M&A under Russian law: to be or not to be?

First glance at the recent novelties in the Russian Civil Code

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On March 8 President of the Russian Federation signed a law introducing another tranche of changes to the Russian Civil Code (Division III, part 1)[1], effective as of June 1, 2015. They are perhaps one of the most long-awaited novelties that should increase attractiveness of the Russian law of obligations and were discussed in our magazine back in September 2013.[2] The reservation then expressed about feasibility of these novelties still remains valid: their feasibility will depend on approaches taken by Russian courts in practice. Until development of uniform law enforcement practice, Anglo-Saxon legal mechanisms will remain popular in M&A transactions

Representations

Among the novelties of the Russian Civil Code ("CC") that are most important for M&A transactions, the newly introduced concept of "representations" should be pointed out first of all. Practically no serious agreement, much less a share purchase agreement, can omit the parties' assurances about facts and circumstances that are relevant to the subject of the agreement (in a broad sense) or other significant aspects of the transaction.

Under English law, which is traditionally chosen in most cases for structuring

[1] Federal Law "On Amendments to Part One of the RF Civil Code" of March 8, 2015, No. 42-FZ.
[2] Civil Code Reform: Reception of Instruments of English Law. // Legal Insight, 2013, No. 7.

M&A transactions, such assurances are implemented through the concepts of representations and warranties. There is a formal distinction between *representations* and *warranties*. Generally, a representation is a statement made with regard to some past or existing fact to induce somebody to do something (e.g. to induce a party to enter into a contract). A warranty is usually[3] understood to mean a promise that a particular statement of fact is or will be true. In other words, a representation is a statement about past or present time, while a warranty is a promise and, as such, may relate to the future.

Traditionally, remedies for breach of a representation differ from remedies for breach of a warranty: a misrepresentation claim gives rise to damages and rescission, i.e. unwinding of a deal. In practical terms, however, the difference turns out to be merely speculative in many cases. Usually, in contractual documents both terms are used jointly to mean statements of factual circumstances, whether existing or implied.

Although the terms in question were alien to the previous Russian legislation, they were quite actively used in local contractual practice. However, the attempts to implement them within the traditional Russian law of obligations framework inevitably brought about obvious legal difficulties. This rendered such representations and warranties provisions challengeable at minimum.

The new Article 431.2 of CC introduces a concept of *"representations about circumstances relevant to the execution, performance or termination of an agreement"*. If such representation made by a party during or before or after the execution of an agreement is untrue, the other party may claim damages or a penalty stipulated in the agreement.

According to the law, the availability of these remedies depends on the opinion of the party making representations as to the attitude of the other to the representations made: a party is liable for an untrue representation if it assumed (or

[3] As far as we know, the English law doctrine knows different interpretations of these concepts the analysis of which goes beyond the scope of this article.

should have reasonably assumed) that the other party would reply upon this representation. In other words, formally the liability for misrepresentation may arise regardless of whether or not the other party actually relied upon a representation received or was aware about falsity of such representation.

By contrast, as far as we know, the question of whether or not a party relied on representations received by it is essential to representations and warranties under English law. In any case, a contract typically includes a caveat that representations and warranties provided do not apply to circumstances disclosed to the receiving party, in particular, during legal or other due diligence investigation of a target asset.

It is noteworthy that the new provisions of the Civil Code set more severe rules for a party that makes representations in connection with its business operations, shareholders agreement or share transfer agreement (i.e. in an M&A transaction). Such party is liable for untrue representations regardless of whether or not it was aware about falsity of such representations. Also, it is assumed that such party was aware that the other party would rely upon its representations.

In addition to damages (or penalty), a party that relied upon untrue representations may claim termination of an agreement if such representations were essential. These remedies are available to such party without prejudice to its right to seek protection of its interests in court by challenging the validity of the agreement as being made as a result of fraud or material delusion.

Generally, the discussed novelty should certainly be regarded as positive. The lack of clearness about potential application of such legal mechanisms in most situations was the key reason why contracting parties used to choose a foreign law rather than Russian law to govern their M&A transactions.

It should be noted however that, when introducing into Russian law a novelty originating from Anglo-Saxon legal concepts, legislator has actually provided for a

symbiosis of representations and warranties. This is evidenced in particular by the possibility to claim both damages and rescission of a contract as remedies for breach of Russian representations. As mentioned above, in English law rescission is a typical remedy for breach of representations, first of all.

It is not altogether clear whether the new concept of representations may cover future circumstances. We note that Section 431.2 (1) of CC, which outlines potential matters in respect of which representations can be made, refers to circumstances that are relevant not only to the execution of a contract, but also its performance or termination. In light of this, a positive answer to the above questions seems to be possible (at least a review of the novelty provisions in conjunction with the currently effective provisions of the Civil Code does not clearly reveal any formal legal obstacles for such approach).

Indemnity

In the Anglo-Saxon legal system, the concept of representations and warranties is closely connected with the concept of indemnity, which can be generally understood as an undertaking to a compensate for an anticipated loss. The key difference between indemnity and reimbursement of damages is that the indemnity is conditional upon the fact of occurrence of certain losses or other adverse events and does not necessarily depend on the conduct of the indemnifying party (such as a breach by it of a contractual obligation). In M&A transactions, indemnity is not infrequent as one of the possible remedies in the event of a misrepresentation or breach of a warranty.

As mentioned earlier, the amended Civil Code provides for the traditional reimbursement of damages as a generally available remedy for a breach of representations. However, according to the new Article 406.1 of CC, now the parties to a contractual obligation may enter into an agreement providing that either party will reimburse the other party for its pecuniary losses arising from certain events other than a breach of the obligation. Such agreement should

determine an amount of reimbursable losses or a manner of calculation thereof. The opportunity to enter into such agreement is only afforded to parties of a contractual obligation who enter into it in connection with their business operations. The latter requirement does not extend however to a shareholders agreement or a share transfer agreement, a party to which is an individual (apparently, the legislator did not intend to extend such exception to agreements made by legal entities but otherwise than in connection with their business operations).

Obviously, this means introducing into Russian law of a kind of an equivalent of the Anglo-Saxon indemnity concept, although it is an incomplete equivalent with a limited scope of application. Nevertheless, the a key distinction in the Russian version is present: unlike a claim for damages, a claim for losses (indemnity) is not linked to a breach of a contractual obligation by the indemnifying party and therefore does not require proof of the cause-and-effect relation between the breach and losses caused thereby or an amount of such losses. It seems that this concept may to a certain extent be used in conjunction with representations (although the decisive factor will most likely be relevant case law, in particular relating to mandatory nature of the provisions of Article 431.2 of CC that refer to potential consequences of misrepresentation).

Possibly, it will be difficult to apply the provisions of Article 406.1 of CC in practice, at least until a uniform approach is developed and authorized by higher courts. In particular, interpretation of the term "losses"[4], which does not appear elsewhere in the Civil Code, may become an issue of heated debates. The point-by point analysis of the Article shows the following:

- The term "losses" refers to some adverse pecuniary effects that should be distinguished from damages. At the same time, it would be hardly reasonable to assume that the term "losses" used in this Article excludes losses covered by the definition of damages provided in Article 15 of CC

[4] Apparently, the Russian terms is a calque of the English term "losses".

(such as expenses, loss of property, lost profit, etc.);

• Losses are suffered by a party to an obligation (while the Anglo-Saxon indemnity mechanism is widely used to cover losses of third parties, such as a company whose shares are the subject of a sale transaction or officers of the purchaser, etc.);

• Reimbursement of losses should be conditioned upon occurrence ("arise upon occurrence") of events stipulated in an agreement, such as impossibility to perform an obligation or a claim made against a contractual party or a third party. The latter suggests that there is an inherent contradiction in the new provisions, as it is obvious that a claim made against a third party results in losses are suffered by such third party;

• Losses should not result from a contracting party's breach of its obligation (apparently this forms another distinction between the Russian novelty and the English indemnity which as matter of principle is not subject to such limitation and may also be linked to a breach of an obligation);

• An amount of losses (or a method of calculation thereof) may only be determined by parties' agreement to that effect and a court may not reduce such amount unless the claiming party has intentionally contributed to increase of the losses.

It seems that the only way to prevent dilution of this novelty would be an approach implying parties' rights to determine at their discretion not only an amount of losses, but also a nature of reimbursable losses (subject, of course, to the limitations that follow from the principles of bona fide conduct and non-abuse of rights).

Conditional Performance of Obligations

Another problem previously encountered during attempts to structure M&A transactions under Russian law was inconsistency of the case law relating to so-

called potestative and mixed-type conditions (i.e. conditions being within the control of one of the parties to a transaction). Following the existing interpretation of Article 157 of CC, courts in many cases assumed that any conditions linked to events being within a parties' control were invalid (inadmissible)[5].

However, in any serious M&A transaction (except for very simple agreements performed upon their execution) there is commonly a time interval between the execution of the agreement and its performance relating to the transfer of the target asset (so-called "closing"), the performance being conditional upon occurrence of certain events and circumstances, a substantial part of which normally depends on the parties (e.g., sale of shares in a company which is conditional upon fulfillment of certain pre-sale preparation of a target asset, such as company reorganization, settlements with its officers, etc.). In such cases, structuring a transaction under Russian law inevitably brought about serious risks for the parties. The only reliable way to avoid such risks was to structure a transaction within a foreign law framework that allowed parties to stipulate conditions for such transactions and mechanisms for walking away from a deal in case such conditions have not been fulfilled.

We believe that the recent changes to the Civil Code should finally eliminate the existing obstacles and open up the possibility for making complex multistage transactions under Russian law. While the changes do not affect the provisions of Article 157 of CC, they add the new Article 327.1 which introduces the concept of conditional performance of obligations. Now, the performance of obligations as well as the exercise, alteration or termination of rights under a contractual undertaking may be conditional not only upon the occurrence of some events (including those being within the parties' control), but also upon certain action or inaction of a party.

It should be noted however that legislator's wording *"performance of obligations*

[5] This position is in our view far from being unobjectionable: Article 157 of CC is aimed expressly against unfair conduct of the parties that may affect the occurrence of relevant event, but it is silent about bona fide conduct.

as well as the exercise, alteration or termination of rights" stylistically sets rights in opposition to obligations. It is obvious, however, that in a contractual undertaking the creditor's right always goes with the debtor's obligation. Consequently, the exercise, alteration or termination of z right should always imply the performance, alteration or termination of an obligation. Hopefully, when it comes to application in practice, this wording (which seems to be used by legislator for the sake of a smoother syntax) will not bring about any difficulties with *i.a.* recognition of admissibility of contractual conditions that provide for alteration of rights but not for altering obligations.

The general admission of potestative and mixed-type conditions in Article 327.1 of CC is further developed in some other novelty provisions of the Civil Code, such as provisions on options and timelines for performance of an obligation.

Options

In a general sense, an option can be defined as an agreement, the performance of which is dependent upon a party's discretion and which is usually implemented upon occurrence of certain events by the party's submitting a relevant request. The amended Civil Code provides for two types of options: *option to make a contract* and *option agreement* (Article 429.2 and Article 429.3 respectively).

An option to make a contract is defined as an agreement, under which a party making an irrevocable offer grants the other party the right to make a contract or contracts envisaged by such agreement. It is expressly stipulated that the possibility of accepting the offer may be conditional upon fulfillment of a certain condition, whether or not being within the other party's control.

An option agreement is an agreement which grants a party the right, exercisable at the agreed time and on the agreed terms, to request that the other party shall perform certain actions (make payment, transfer or accept property, etc.).

The key difference between these two (rather similar) instruments is that an option to make a contract has structural similarity to a preliminary contract, under which

the execution of a target (main) contract depends on discretion of one of the parties, while an option agreement itself is the main contract.

Timelines for Performance of Obligations

In the context of acknowledging the validity of potetstaive ando mixed-type conditions, the provisions of Article 314 of CC relating to timelines for performance of obligations have been amended. The Article now contains an important new provision allowing contractual parties to define such timeline as a period calculated from the moment of occurrence of certain events, including the performance by a party of its obligations. According to the prevailing approach shown by the relevant case law until now, the timeline could only be defined by linking it to some inevitable events. Accordingly, if the timeline was defined in an agreement otherwise it was regarded as not agreed. This was critical to agreements, in which time element was of essence.

Negotiating Agreements

In many cases an M&A transaction requires long-lasting hard negotiations. We are aware of negotiations that lasted for 1.5–2 years and even more. Actually, there was no legal regulation of this important lengthy stage, except where parties to negotiations entered into a specific agreement for such purpose (although even in that case the question of consequences of non-compliance with the terms of such agreement remained open). It is obvious however that such situation requires certain rules of conduct and sanctions for non-compliance: pre-contractual work for an M&A transaction requires substantial efforts and very often substantial costs. Besides, an unfair party may use negotiations as a competitive tool or at least as a means to gain certain advantages over or business information of a might-have-been contracting party.

Now the Civil Code sets certain negotiation requirements, non-compliance with which may have ponderable consequences. The new Article 434.1 of CC follows the general trend of setting specific fairness-principle-based requirements in

dedicated articles of the Civil Code and specifies application of this principle with regard to conduct of parties during precontractual negotiations. A party that deliberately enters into negotiations with no intent to reach an agreement or provides incomplete or untrue information (in particular, by not disclosing material circumstances) or disrupts negotiations unexpectedly without good reason may be held liable and, as such, may be required to reimburse damages (including those resulting from loss of a contract with a third party). The new provisions specifically determine the duties associated with receipt of confidential information during negotiations: unauthorized disclosure of such information or its improper use for the receiving party's own purposes is prohibited.

Obviously, the amendments to the Civil Law are not intended to set detailed negotiating rules. Instead, they allow parties to make a negotiation agreement to specify and develop the provisions of law on a transaction-specific basis and, in particular, to determine how the negotiation costs will be distributed between the parties.

Apart from the foregoing, the tranche of changes to the Civil Code which is discussed herein also includes some other changes that seem to be rather useful for structuring M&A transactions within the Russian legal framework, such as.

• updated written form requirement, which will evidently afford contractual parties broader opportunities to use modern means of telecommunication (such as e-mail);

• independent guarantees now can be issued not only by credit institutions, which expands security mechanisms currently available (e.g. guarantees now can be issued by a mother company or connected company);

• right to unilaterally withdraw from a contract can be made conditional upon payment of a certain amount (break-up fee), etc.

First Impressions

Notwithstanding the general positive assessment of the amendments to the Civil Code, we would like to note that the mere fact of their introduction into Russian law will hardly be sufficient for “mass repatriation” of M&A transactions (in the nearest future, at least). Certainly, now we have a substantial background for this, but the decisive factor for effectiveness of the new provisions will be the establishment of relevant case law supporting the set trend for making the domestic civil law more flexible and competitive.