5

Consideration

I INTRODUCTION

Consideration is one of the compulsory requirements in English contract law for a binding informal contract,[1] along with agreement (offer and acceptance) and intention to be legally bound. Consideration, in English law, is what party B gives to party A to support a promise by A which B wishes to enforce. This applies for both bilateral and unilateral contracts.[2]

Russian contract law does not have an exact equivalent of consideration. Consideration is not required for a contract to be considered concluded. However, there are two legal mechanisms in Russian contract law which are to a large extent analogous to executed consideration in English law and perform a similar function. These are:

- counter-performance (встречное исполнение; *vstrechnoe ispolnenie*) of obligations; and
- counter-giving for performance (встречное предоставление; *vstrechnoe predostavlenie*).

These expressions sound rather awkward in English, but the role each concept plays matches its literal translation, as will be seen in this chapter.

II COUNTER-PERFORMANCE

A Definition of Counter-Performance

Counter-performance is defined in Civil Code (CC) article 328(1): 'The performance of an obligation by one of the parties which in accordance with a contract *is conditioned* by the performance by the other party of its obligations shall be deemed to be counter-performance'[3] (emphasis added).

[1] Informal in the sense that it is not binding as a result of being in a special form, ie a deed under seal.

[2] Bilateral contracts are contracts where both sides have obligations. Unilateral contracts are contracts where only one side is under an obligation, eg, to pay the promised reward in return for the successful retrieval of a lost dog.

[3] WE Butler, *The Civil Code of the Russian Federation Parts 1, 2 and 3: Parallel Russian and English Texts* (Moscow, JurInfoR-Press, 2008) 252–3.

Thus to qualify as counter-performance, it must be performance in circumstances where the two parties A and B do not perform their contractual obligations simultaneously, and have the following two characteristics: first, it is performed by B after A has already performed their contractual obligation. Performance by A, the party who performs first, can never be regarded as counter-performance. Secondly, to qualify as counter-performance, B's actions must be *conditioned* (that is, conditional on) performance by A.

The practical application of these is illustrated by examples from court practice below.

Bearing these characteristics in mind, it is be apparent that counter-performance, unlike English consideration, only occurs in bilateral contracts. However, as noted, it is not a requirement, unlike English consideration, and its absence does not adversely impact the formation or binding force of any contract. Rather, it affects what B may do if A fails to perform as promised.

B Function of Counter-Performance

If the conditions outlined above are fulfilled so that B's performance qualifies as a counter-performance, and the other party, A, fails to perform at all or on time, B is given specific rights under CC article 328. It is important to emphasise that in these circumstances B does not have any other alternatives except for those provided in CC article 328 and discussed below.

According to CC article 328(2), if the other party, A, fails to perform, or it is clear that A's performance will not be made in due time, B 'shall have the right to suspend the performance of his obligation'.[4] Alternatively, B may 'waive the performance of this obligation and demand compensation of losses'.[5] The difference between suspending performance and waiving performance is that suspending performance means merely postponing the contractual obligation to perform; waiving performance terminates that obligation.

Under this provision, if B elects to suspend its counter-performance, B will have no right to sue A for either required performance[6] or compensation for losses. However, if B elects to waive performance of its own counter-obligation and sue A for its losses, B is entitled to compensation from A. But, as in the first alternative, B will have no right to sue A for required performance.

CC article 328(3) gives a third alternative. If B provides the counter-performance, then B has a right to sue A for both compensation and also required performance, and A is obliged to provide them.

[4] Ibid 253.

[5] Ibid.

[6] See Chapter 9 at p 193 and Chapter 10 at p 251 for details of required performance as a remedy (in instances when it is other than payment of an agreed sum).

If A only performs in part, B has the right either to suspend performance of its own obligation, or to waive its performance, in proportion to the performance A has failed to provide.

It is worth stressing that if B has not provided any counter-performance, B has absolutely no right to demand that A performs its obligation. In return, A cannot demand that B performs B's obligation before A has itself provided performance. Therefore, in a bilateral contract which is not performed simultaneously, the Russian concept of counter-performance has a similar effect to the English doctrine of consideration, in supporting the right to enforce the other party's duty to perform.

This can be illustrated by cases of claims for pre-payment, when the delivery of goods, provision of work or services is conditional on such payment. In Russia it is very common to include a contractual term requiring partial or full pre-payment. Most purchase-sale contracts, for example, would include such a term.[7] Then the delivery of goods by seller B is conditional on the pre-payment by buyer A. The delivery is B's counter-performance, in return for A's pre-payment. In many instances when a buyer fails to make pre-payment the seller will sue for non-performance, demanding both the pre-payment and compensation for losses; such claims are normally rejected by courts on the grounds that the option to sue for the pre-payment is only available to the seller after they have performed their contractual obligation to deliver the goods.

The Supreme Commercial Court has held in multiple Resolutions[8] that the provisions of CC article 328 which sets out the exhaustive list of rights that the party who would provide the counter-performance (in our example, B) has if A fails to perform, are imperative. This means that the parties cannot agree on any other options. For example, A and B cannot include a term in the contract that B may, without providing any counter-performance, sue A for required performance.

Thus, in a contract containing a pre-payment clause, seller B can demand that buyer A provides pre-payment and compensates B's losses arising from late payment of pre-payment only once B has delivered the goods to A, ie has made its counter-performance. The Supreme Commercial Court has also underlined that the Civil Code does not contain any provisions which would allow a seller B to sue A for pre-payment for the goods before the goods have actually been delivered.[9] The idea behind this approach is rather simple. From CC article 487 it follows that a pre-payment is payment *for the goods* to be delivered under a

[7] For discussion about the lack of institutional trust in business contracts, see K Hendley, 'Coping with Uncertainty: The Role of Contracts in Russian Industry During the Transition to the Market' (2010) 30(2) *Northwestern Journal of International Law and Business* 417.

[8] See, eg Ruling of Supreme Commercial Court of 16 November 2010 No VAS-15009/10; Ruling of Supreme Commercial Court of 27 December 2010 No VAS-17344/10; Resolution of Presidium of the Supreme Commercial Court of 30 November 2010 No 921, case No A56-47705/2008.

[9] See also Resolution of Federal Commercial Court of Volgo-Viatskii District of 9 February 2011 No A79-4622/2010; Ruling of Supreme Commercial Court of 1 July 2011 No VAS-8289/11; Resolution of Federal Commercial Court of Moscow District of 17 January 2012 No A40-25631/11.

purchase-sale contract which is paid before the actual delivery. The courts deduce that no one can be *coerced* to pay for something they have not yet received. The same approach is applied in courts dealing with claims for prepayments in other types of contracts.

It should be mentioned that according to CC article 328(4), the rules in article 328 outlined at the beginning of this section apply 'unless provided otherwise by the contract or by a law'.[10] In line with the Supreme Commercial Court's established position on this, this provision is narrowly interpreted by courts to the extent that parties may provide in a contract that some or all of the CC article 328 rules do not apply. In other words, A and B may agree to deprive B, the party who must counter-perform, of one or all the rights granted by CC article 328, limit those rights or agree on the losses which could be claimed. Thus, this provision allows the parties to alter some aspects of their contractual relationship but does not override the imperative rule, that a party who would be providing counter-performance (in our example, B) cannot sue the other party (A) for required performance before providing their own counter-performance.

Draft Amendments to the Civil Code propose a new paragraph to CC article 328, which explicitly states that:

> neither of the parties to an obligation, which provides for counter-performance, has a right to claim in court the performance of the other party if it has not provided the other party with the performance due from it under the obligation.[11]

This rule is clearly aimed at formalising the Supreme Commercial Court's established position, noted above.

C Main Characteristics of Counter-Performance

The main characteristics of counter-performance were outlined above. Here each of them is discussed in greater detail.

(i) Counter-Performance is Performance by the Second Party, B

We have seen above that the Civil Code provides certain rights to B if A does not perform its contractual obligation, including B's right to suspend or waive counter-performance. The following Supreme Commercial Court case illustrates the fact that that counter-performance is always the performance of the second party B and, hence, only B may exercise these rights.

> Company A and company B concluded a contract of barter, under which A was obliged to deliver sunflower oil to B by 1 May 2000, and B was obliged

[10] Butler, above n 3, at 253.

[11] Draft Federal Law on Amendments to Parts One, Two, Three and Four of the Civil Code approved by the State Duma at first reading on 27 April 2012 No 47538-6 art 1 para 165.

to deliver diesel fuel to A by 15 May 2000. Although this was a contract of exchange, not purchase-sale, under its terms A had to make delivery first. A did not deliver the sunflower oil by the due date, which led B to exercise its right under CC article 328 to suspend its own performance.

Afterwards B sued A for the penalty set in the contract for non-performance by A. A objected that the penalty should only be paid for the period between 1 and 15 May 2000, claiming that, as B had not performed its obligation by 15 May, A had the right under CC article 328 to suspend its own performance.

The Supreme Commercial Court declared that A had no right to do this, because performance by the first party, here A, can never qualify as counter-performance. It followed that A could not exercise the rights in CC article 328.[12]

(ii) Counter-Performance is Always Conditional on Performance by the First Party

Qualification of a performance as counter-performance is important because it directly affects the rights of the second party, B, when the first party, A, has failed to perform.

The issue of whether or not B may use the rights granted to it by CC article 328 is a frequent ground for litigation in the Russian commercial courts. Interpreting the notion of counter-performance as defined in CC article 328(1), most courts reasonably conclude that, to be counter-performance, B's performance must be conditional on A's performance, as in the following example.

In a case reviewed by the Fifteenth Commercial Appellate Court, S, a service provider and C, a client, concluded a contract for the provision of services. The contract specified that payment was to be made in two instalments; the first as a pre-payment and the second by 4 September 2009. The contract also provided that the provision of services was to start on 8 July 2009. No services had been provided by the end of 2009 so C sued S, claiming for reimbursement of the pre-payment. S counterclaimed and demanded payment of the second instalment. S asserted that, in accordance with CC article 328, he had suspended performance of his obligation to provide the services because C had not paid the second instalment.

The court noted that under CC article 328(1) counter-performance is performance which is conditional on performance by the other party. Therefore, counter-performance has to be something provided *only after* the other party has performed their obligation. The court emphasised that a necessary prerequisite to qualify as counter-performance is that the

[12] Informational Circular of Supreme Commercial Court of 24 September 2002 No 69 'Overview of Practice on Resolution of Disputes connected with the Contract of Barter' para 16.

contract explicitly provides this. The exact wording can vary. It can specify precisely that performance is only to be provided after the first party has performed; or it can set a sequence for the two parties' performances which makes this clear, for example, by a term under which a contractor will commence work no later than one month after receiving prepayment.

Following this reasoning, the court rejected S's counterclaim and upheld C's claim. It held that the contract between the parties did not include a term under which S's performance of its obligation was conditional on C's payment of the full fee for the services (including the second instalment). Rather, the dates in the contract showed that S should provide services two months before the second payment, so clearly not consequential on it. Here clearly S was not providing a counter-performance.[13]

Another case shows court reasoning based on the requirement for conditionality.

Leasing company L and airline E contracted for E to lease an aircraft engine from L. According to the contract L was also obliged to extend the engine's lifetime beyond 3,000 hours at its own expense.

After a certain time E requested that L extended the engine's lifetime up to 4,800 hours. L refused. It held that its obligation to extend the engine's lifetime was a counter-performance conditional on E's payment of rent; since E had not paid the rent for leasing the engine, L claimed the right to suspend its performance on the basis of CC article 328(2).

L sued E for the rent for E's use of the aircraft engine. Among other claims, L demanded the payment of the minimal rent specified by the contract for the period when E could not use the engine because L had failed to extend its lifetime.

The court found for L in respect of the rent of the aircraft engine but rejected L's claim for the minimal rental fee for the period when E could not use the aircraft engine. The court held that E only had to pay the rent for the period when the engine functioned.

The court rejected L's argument that it had a right to suspend its obligation to extend the engine's lifetime. It held that CC article 328 only applied to counter-performance, and here the engine rental contract did not specify that L's obligation to extend the engine's lifetime was conditional on E paying rent for its actual use of the engine. Therefore, L's obligation to prolong the engine's lifetime could not be counter-performance; hence L could not rely on CC article 328 as grounds for refusing to carry out its contractual duty to prolong the engine's lifetime. [14]

[13] Resolution of Fifteenth Commercial Appellate Court of 23 June 2011 No 15AP-5186/2011/.

[14] Resolution of Federal Commercial Court of Moscow District of 23 August 2007 No KG-40/7679-07.

The Federal District Commercial Court of Far-Eastern District in one of its decisions used a different approach to decide whether a performance was counter-performance.

> In 2000 landlord L contracted to let premises to tenant T for 10 years for T to use for his sewing business. Unfortunately, T stopped paying rent to L from 1 February 2004. As a result, on 20 April 2004 L instructed the security guards at the entrance to the premises not to let in T's workers. At the end of 2004 L sued T for the unpaid rent for the period from 1 February until 1 December 2004.
>
> The court upheld L's claim but only in part. It held that a landlord's obligation to a tenant is to provide premises for possession and use. The tenant's obligation is to pay for that possession and use. Therefore, payment of rent is counter-performance. So if L did not fully perform his side of the contract, T, who was due to provide counter-performance, might accordingly suspend or waive his obligation to pay, exercising his rights under CC article 328. The court therefore concluded that T did not have to pay rent for the period when L had denied access to the premises for T's workers. [15]

In this case the court construed CC article 328 by applying a notion of fairness rather than the literal wording of the article as commonly understood in court practice. Even though the outcome of this decision is reasonable from a legal standpoint, the Civil Code provides other legal instruments which might have been more appropriate in this situation to achieve the same result. For example, after T failed to pay the rent on time twice in a row, L could have used the right to demand early discharge of the contract under CC article 619(3) and claim in court the amount of rent due from T. According to this article, a rental contract may be dissolved before time by a court at the demand of the landlord if the tenant does not pay rent 'more than two times in succession upon the expiry of the period established by the court'.[16] However, this case is particularly interesting in the way the court based its reasoning on reciprocity, analogous to the English concept of consideration, instead of applying the provisions of CC article 619(3) on early discharge.

(iii) No Counter-Performance if Obligations are Performed Simultaneously

Performance by the party which actually performs second can never be counter-performance, if the wording of the contract requires both parties to perform their obligations simultaneously or within the same short timeframe, for example, within one week of the contract being concluded. If the contract does not

[15] Resolution of Federal Commercial Court of Far-Eastern District of 19 May 2006 No A51-18938/04-2-307/23.

[16] Butler, above n 3, at 447.

explicitly specify that one performance must be earlier in time, it does not define which party would be counter-performing, therefore there can be no counter-performance.

The contrast between a contract with counter-performance and one without can be demonstrated using the example of a contract of barter. CC article 569 specifies in relation to barter:

> if the periods for delivery of the goods to be exchanged do not coincide, the rules concerning counter-performance of obligations (article 328) apply to the performance of the obligation to transfer the good by the party which must transfer the good after the transfer of the good by the other party.[17]

Thus, if A and B conclude a barter contract under which B has to deliver to A 100 kg of chicken meat within five days from the date when A delivers to B a ton of sawdust, B's performance will be qualified as counter-performance. By contrast, if B and A specify in their barter contract that they will exchange 100 kg of chicken meat for a ton of sawdust within seven days after formation (conclusion) of the contract, performance of neither party can be considered as counter-performance, as the contract does not determine which party must perform first. The following case is an example.

> Cooperative W and company C agreed to exchange three wagon-loads of construction materials for a certain number of personal computers (PCs) within one week from the conclusion of the barter contract between them. On the last day of the exchange period W had only delivered to C one wagon-load instead of three. C could not reasonably expect delivery of the two remaining wagon-loads. C considered its performance to be counter-performance, so, on the basis of CC article 328, suspended performance of its obligation.
>
> In this situation, on one hand both parties had to deliver within the same period. On the other hand, by the last day of that period it was clear that W would not fully perform its obligation, but C was ready to deliver the required number of PCs when it decided to suspend its performance.
>
> Both the Court of Cassation and the Supreme Commercial Court held that C's readiness to perform could not be considered as counter-performance, because both parties had to perform within the same period, and not necessarily sequentially. Moreover, C's performance was not conditional on W's performance. Therefore C could not apply CC article 328.[18]

From the discussion above we can deduce the following differences between the English doctrine of consideration and the Russian concept of counter-performance:

[17] Ibid 419.

[18] Informational Circular of Supreme Commercial Court of 24 September 2002 No 69 'Overview of Practice on Resolution of Disputes connected with the Contract of Barter' para 10.

(1) While consideration is any performance (or promise of performance) by one party to the other, counter-performance is always the performance by the second party (whom we have called B above) which is conditional on performance by the first party, A, provided that the contract specifies different time limits for the performance of each party's obligations, such that A performs before B.
(2) While there must be consideration from the party seeking to enforce a promise in unilateral, as well as bilateral contracts, by definition counter-performance can only be present in bilateral contracts.
(3) While the absence of consideration negates the existence of a contract, the presence or absence of counter-performance does not affect the validity of the contract.

Thus Russian counter-performance is a narrower concept than the English doctrine of consideration.

What makes counter-performance similar to consideration is the function it performs in bilateral contracts. When the performance by B is qualified as counter-performance, B cannot sue A for non-performance unless B has provided the counter-performance (under English analysis, has provided executed consideration). B does have an option to claim damages, but cannot obtain required performance if the reciprocity of B's performance is lacking.

III COUNTER-GIVING FOR PERFORMANCE

The second concept in Russian law which has an analogous function to English consideration is 'counter-giving for performance' (встречное предоставление; *vstrechnoe predostavlenie*), which is particularly important in relation to contracts in Russian law which may be binding despite there being no payment or other compensation by one party in return for something they receive from the other party, such as a contact of gift.

A Understanding the Concept of Counter-Giving for Performance

As noted in the introduction to this chapter, in English law consideration is an indispensable requirement for all legally binding informal contracts. It thus works as a mechanism to exclude promises for which nothing is given in return (so *nudum pactum* – a bare promise) from being binding in law as part of an English contract.[19] In Russian contract law, as well as 'counter-performance' discussed above, there is also the concept of 'counter-giving for performance'. This is used to distinguish between contracts for compensation and contracts without compensation which are nevertheless binding.

[19] Some promises may be enforced under the equitable doctrine of estoppel (promissory or otherwise) but they are arguably outside the ambit of contractual promises.

6

Factors Tending to Defeat Contractual Liability

I INTRODUCTION

This chapter explores the circumstances under which vitiation of a contract can occur, that is, the contract is undone. This is an area where there have been recent reforms in Russian law. It also has serious significance beyond the interests of the parties immediately affected. One of the main functions of contract law in any jurisdiction is to guarantee the stability of civil transactions. Parties to a contract need to be confident that, unless something extraordinary happens, they will be able to enjoy any agreed lawful benefits gained through their contract. Unfortunately, under Russian law, the parties' will may be overridden. Contractual parties may think that they have concluded a contract in due form and may even have performed their part, but the contract might still be vitiated by a court, with all the relevant consequences. This happens much more frequently under Russian law than under English law and represents a serious threat to the reliability of legal transactions. It is one reason why many businesses based in Russia choose English law to govern their commercial dealings.

Under Russian law there are two different circumstances under which contractual obligations can be vitiated. These are, first, when a contract is regarded as invalid (недействительный; *nedeistvilelniy*) or, secondly, when a contract is deemed to be 'not concluded' (незаключенный; *nezaklyuchenniy*).

In both situations the contract is generally regarded as never having existed, similar to being void under English law. However, there are a number of important differences between the effects in Russian and English law. For example, under Russian law the validity of a contract can in certain cases be 'restored', which would be impossible for a void contract in English law. Also, under Russian law, one of the parties to a void contract may have a right to claim damages suffered as a result of the contract's invalidity.

In this chapter we explore the two situations under which contracts may be vitiated, starting with invalidity, then followed by discussion of the situations when contracts are considered 'not concluded' (in relation to the latter, see also Chapter 4 at p 86).

II INVALIDITY OF CONTRACTS

A Invalidity of Contracts under Russian Contract Law

There are two types of invalid contracts in Russian contract law: 'void contracts' (ничтожные договоры; *nichtozhniye dogovori*) and 'contested contracts' (оспоримые договоры; *osporimiye dogovori*). Either of these types of invalidity can also apply to individual terms within a contract, as well as to a contract as a whole (Civil Code (CC) article 180). The general rule is that neither type of invalid contract gives rise to any legal consequences except for those flowing from its invalidity, and it is regarded as invalid from the moment of its apparent conclusion. However, as we will see below, there are exceptions to this general rule.

The important difference between a void contract and a contested contract (or, for example, contested terms within a contract) is that a void contract is invalid irrespective of any court action but a contested contract only becomes invalid when declared so by a court (CC article 166(1)).

The situation with regard to void contracts is slightly complex. A contract is void when particular circumstances specified in law are present, irrespective of whether it has been deemed void by a court. The types of circumstances which render a contract void are discussed in detail below; they are such things as illegality, immoral purpose, lack of capacity, and similar. However, a party must apply to court and prove that the relevant legal grounds for invalidity are indeed present which make the contract void, otherwise they are unable to enforce the consequences of the contract's invalidity.

The concept of a contested contract has some similarity to the English concept of a voidable contract; that is, that the contract exists until it is 'avoided', although in Russia, unlike in England, that step must be taken by a court. Thus if a contract under Russian law has been concluded and has not been contested by a party or other person with standing to contest it (discussed below), the contract remains in force. Property passes under the contract and can be passed to a third party, unless and until the contract is successfully contested. Again in contrast to English law, the right to contest such a contract is not extinguished when the property is passed to a third party but when the limitation period stipulated by law expires.

In practice the difference between a contested and a void contract is as follows. If a party to a contract considers a contract or particular term within it void, they can refuse to perform, referring to CC article 167(1) which provides that invalid contracts do not entail any legal consequences. However, the party doing this must accept the risk that the other party might sue them for breach, and the court might consider the questionable term valid, not void, in which case they will be liable. By contrast, a party has no legal right to refuse to fulfil a contract, or particular term within it, on the ground that the contract (or

term) is contested. They would first have to prove in court that the contract or term is contested and thus no obligations arise.

(i) Applying for Application of Consequences of Invalidity of a Contract

(a) Applying in relation to Void Contracts

If one contractual party considers that the whole contract is void, on one of the grounds provided in the legislation (see below), they may offer the other party the possibility of resolving the problem amicably in some way, for example, by signing a contract on different terms which comply with the relevant law, or agreeing to restitution of anything transferred under the invalid contract.

Alternatively, they may go directly to court and apply for the application of the consequences of invalidity of the contract, or any terms in it which they claim are void. Application to court for a declaration that a contract or any of its terms is void can not only be made by a party to the contract, but also by other people, to whom the law directly awards such a right. The definition of who is in this group has recently changed.

For contracts concluded before 1 September 2013, the second paragraph of the original version of CC article 166(2) applies. It said that, 'A demand concerning the application of the consequences of the invalidity of a void transaction may be presented by *any interested person*. The court shall have the right to apply such consequences at its own initiative' (emphasis added).[1] The first sentence here was interpreted to mean that anyone who was in any way affected by a contract could apply for the application of the consequences of invalidity; as the Supreme Commercial Court stated, disputes connected with void contracts are resolved upon application from any *interested* person.[2]

The courts' role has been very important in deciding who was considered to be an interested person (apart from the parties to the contract, who are always considered to have an interest). In one case, someone who had unsuccessfully submitted a tender was held to have a right to claim for the invalidation of the contract concluded between the organiser of the tender and party whose tender was accepted.[3] Another case was as follows.

> Participants (shareholders) of a limited responsibility society (общество с ограниченной ответственностью; *obshchestvo s ogranichennoi otvetstvennost'iu* (ООО))[4] were considered to have a right to claim for the

[1] WE Butler, *The Civil Code of the Russian Federation Parts 1, 2 and 3: Parallel Russian and English Texts* (Moscow, JurInfoR-Press, 2008) 150.

[2] Resolution of Plenum of the Supreme Court No 6, Plenum of the Supreme Commercial Court No 8 of 1 July 1996 'On Certain Questions of Application of Part I of the Civil Code of the Russian Federation' para 32.

[3] Resolution of Federal Commercial Court of Volgo-Viatskii District of 24 December 2010, case No A11-3657/2010.

[4] An OOO is type of Russian legal entity where a participant/shareholder will own a participatory share (доля; *dolia*) (see CC arts 87–94). This contrasts, for example, with a joint stock society

application of the consequences of invalidity of a contract the OOO had concluded which contradicted the law. In the particular case the OOO had concluded a contract for the sale of a building it owned. The contract did not conform to law. The OOO's shareholders therefore considered it invalid and brought a claim for the application of the consequences of invalidity.

The lower courts decided that the shareholders were not interested persons because they could not prove that the contract affected their rights and duties nor that the conclusion of the contract caused them any negative consequences.

The Supreme Commercial Court held that the lower courts' decisions were incorrect. Under CC article 166(2) in the version in force at the time, any interested person was entitled to go to court claiming invalidity of a transaction. The Code did not oblige them to prove that they suffered any negative consequences as a result of the contract.

Shareholders of an OOO have rights arising from their ownership of a share in it, one of these being a right to receive the value of their share in the OOO if they withdraw from it. Thus they would have an interest in the success of the OOO's activities and so were considered interested persons for the purposes of an application of the consequences of invalidity of a contract concluded by the OOO.[5]

It has also been common for government agencies to claim that contracts or certain terms within contracts were invalid and apply the corresponding consequences. For example, the tax authority could claim that a contract was invalid and as a result apply penalties for the incorrect calculation of taxes by the taxpayer.[6] Government agencies such as the tax authority have been especially privileged in that they have not had to go to court to apply the consequences of invalidity of a contract. They could act on their own initiative and at their own discretion. If the contractual parties disagreed they might challenge in court the government agency's decision about the invalidity of their contract, and prove either that the contract is valid or that the government agency should not be considered to be an interested person.

This question of who is an interested person with regard to the invalidity of a contract is still extremely important. First, the, old rules just outlined are applicable to all contracts concluded before 1 September 2013 which means that the courts will be applying those rules for some time. Secondly, the new version of CC article 166(3) stipulates that a person 'who has an interest protected by law'[7] to deem the contract invalid can apply for invalidation of the contract 'if such

(акционерное общество; *aktsionernoe obshchestvo* (AO)) (see CC arts 96–104) where shareholders hold stock (акция; *aktsiia*) which is freely transferable through a stock exchange.

[5] Resolution of Supreme Commercial Court of 22 December 2009 No 9503/09.

[6] Resolution of Supreme Commercial Court of 1 June 2010 No 16064/09.

[7] Federal Law of 7 May 2013 No 100-FZ, amending the Civil Code.

application is not connected with the application of consequences of contractual invalidity'.[8]

It follows that a government body, such as tax or competition authority, would potentially still be able to invalidate contracts between companies and individuals.

Also, unfortunately, use of the vague criterion of 'a person who *has an interest protected by law*' offsets the positive effect of the new rules regarding the application of consequences of invalidity of a contract. It is for the courts to apply the new rules and choose whether to follow the old pattern of creating uncertainty for the contracting parties about the legal validity of their contract, or to follow the new rules in new spirit and try to enhance the stability of civil relations.

The court has retained the right to apply the consequences of invalidity of a contract on its own initiative, including restitution, but only when 'it is necessary to protect public interests and in other cases stipulated by law'[9] (new version of CC article 166(4)). Again, the old rules in CC article 166(2)[10] apply to all contracts concluded before 1 September 2013. These allow courts to apply the consequences of invalidity at their own discretion. It has not been easy to define when the courts might decide to exercise this right. The Supreme Commercial Court accepted in one case that a lower court had correctly refrained from doing this 'considering the circumstances of the case, inter alia, that the parties did not refer to the possible application of restitution and the case materials did not contain enough evidence to make conclusions on the order for restitution'.[11] The case was as follows.

> A state-owned unitary enterprise (унитарное предприятие; *unitarnoe predpriiatie*), E, had rented equipment to company C. C did not pay for the use of the equipment and E sued, demanding payment of the unpaid rent. C counterclaimed that the contract was void. The commercial court hearing the case rejected E's claim on the grounds that the lease agreement was invalid because E did not have the right to rent out the equipment.[12]

It should be pointed out that the payment could still be recovered in the form of unfounded enrichment. However, in the particular case the claim was based on contract and under procedural rules the basis of the claim could not be changed. In order to recover the debt as unfounded enrichment, E would have to bring a new claim based on unfounded enrichment (for more on this, see below at p 134).

[8] Ibid.
[9] Ibid.
[10] See above, text to n 1.
[11] Informational Circular of Supreme Commercial Court of 13 November 2008 No 126 'Overview of the Court Practice on Certain Questions connected with the Vindication of Property from Unlawful Possession by Other Persons' Part 1.
[12] Ibid Part 3.

Under the original version of CC article 166(2), if none of the parties has applied for the application of the consequences of invalidity, the court had a right rather than a duty to make a ruling on its own initiative. Thus to be sure that a ruling on consequences of invalidity would be considered, a disputing party needed to apply for that; it would be unwise to rely on the court's own discretion.

The version of CC article 166(4) applicable to contracts concluded after 1 September 2013, quoted above,[13] limits the right of a court to apply the consequences of invalidity on its own initiative to situations where 'it is necessary to protect public interests and in other cases stipulated by law'. This approach should make contractual disputes more predictable. However, it is not obvious what 'public interest' will mean with respect to contractual relations. There is always a risk that the new rule will be applied selectively and thus will not fulfil the purpose of contributing to the stability of civil law transactions.

One interesting novelty has been introduced to the Civil Code for contracts concluded after 1 September 2013. A new rule incorporated into the Code (article 166(5), as amended by Federal Law of 7 May 2013) states that:

> A claim of invalidity of a contract does not have any legal effect if the person making the claim is acting in bad faith and in particular if that person's behaviour after the conclusion of the transaction induced other persons to rely on the validity of the contract.[14]

This not only raises the issue of motivation but also creates protection somewhat analogous to estoppel in, for example, Australian law, where reliance by another induced by deliberate behaviour gives rise to an enforceable right.[15]

Further, the revised version of CC article 167(1) has an added paragraph which stipulates that 'A person who knew or should have known of the grounds for invalidity of a contested transaction after the transaction has been deemed invalid shall not be considered as having acted in good faith'.

These provisions are a complete novelty and there has been nothing similar in any previous version of the Code. It may therefore take several years before it can be seen how the courts are going to use these new rules and in what situations they will be applied.

(b) Applying in relation to Contested Contracts

A contested contract can only be challenged by a person whose rights and lawful interests it violates, although they do not necessarily have to be a party to the contract. The definition of who can challenge a contested contract is one of the recent reforms to the Civil Code, as will be discussed shortly.

For contracts concluded before 1 September 2013, CC article 166(2) in its original form said rather simply, 'A demand to deem a contested transaction to

[13] See above, text to n 9.
[14] See above n 7.
[15] As in *Waltons Stores (Interstate) Ltd v Maher* (1988) 164 CLR 387.

be invalid may be brought by the person specified in the present Code'.[16] Only those specifically identified in the law for each kind of contested contract were allowed to challenge the contested contract.

The amended provision in CC article 166(2) broadens the range of potential claimants to include those whose rights and lawful interests have been breached. Further, it connects such breach with 'unfavourable consequences suffered by such person'.[17] The new version of the Article creates a presumption that if a person suffered unfavourable consequences as a result of a contract, even if they are not a party to it, they have a legitimate interest which allows them to challenge the contract.

It is clear that the amendment has widened the circle of potential applicants for invalidity of contested contracts. At the time of writing it is too early to predict the practical implication of this. However, we fear that the new version is potentially dangerous as creating uncertainty for many contracts.

(ii) Consequences of Invalidity of a Contract

CC article 167(2) sets out the general consequences of invalidity of contracts, and applies to contracts invalid both as a result of being void and being 'contested'. It provides that:

> In the event of the invalidity of a transaction [contract], each of the parties shall be obliged to return to the other everything received according to the transaction, and if it is impossible to return that received in kind [restitution] . . . to compensate its value in money, unless the consequences of the invalidity of the transaction have been provided for by a law.[18]

This means that, for example, if both parties to an invalid purchase-sale contract have already executed the contract, the seller will get their goods back and will return the purchase price to the buyer.

However, this remedy for invalidity is complicated by the fact that there is a conflict between the Civil Code provisions on restitution and its provisions on vindication and the protection of a *bona fidei* purchaser.

In respect of the latter, CC article 301 (in chapter 20 'Defence of Right of Ownership and Other Rights to Things') gives a right of vindication, based on the right of ownership: 'The owner shall have the right to demand and obtain his property from another's illegal possession'.[19] CC article 302 then deals with the situation where a third party has obtained property in good faith from someone who had unlawful possession. In slightly tortuous language it says:

> If property has been acquired for compensation from a person who did not have the right to alienate it, of which the acquirer did not know and could not have known (good

[16] Butler, above n 1, at 150.
[17] Federal Law of 7 May 2013 No 100-FZ, amending the Civil Code.
[18] Butler, above n 1, at 150. The wording has not been amended.
[19] Ibid 239.

> faith [*bona fidei*] purchaser), then the owner shall have the right to demand and obtain this property from the acquirer when the property has been lost by the owner or person to whom the property was transferred by the owner in possession, or stolen from one of the other, or left the possession thereof by means other than the will thereof.[20]

The effect of this can be illustrated in the following example. A sells a flat to B and then B sells the flat to C. If, after the contract between B and C has been signed, the contract between A and B is deemed void, B would not have gained ownership of the flat, therefore does not have any right to sell it to C. Does this mean that C, who did not know about the problems with the contract between A and B, should return the flat to A? Application of the simple restitution rules would mean that C would keep the flat (the B-C contract is unaffected); B therefore cannot give A restitution in kind, so pays A damages instead, as suggested in CC article 167(2) . Application of the rules on vindication would suggest that A could reclaim the flat from C, despite C's claim that they bought the flat in good faith, because A would be able to say that the property left them 'by means other than the will thereof' (CC article 302) as a result of the invalidity of their contract with B.

CC article 9 gives individuals and legal entities the freedom to choose whatever procedure they prefer to defend their infringed civil rights.[21] So, theoretically, a party who transferred property under an invalid contract could base their claim for the return of the property on the invalidity of the contract (claiming for restitution) or on their property right (claiming for vindication). In the former case a *bona fidei* third party purchaser would be protected, in the latter, they would not be.

The Russian Constitutional Court ruled that the courts of general jurisdiction and the commercial courts should decide for each case which civil law provisions are applicable, as there was no inherent unconstitutionality in CC article 167.[22]

The Supreme Commercial Court has taken the position 'since the law specifically regulates the consequences of invalidity of transactions, rules on demanding and obtaining property from another's unlawful possession [vindication] shall not be applicable [in such cases]'.[23] Thus, according to the Supreme Commercial Court, a party to an invalid contract whose property was transferred under the contract has only one remedy, restitution, that is, a claim based on the invalidity of the contract to get the property back, and does not have a vindicatory claim based on their ownership. Application of this to the example with two consecutive transactions would mean that C would keep the flat, and B pay A compensation.

[20] Ibid.

[21] Resolution of Constitutional Court of the Russian Federation of 21 April 2003 No 6-P para 3. See also M Lomovsteva and J Henderson, 'Constitutional Justice in Russia' (2009) 34 *Review of Central and East European Law* 37 at 48.

[22] Ibid.

[23] Informational Circular of Supreme Commercial Court, above n 11, Part 1.

As we saw at the beginning of this section,[24] CC article 167(2) says that if it is impossible to return in kind everything received under the invalid contract, compensation shall instead by made in money to the value of the received goods. The Supreme Commercial Court and the Supreme Court have jointly made clear that when one party to an invalid contract received money and the other received goods, works or services, the obligations of both parties should be regarded as having equal value.[25] This reflects the principle of presuming each contract is mutually beneficial; both parties have acted in their own best interest, so set the values to be equivalent. However, the courts also point out that if the money received by one party clearly exceeds to a considerable extent the value of the goods, services or work received by the other, the rules on unfounded enrichment are applicable. It means that if a party to an invalid contract proves that the performance they received is worth considerably less than the performance they made, they have the right to claim the difference.[26]

A good example of the application of this approach is given by the Supreme Commercial Court in one of its important decisions.[27]

> A lease agreement was deemed invalid following an application by the tenant, T. T also claimed for the return of all sums paid to the landlord L as rent under the invalid agreement. The Supreme Commercial Court explained that T had been using the premises and L could not recover such use in kind. Instead, the value of the use should be paid to L as a consequence of the invalidity of the contract. Since T had already paid for the use of the premises, he did not have to pay a second time, and neither did L have to return to T the money received as rent under the invalid contract. The court hinted, however, that if the rent had been higher than the normal rent for similar premises in that region, T would have the right to receive the difference between the normal rent and the higher rent he had paid.

In fact, through its interpretation of the Civil Code the Supreme Commercial Court has invented this extra consequence of contractual invalidity in addition to the consequences directly stipulated in the Code. The Court specifically stated that the right of a party to an invalid contract to claim unfounded enrichment for the difference in value between their performance and the other party's constitutes an additional consequence of the invalidity.[28] This concept is widely applied in the commercial courts.

[24] See above, text to n 16.

[25] Resolution of Plenum of the Supreme Court No 13, Plenum of the Supreme Commercial Court No 14 of 8 October 1998 'On the Practice of Application of the Provisions of the Civil Code of the Russian Federation on the Interest for the Unlawful Use of Monetary Funds' Part 27.

[26] Ibid.

[27] Informational Circular of Presidium of the Supreme Commercial Court of 11 January 2000 No 49 'Overview of the Practice of Resolution of Disputes connected with the Application of Norms on Unfounded Enrichment' Part 7.

[28] Ruling of Supreme Commercial Court of 22 February 2011 No VAS-1312/11.

Previously, it was very common for a party in breach of contract to try to avoid their contractual obligations by claiming that the contract was invalid. If the grounds for invalidity of the contract existed, the courts had no choice but to deem the contract invalid. At the same time they tried to protect the interests of the party who had performed in good faith. The following case is an example.

> Contractor C performed their obligations under a contract for independent work, carrying out all the work stipulated. Customer P did not pay and brought a claim to deem the contract invalid. Since there were grounds for invalidity, the court declared the contract invalid. However, the court also noted the impossibility of returning the work in kind and ruled that P should therefore pay a fair price for it, as determined by an independent surveyor.[29]

Thus, even though technically invalidity is a factor which would defeat contractual liability, in practice it can act as a ground for an obligation of a different type, such as restitution or an obligation to compensate for services received under the invalid contract, to avoid unfounded enrichment. This works fairly well with respect to payment for a service already performed on the basis of an invalid contract. However, when the performance due under an invalid contract is non-monetary, the approach taken by the Russian Civil Code can be rather punitive to one of the parties, as seen in the following example.

> A construction company, C, entered into an investment contract with the Moscow Local Government, M. The investment project included the demolition of a hotel belonging to M and the construction of a new hotel on the same site. Under the contract C was obliged to prepare and obtain the necessary administrative approval, and also obtain permits for the demolition and construction work. The contract provided that on the completion of the new hotel, C and M would each acquire a specified share of it. C's share in the finished hotel was its remuneration for the services and works C provided.
>
> The investment contract was deemed invalid and C applied for the application of the consequences of invalidity. By that time C had prepared the project documentation, and hired a number of subcontractors to fulfil its contractual obligations. In C's opinion, M was obliged to compensate for C's expenses incurred in connection with performance of the invalid contract. However, the Supreme Commercial Court held that there was no unfounded enrichment by M and thus C was not entitled to any compensation.[30]

[29] Ruling of Supreme Commercial Court of 27 December 2010 No VAS-17039/10.
[30] Ruling of Supreme Commercial Court of 10 December 2010 No VAS-16663/10.

So far we have been discussing the general consequences of invalidity. However, for some vitiating factors the law provides special consequences of invalidity. They will be discussed in detail below in relation to those particular vitiating factors.

B Grounds of Invalidity: Void Contracts

The Civil Code provides for a number of factors which may lead to a contract being void and a number of factors which may lead to a contract being contested. In this section we deal with the first: factors which make a contract void. Below in the next section we examine contested contracts.

(i) Non-Conformity of a Contract with a Law or Other Legal Act

As discussed in Chapter 2 (at p 53), contracts must comply with mandatory norms of law and other legal acts (mandatory legal norms). Logically enough, if a contract or any term within it does not comply, it is void.

Before amendments to the Civil Code which came into force on 1 September 2013,[31] non-conformity with legislation was the most common ground for contractual invalidity; such contracts would be void.

Now, following the amendments, they are considered to be contested and can become invalid if they are invalidated by a court. (For the difference between void and contested contracts, see above.) The amendments to the Civil Code have changed the rules on invalidity of contract which do not comply with mandatory legal norms. In this section we focus on the circumstances under which a contract (or a term within it) will be considered to contradict such norms. We refer to court decisions prior to September 2013 because they illustrate the way courts substantiated their positions on non-compliance of contracts with legislation. It is unlikely that their approach will change under the amended rules.

Predicting whether or not a contractual term complies with mandatory legal norms is not straightforward. Courts have to interpret both the contract term and the legislation, to decide about the validity of the challenged contractual terms.

In practice, the issue of non-conformity with mandatory legal norms mainly arises in relation to a particular term of a contract. It is relatively uncommon for a whole contract to be declared void for non-conformity with legislation. However, such cases do exist. They are mainly concerned with special legislative requirements for certain contracts as a whole, for example, if the law sets out special requirements for one contractual party and they do not comply, the whole contract is void. For instance, the Civil Code stipulates that all parties in

[31] Federal Law of 7 May 2013 No 100-FZ on Amending Subsections 4 and 5 of Chapter I of Part One and Article 1153 of Part Three of the Civil Code of the Russian Federation.