Russia Practice

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Damages, bad-faith conduct of negotiations, penalties and interest in new clarifications from the Supreme Court of Russia

In connection with the extensive amendments to the Civil Code of the Russian Federation (the "Civil Code"), the Supreme Court of the Russian Federation has prepared clarifications[1] (addressed first and foremost to Russian courts) as to how to apply rules of liability for the breach of obligations – an issue that arises in virtually all court proceedings.

Below we examine the main provisions of Resolution No. 7, which in the current challenging economic situation may help hold bad-faith counterparties fully liable.

1. Damages

The Supreme Court confirmed that as a general rule when reimbursing losses, priority is given to protecting the **expectation interest** of the creditor: the reimbursement of losses should restore the injured creditor to the position that it would have been in if the debtor had duly discharged its obligations. The Supreme Court also continued the trend to lowering the standard of evidence for damages.

Special rules are foreseen for bad-faith conduct or breaking off negotiations. In this case, the **reliance interest** is to be reimbursed: the economic position of the injured party should be restored to what it would have been if the injured party had not entered into negotiations with the bad-faith counterparty. For example, claims can be made to recover expenses on organising negotiations and preparing to conclude a contract (business travel, lease of premises, lawyers' fees), as well as losses incurred related to the loss of the possibility of concluding a contract with a third party.

2. Lost profits

The Supreme Court emphasised in particular that when calculating lost profits, reasonable expenses on generating income must be taken into consideration. The position of the Supreme Court may be interpreted as follows:

- if a creditor that has suffered from the debtor's breach of its obligations did not incur any expenses to receive future income (but can nonetheless document that it has taken specific steps and made preparations to generate income), **the amount of lost profit is equal to the potential profit** (possible income less reasonable and necessary expenses not incurred);
- if this creditor incurred all necessary and reasonable expenses to generate profits, but did not receive income as a result of the debtor's breach of obligations, **then the amount of lost profit will consist of the entire amount of potential income** (to cover both expenses and the profits not generated by the creditor).

In both cases, the creditor must prove the real possibility and probability that it would receive income. When proving lost profits, not only evidence of measures taken and preparations made can be provided, but also any other evidence of the possibility of generating profits. For example, data on the claimant's profits for a similar period of time before the debtor's breach of obligations/after elimination of the breach.

The calculation of possible income may be approximate and probabilistic in nature; however, the creditor is not exempt from the duty to prove that it has taken measures and made preparations to generate income, and also to justify the composition and amount of reasonable expenses that it incurred and/or would have incurred to generate this income, and to take these into consideration when calculating lost profits.

In turn, the debtor may dispute the claimant's calculation and show that the lost profits would not have been received by the creditor even if there had been no breach of obligations (for example, if the creditor did not make the necessary preparations, or due to the fact that the claimant lacks production capacity and personnel sufficient to manufacture the amount of products stated by the claimant, etc.).

3. Causation

In view of the various approaches taken by the Russian courts to proving causal links, the Supreme Court has established the presumption of a causal link between a breach and losses proved by the creditor, if the appearance of the losses for which the creditor is claiming reimbursement is a normal consequence of the breach of obligations committed by the debtor. The debtor may challenge this presumption and prove that there was another cause for the appearance of the creditor's losses.

4. Limitation of liability

The Supreme Court has confirmed that the prior conclusion of an agreement on eliminating or limiting liability cannot create an exemption for deliberate breach of obligations.

For example, if t**he contracting parties excluded the recovery of lost profits or limited liability to a specific amount**, the debtor may cite this limitation only if it can prove the absence of intent (presumption of deliberate breach). To do so, it may provide evidence that it exhibited at least minimal care and prudence in discharging obligations (i.e. that the breach occurred due to negligence or with no culpability at all).

Similar rules are also in place in respect of agreements on eliminating or limiting liability in the performance of business activity, despite the fact that as a general rule such activity involves liability without reference to culpability.

An agreement limiting the debtor's liability is null and void if it violates a statutory prohibition or contradicts the substance of the obligation (for example, a professional freight carrier cannot limit its liability to cases of deliberate breach of obligations).

5. Specific and abstract assessment of damages

The Supreme Court has clarified the main difference between specific and abstract damages: if after the debtor's breach of its obligation the creditor concluded a substitute transaction (acquired comparable goods), it may recover from the debtor **specific damages** – the difference between the price of the initial contract and the price of the substitute transaction.

[1] Resolution of the Plenary Session of the RF Supreme Court No. 7 dated 24 March 2016 (Resolution No. 7).

If no such substitute transaction has been concluded, this does not deprive the creditor of the right to demand reimbursement of **abstract damages** in the form of the difference between the price of the terminated contract and the current price (charged at the time of termination of the contract for comparable goods, work or services at the place of implementation of the contract; in the absence of a current price at the given place – a price that was charged in another place and which may serve as a reasonable replacement, taking transportation and other additional expenses into consideration).

There is a presumption that the creditor acts reasonably and in good faith in concluding the substitute transaction. The debtor may attempt to refute this presumption (for example, by showing that the price of the substitute transaction is clearly different from the current price).

6. Bad-faith conduct of negotiations

The Supreme Court indicated that by itself the groundless refusal to continue negotiations does not mean a party is acting in bad faith. However, if the circumstances stipulated in Clause 2 of Article 434.1 of the Civil Code apply (provision of incomplete information; sudden and unjustified termination of negotiations which the other party could not reasonably have expected), the bad faith of the respondent is presumed, and it must prove the contrary. In all other cases, the presumption of good faith of the respondent holds, which may be refuted by the claimant.

The parties may conclude an agreement on the negotiating procedure. However, such an agreement may not limit liability for bad-faith actions during negotiations – any such provision is null and void.

7. Astreinte (judicial penalty)

If a court order on a claim on specific performance or on a negatory action is not discharged, then at the request of the plaintiff the court will award a sum of money in order to induce the debtor to discharge it (astreinte, or judicial penalty in the interpretation of the Supreme Court). The Supreme Court emphasised that astreinte does not apply to monetary obligations, nor to labour, pension or certain family disputes.

The Court does not have the right to refuse to establish an astreinte if the primary claim has been granted. This penalty is punitive (losses caused by the failure to discharge an obligation in kind are to reimbursed over and above the judicial penalty). As a benchmark for determining the amount of the judicial penalty, the Supreme Court indicates that as a result of its award it should be more advantageous for the debtor to comply with the court order than not to comply.

8. Penalties and interest

If an offset penalty has been established for the violation of a monetary obligation, then interest on money had and received (Article 395 of the Civil Code) is not collected, unless otherwise stipulated by law or contract.

Compliance with the pre-trial claims procedure (sending claims in good time before a claim is filed in court) in respect of the principal amount means that the claims procedure has also been followed for the recovery of penalties and interest under Article 317.1 of the Civil Code and the application of other similar remedies.

The failure to observe the written form of an agreement on a penalty will render it null and void. In addition, any contractual provision limiting the application of Article 333 of the Civil Code (possibility of a court lowering the penalty) is also null and void.

The Supreme Court emphasised that when considering business disputes the courts may reduce penalties only at the substantiated request of the debtor and only in exceptional cases (if the creditor would otherwise receive unjustified enrichment). In other disputes, the court may reduce penalties on its own initiative; however, it must discuss with the parties to the dispute the circumstances indicating a disproportion between the penalty and the consequences of the breach of obligations. The respondent must prove that the penalty is disproportionate and the enrichment unjustified. At the same time, Clause 2 of Resolution No. 81 of the Plenary Session of the Supreme Commercial Court dated 22 December 2011 remains in force; under this clause, the benchmark for the court when determining a sufficient amount for a penalty may be two times the discount rate of the Bank of Russia; as a general rule, a reduction of the penalty below this figure is only permitted in exceptional cases, but not below the discount rate itself.

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