

# Insight

## Disputes Resolution

March 2014

### Special Alert

#### Invalidity of Transactions with a Flaw in Will

**On 10 December 2013 the Presidium of the Supreme Commercial Court (the "Presidium") issued Information Letter No. 162 with an overview of court practice on the application of Articles 178 and 179 of the Russian Civil Code (the "Overview").**

According to the Russian Civil Code, the court may declare a transaction invalid, in particular, if it has been made under the influence of (i) a substantive delusion – *Article 178 of the Civil Code* or (ii) deceit, violence, threat or adverse circumstances – *Article 179 of the Civil Code*<sup>1</sup>. The SCC Presidium has summed up the legal views of the courts in this regard.

In this alert we refer to the more significant conclusions of the SCC Presidium covering (i) competitiveness of claims; (ii) the nature of a one-sided transaction; (iii) delusion regarding the legal effects of a transaction; (iv) threat to perform lawful actions; (v) the importance of due prudence in the making of a transaction; and (vi) conclusion on the relevance of the clarifications established in the Overview in terms of the Civil Code reform. We also examine issues included in the draft overview<sup>2</sup> but dismissed by the Presidium.

#### The More Significant Clarifications of the SCC Presidium

##### Legal Nature of a Transaction (Item 3 of the Overview)

The Presidium has clarified that a delusion regarding the legal nature of a transaction means a delusion regarding the type of transaction (e.g., where a contracting party entered into a sale and purchase contract while believing it was making a donation contract). Such transaction may be declared invalid. If a contracting party realizes what transaction it is making but is deluded as to the effects of such transaction on its rights and obligations, such transaction is valid. The Presidium cited the following example.

- As an individual transferred his property as a contribution to the common property of a farmstead, he did not know that he would lose the right to solely dispose of the property transferred. The court declared the transaction valid because the individual was deluded about his contractual rights and obligations, i.e., the legal effects of the transaction, not about its type.

<sup>1</sup> In its Information Letter, the SCC Presidium clarified Articles 178 and 179 of the Civil Code as in effect before 1 September 2013. Federal Law No. 100-FZ dated 7 May 2013 amended these Civil Code provisions, and the new version entered into force on 1 September 2013 (please refer to our Client Insight for 29 April – 26 May 2013).

<sup>2</sup> The draft was prepared by the Private Law Department of the SCC and made available on the Court's official website on 4 October 2013.



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### Competition of Claims (Item 6 of the Overview)

Generally, the law prohibits competition of claims, except for specific claims, in particular, related to consumer protection. Now the Presidium has clarified that such competition is permitted in disputes arising out of agreements on the sale and purchase of goods, in order to protect the interests of the buyer. The aggrieved party, where there are relevant grounds, may claim invalidation of the transaction under Articles 178 and 179 of the Civil Code even if the law provides for other remedies to protect the adversely affected rights arising out of the contractual relations. The Presidium illustrated this approach as follows.

- The parties made a contract on the sale and purchase of a vehicle. Prior to the making of the transaction, a diagnostic inspection had revealed no defects that were discovered soon after the contract was made. The buyer filed a claim to invalidate the transaction as a contract made under the influence of a delusion concerning the quality of its subject matter (under Article 178 of the Civil Code). The seller objected noting that the buyer had chosen the wrong remedy and had been supposed to refer to the remedies provided for under the Civil Code provisions regulating sale and purchase contracts (Article 475 of the Civil Code). The court declared the transaction invalid under Article 178 of the Civil Code.

### Due Care When Making a Transaction (Item 5 of the Overview)

The contracting party that, when making a transaction, failed to act with due care customary for similar transactions and therefore made an error loses the right to have the contract invalidated under Article 178 of the Civil Code. One of such cases is failure to use all available and usual in the course of business opportunities to obtain information relevant for the transaction, as in the example below.

- The lessee, the auction winner, has discovered that he had rented basements though the extract from the technical passport of the building and the tender documentation indicated the premises as located in the semibasement. The lessee could not use the basements according to the purpose indicated in the contract. During the tender process the lessor demonstrated the premises but the lessee failed to visit them. The court declared the transaction valid because the lessee could have learned about the condition, location and other features of the rented premises having visited the premises, but it failed to demonstrate due care that is usual when entering into such transactions and relied on documents only when entering into the contract.

The SCC Presidium did not cite other examples of the claimant's rashness in the making of a contract that would rule out the possibility of having a contract invalidated even where possible under Article 178 of the Civil Code. Consequently, it is up to the court to assess such circumstances in each particular case. In addition, Item 5 of the Overview does not consider other remedies (claims for damages) available to a party after dismissal of its claim for invalidation.

### Conditions of a One-Sided Transaction (Item 11 of the Overview)

The court may declare a transaction one-sided as per Article 179 of the Civil Code if the contract price unfoundedly and excessively exceeds the prices of similar contracts and it is proved that the creditor took advantage of the concurrence of the debtor's grave circumstances when overstating the price. One of the common examples is a loan agreement with an excessive interest rate.

- A company, a non-lending organization, and an individual entrepreneur have entered into a loan agreement for one year at an interest rate of 100% per annum while the average market interest rate for similar loan agreements was no more than 30 – 40% per annum. The court declared the transaction one-sided because the contract price excessively exceeded the prices of similar contracts of such type.

The SCC Presidium has adjusted this clarification as compared to the first version proposed in the draft overview according to which a twofold or other excessive overrun of the contract price against the prices of similar contracts was enough to declare the transaction one-sided. The specification of the twofold overrun raised criticism among the Russian legal community. However, the SCC Presidium, having dropped this estimating criterion formally, in its Overview in fact cites example where the price of the transaction exceeds the market price of similar transactions a bit more than twofold. Such example may result in the courts automatically declaring transactions one-sided where the contract price is double the market price of similar contracts.

### Threat to Perform Lawful Actions (Item 14 of the Overview)

The Presidium has clarified that the ability of a person to perform lawful actions unfavorable to its counterparty thwarts the will of such party when making a contract; therefore such conduct is regarded as a threat. This applies, in particular, to the possible use of lawful commercial tools in order to create severe conditions for the counterparty's business as well as to provide the state authorities with unfavorable information, as considered in the examples below.

- A person has bought up a company's receivables and secured attachment of the company's shares. The company was forced to agree to make, with this person, a contract on the sale and purchase of the company's shares so as to lift the attachment. The interim measure was lifted at the buyer's request, and the contract was made. The court declared the transaction invalid under Article 179 of the Civil Code. In another example, the possibility of a person to inform the public prosecutor about a deviation of its counterparty from paying taxes was regarded as a threat.

These circumstances are to be considered when selecting the tactics for business negotiations and negotiations regarding an out-of-court settlement of the conflict.

### Matters Reflected in the Draft but Not Included in the Overview Following Their Discussion

#### Implication of the Financial and Economic Condition of the Share Issuer and Limitation of the Share Seller's Liability<sup>3</sup>

The drafters proposed direct provisions to the effect that the economic and financial condition of the share issuer affects the quality of the shares as the subject matter of a sale and purchase contract. However, based on the results of the discussion, the Presidium had the Overview include the clarifications allowing competition of claims only.

In another example, the drafters suggested allowing the limitation of liability of the seller under a share sale and purchase contract to the extent of such defects (circumstances reducing the value of shares) of which the seller was unaware as the contract was made.

#### Delusion regarding the Counterparty's Solvency and Misrepresentation<sup>4</sup>

It was suggested that the overview lay down that delusion concerning the solvency of the counterparty caused by misrepresentation of its part constitute grounds for invalidation of the contract under Article 178 of the Civil Code. However, during the discussion, this item raised serious objections and was dropped from the Overview for the following reasons: (i) the contradictory facts of the model case (in fact they illustrated deceit but not delusion); (ii) uncertainty regarding the obligation of the buyer to verify the seller's representations and the extent of the buyer's care in this regard; (iii) delusion regarding the counterparty's solvency constitutes very broad grounds difficult to prove, which may lead to abuse of rights and injure the stability of the turnover.

#### Application of the SCC Presidium Clarifications in the Context of the Civil Code Reform

Generally, the Overview reflects the amendments to Articles 178 and 179 of the Civil Code made under Federal Law No. 100-FZ dated 7 May 2013 that entered into force on 1 September 2013. The clarifications provided for in the Overview would, primarily, apply to transactions entered into before 1 September 2013 and ensure uniform application of Articles 178 and 179 of the Civil Code before and after the making of the amendments.

*The Overview will serve as guidance for lower courts when considering similar matters.*

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<sup>3</sup> Item 4 of the draft overview.

<sup>4</sup> Item 3 of the draft overview.