

Penalty as a Means of Enforcing Shareholders Agreements Under Russian Law

By [Andrey Nosikov](#)

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Andrey Nosikov
Senior Associate
Pepeliaev Group

Under Article 32.1 of the federal law on joint stock companies, shareholders agreements can be secured, inter alia, by penalty. Being one of the most extensively used means of securing contracts, penalties have been known in Russian legal practice as the one that can be mitigated (reduced) by the court, in case the latter finds it to be excessive.

The right to mitigate the penalty is provided in Clause 333 of the Russian Civil Code. However, interpretation of this clause by Russian high courts made it work just upside down: The Constitutional Court in its decisions of 2000 and 2004 made it almost obligatory for both arbitration courts and courts of common jurisdiction to bring up and see into the issue of mitigating the penalty. Thus, the courts implicitly followed the approach of any contractual penalty being presumably excessive and bound to be mitigated.

This kind of approach would usually hamper potential contractual parties to ensure that the promisee is in the secured financial position since he would be presumably able to recover his losses from the promisor by way of penalty. It is vital since damages are yet to be proven in the court and are recoverable in the amount that can still be disputed by the other party in court. Shareholders agreements under Russian law are still rarely used partly due to the lack of legal means of securing reasonable interests of the shareholders by contractual tools, e.g. penalty.

In this regard, the position of the Supreme Arbitration Court of the Russian Federation formulated in its Guidelines for understanding the application of Clause 333 of the Russian Civil Code on Dec. 22, 2011, was supposed to shed some light on any progress in court's considerations in respect of the penalty mitigation.

What's new?

1. Penalty is presumed to be reasonable unless otherwise proven in the court. The court comes up with three criteria that make it reasonable:
 - penalty shouldn't exceed the double refinancing rate of the Central Bank of Russia (however, the interested party can prove that the average cost of short-term credits in the debtors location varies from the refinancing rate of the Central Bank existent at that moment);
 - penalty should be more than the amount of single refinancing rate of the Central Bank;
 - penalty may be less than the single refinancing rate of the Central Bank in extraordinary cases, namely when the creditors damages are reimbursed by the cost of the use of money under the obligation that far exceeds the average cost payable in such cases.
2. Penalty can be reduced upon claim of the debtor in the court of first instance only. The court of appellate jurisdiction can decide whether the penalty amount is reasonable or not on the condition that in the first instance it wasn't reduced upon claim (or was reduced but either party doesn't agree). The court of cassation can only award the penalty in full if it was reduced in the first instance without claim of the debtor or if the awarded penalty amount was less than the single refinancing rate of the Central Bank (except for the last case in Item 1).
3. Provisions of Article 333 of the Civil Code are applicable both to penalty provided in a contract and statutory penalty (expressly stipulated by law).
4. The court also clarified that all penalties, fines and surcharges payable under the same obligation are calculated in aggregate and in this amount is subject to mitigation.
5. Contractual provisions setting forth a non-pecuniary penalty (non-cash), e.g. in case of default to transfer some kind of asset to creditor, are enforceable.
6. The court explained that the provisions of Article 330 of the Civil Code are also applicable to relations regarding earnest money collection.

Based on the position of the Supreme Arbitration Court, parties to shareholders agreements governed by Russian law are likely to be less reluctant to resort to penalty as a means of securing their position in relations with other shareholders as well as be more confident in recovery of their potential losses caused by potential violations.

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