Civil Code of the Russian Federation (the "**Draft Bill**") which is expected to change significantly "the rules of the game" for all areas of business, from corporate relationships and M&A to the real estate market, banking activities and structured finance products (securitisation). We set out below a brief overview of the most salient of these changes.

There is much in the Draft Bill that is potentially helpful; and some that is potentially alarming. Over the coming weeks our internal cross-practice working group will be working to unpack these provisions more fully, and to understand better the possible opportunities and concerns they create, and we will be circulating further briefings as this process evolves. We also plan to arrange client seminars, including in London, to discuss the proposed changes in more detail.

The first reading of the Draft Bill in the State Duma is scheduled for 27 April. The majority of the amendments contemplated by the Draft Bill are expected to enter into force as early as 1 September this year.

Bona fides as the overriding principle

The Draft Bill expressly states that the duty to act in good faith is the guiding principle in civil relations. This is reflected in a number of important provisions aimed at making civil relations more certain:

- It is expressly provided that *a person that acted* on a transaction *in bad faith*, including where his/her behaviour gave grounds for third parties to believe that the transaction was valid, *may not challenge the validity of that transaction*. This provision is of great importance given that invalidation of a transaction has often been used for the bad faith avoidance of contractual obligations.
- *Pre-contractual liability for negotiating a contract in bad faith and for the bad faith termination of contractual negotiations* is for the first time introduced into Russian law. The relevant provisions apply to contract formation in commercial relations.
- The legal consequences of making a *material misrepresentation or mistake (zabluzhdenie)*, and of *fraud (obman)*, are clarified: a transaction may be challenged if a party is mistaken as to the circumstances of a contract and this is obvious to the other transacting party; fraud is defined to include, among others, fraudulent concealment by a party of circumstances which it would have disclosed if it acted in good faith.

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Transactions and contracts

Transactions – general provisions

The following are the most important amendments for the business:

- *Conditional transactions and options*: the prohibition on entering into transactions subject to conditions which "exclusively or predominantly" depend on the will of one of the parties is reconfirmed – this has historically been an issue for entering into option agreements in Russia. However, the Draft Bill expressly provides that the discharge of obligations or the exercise, alteration or termination of certain rights under a contract may be made conditional upon circumstances that are entirely dependent on the will of one of the parties. Furthermore, the Draft Bill introduces a dedicated article on *option agreement*.
- The rule that *failure to document a cross-border transaction* in writing renders it void *ab initio* is abolished.
- The Draft Bill provides for the issuance of an *irrevocable power of attorney*, as well as a *joint power of attorney* granted to several representatives who must exercise their authority jointly.
- The Draft Bill establishes rules for the granting of corporate approvals and regulatory consents for transactions in cases where such approvals/consents are prescribed by law and provides for the withdrawal of a prior approval/consent before the transaction is executed.

Welcome "representations and warranties" and "indemnity"!

For the first time the following legal concepts are to be recognised and protected under Russian law:

- Representations on matters where the party making representations will be obliged to reimburse the losses suffered by another party as a result of the representations being incorrect, where the injured party reasonably relied on such representations (similar to the concept of "*representations and warranties*").
- The reimbursement by an indemnifying party of losses incurred by another party even where these are not associated with a breach of contract by the indemnifying party (similar to the concept of "*indemnity*") in the context of agreements entered into by parties engaged in commercial activities.

New types of agreements

The Draft Bill introduces a number of new types of agreement, with a view to simplifying entry into and performance of transactions, including:

- A *conditional deposit (escrow) agreement*, which is designed to facilitate settlements between counterparties where the making of a payment or transfer of an asset is conditional on the satisfaction of certain conditions precedent, and therefore requires the

involvement of an independent party who would hold the relevant asset until the conditions precedent are satisfied and then transfer it to the beneficiary.

- *Special bank account regimes*. The Draft Bill introduces, among others, the following special bank account regimes: accounts opened in the name of several clients (joint accounts); accounts which are opened in the name of a person which is not the owner of the funds in the account (nominee accounts); and escrow accounts.
- *Intercreditor agreement*. The Draft Bill expressly entitles a debtor and its creditors to agree by contract the order of and priority for payments of the debtor's obligations.

Security

The Draft Bill upgrades and specifies in more detail the existing rules applying to different types of security:

- *Mortgage (security over real estate)*. The requirement for a mandatory certification of a mortgage agreement by a notary is re-introduced; however, this will become effective only upon the adoption of new legislation on notarial activity. The terms and the order of enforcement against a mortgaged property are once again fine-tuned. Notably, the Draft Bill introduces the new instrument of an *independent mortgage*, which will not be confined to securing a particular secured obligation to the same extent as existing mortgages, as the pledgee will be able to determine which obligations are to be secured by the mortgage. Such a mortgage will exist for the term for which it was granted, notwithstanding the termination of the secured obligations.
- *New types of pledges are introduced*: The Draft Bill expressly provides for a *pledge of rights under bank account agreements* (introducing a restriction on the right of the pledgor to operate the pledged accounts, as well as providing for a specific procedure for the enforcement of such pledges), a *pledge of corporate rights*, and contains detailed rules on a *pledge of rights under contracts* (including a *pledge of future rights*), amongst which are specific rules for the enforcement of this type of pledge.
- *Pari passu security*: The Draft Bill provides for the creation of security of equal ranking over the same asset (*pari passu security*) in favour of multiple creditors (co-pledgees) under different obligations. Moreover, the Draft Bill allows several creditors to appoint a sole security holder (*security manager*) who, acting in its own name, will be able to enter into a pledge agreement and exercise the rights on behalf of all secured creditors.
- *Independent guarantees* will replace bank guarantees and are expected to be more widely used in commercial transactions – an independent guarantee may be issued not only by banks and insurance companies, but also by any other commercial legal entity.

- *Security payment.* A new type of security interest – security payment (which can be made by way of cash or, where the secured obligation is for the delivery of securities or fungible assets, delivery of such securities or fungible assets) - is introduced to secure performance of monetary obligations, including those under cash-settled derivatives.

Corporate law

In the corporate sphere the following new developments are worth noting:

- *Classification of companies into public and private.* Public JSCs will now include joint stock companies whose shares are publicly placed or publicly traded, in relation to which more stringent requirements for corporate governance and disclosure will apply. At the same time, private companies are given a certain amount of freedom to decide matters of internal corporate governance and the distribution of authority among management bodies.
- *Abolition of the CJSC as a corporate form.* By 1 July 2013 all closed joint stock companies will have to transform into limited liability companies or production cooperatives; otherwise, new and oftentimes more stringent rules applicable to joint stock companies foreseen by the Draft Bill will apply to them.
- *Restriction on voting quasi-treasury shares.* The Draft Bill prohibits a controlled company from managing the affairs of its controlling company, such as by voting shares in the controlling company.
- *New provisions on affiliation and controlling parties.* The Draft Bill substantially broadens the definition of affiliation, and grants a discretion to the courts to determine whether or not parties are affiliated based on particular circumstances, even where the formal criteria are not met. The Draft Bill also clarifies that there is no formal affiliation for companies solely on the basis of the state being a common shareholder.
- *Liability of controlling parties:* The Draft Bill introduces the term 'controlling party' to the Civil Code, as well as liability for such controlling parties for the activities of the controlled party (effectively 'piercing the corporate veil') to the controlled party and its other shareholders.
- *Foreign company in Russia:* if a foreign company predominantly carries out business in Russia, the persons exercising control over such company may be held accountable for such company's liabilities under Russian law.
- *Right of restoration of corporate control.* A participant of a company who has lost his interest in the company against his will may bring an action for the return of the participation interest which has passed to other persons. If returning a participation interest would be a clearly disproportionate privation for other persons and would

cause "extremely negative" public consequences, a court may deny the action for the return of the participation interest and award payment of "fair compensation" instead.

- *New rules on corporate agreements (shareholders' agreement).* The Draft Bill provides that participants of a company may enter into a corporate agreement not only with each other but also may make an agreement (similar to a corporate agreement) with the company's creditors and/or other third parties to protect the latter's interests (e.g. in the context of a debt restructuring).

Real estate and construction

The key new developments in the real estate sector are:

- *Notarisation requirement for real estate transactions.* The rule that real estate transactions are subject to mandatory certification by a notary is re-introduced. However, this will become effective only upon the adoption of new legislation on notarial activity.
- *Premises as a distinct type of real estate.* The Draft Bill distinguishes between residential and non-residential premises as separate types of real estate, and includes provisions regulating the common areas of a building. The owners of premises within a building will automatically acquire a share in the common ownership right in the land plot on which the building is situated.
- *Development right.* The lease of land for construction purposes is replaced with a so-called 'development right'. In cases where lease rights to public land for construction purposes were obtained prior to enactment of the Draft Bill, the lessees will be given the opportunity to convert them to ownership rights or development rights. Lessees who do not undertake the conversion procedure will automatically be granted a development right for a 50-year term upon expiry of their lease.
- *Neighbours' rights.* When preparing the design documentation for construction projects, developers will have to take into account neighbouring landowners ("neighbours' rights"). Neighbours' rights may apply to both adjoining and non-adjoining land plots.
- *Right of limited possession of land.* The permanent (perpetual) right of use of land will automatically be replaced with a so-called 'right of limited possession'. The same right will be granted to owners of buildings and structures who currently have no formalised rights to the underlying land. The right of limited possession is not subject to state registration and is in fact a temporary/intermediate right, given that the Draft Bill stipulates that it must ultimately be converted into a lease right, development right or permanent right of land possession.
- *New encumbrances over real estate.* The Draft Bill introduces new types of encumbrances such as usufruct and the 'right of benefit from property' (analogous to rent). Pursuant to the Draft Bill, usufruct will typically

be established for the benefit of individuals. A so-called 'social' usufruct (*pravo sotsial'nogo pol'zovladieniya*), which will be established by operation of law in favour of persons entitled to alimony from a property owner and in favour of dependants of a property owner who share his/her place of residence, may render real estate transactions and the refinancing of mortgage loans through securitisation more complicated.

- *Option to purchase real estate.* The legal framework for real property acquisitions is to become more market-oriented, as the Draft Bill enables market participants to effectively 'reserve' a property of interest to them by registering a special right to acquire third-party property, which is essentially an option to purchase real estate.

Assignment and securitisation

The Draft Bill introduces a number of changes to the rules on the assignment of claims and factoring, as well as to certain other provisions of the Civil Code which may have an impact on the securitisation market.

Assignment of claims

- The Draft Bill expressly caters for *the possibility of the assignment of future claims*, where such assignments are made on the basis of agreements entered into by parties engaged in commercial activities.
- The Draft Bill 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 the parties in connection with the carrying out of commercial activities is *permitted, even if the underlying agreement restricts or prohibits such assignment*.
- The Draft Bill introduces the *joint and several liability of an assignee and an assignor* for reimbursement to a debtor of any "necessary expenses" incurred in connection with the assignment of a claim.

Factoring

- *The claims that may be transferred* under factoring agreements include *any monetary claims* (including claims under loan and consumer loan agreements).

- The Draft Bill introduces a *new requirement* for the *factoring agreements*: they must now provide for *additional services relating to the trade receivables* (book-keeping for or servicing the receivables, or assistance in connection with enforcement). This may potentially limit the ability of factoring businesses to refinance in the structured products markets.
- The Draft Bill contains rules on the *time when a future claim passes to the factor*.
- The Draft Bill alters the principle of allocation of risks associated with the failure by a client to perform its obligations under a contract with a debtor: *the debtor will not be entitled to claim back from the factor any amounts previously paid to the factor*.

Securitisation of consumer and residential mortgage loans

- The Draft Bill introduces special rules for *consumer loan agreements* and expressly provides 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 in any event during the first two weeks from the beginning of the availability period.
- At the moment, it is not clear how the envisaged procedure of *transferring mortgage certificates (zakladnaya)* will interact with the legislation currently in force, and in particular, with the law on mortgage backed securities.
- As mentioned above, the Draft Bill introduces a so called 'social' usufruct which may potentially hamper the enforcement of mortgages over residential property securing residential loans.
- The Draft Bill extends the application of the rules on voidability of a transaction concluded by an individual under extremely disadvantageous conditions of which the other party took advantage to also include transactions concluded due to the individual being *unsophisticated or inexperienced in business or acting frivolously, thoughtlessly or feeble-mindedly*; this obviously may have an impact on the consumer lending market.

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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