

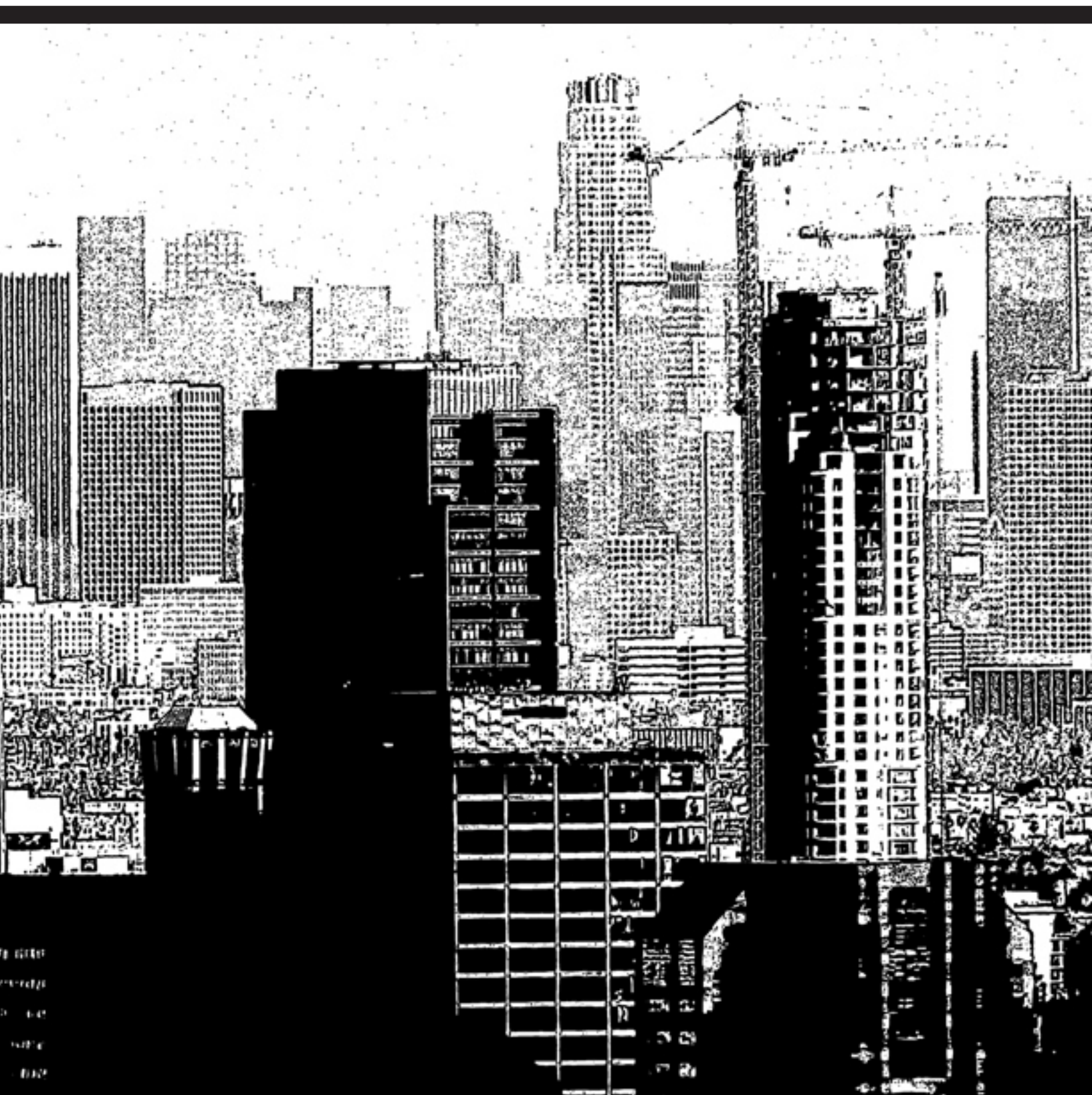


the global voice of
the legal profession®

International Real Estate News

Newsletter of the Real Estate Section of the
International Bar Association Legal Practice Division

**9TH REAL ESTATE INVESTMENT CONFERENCE
29-31 MARCH 2017, RIO DE JANEIRO**



RUSSIA

Andrey Zharskiy
ALRUD, Moscow
andrey.zharskiy@
alrud.com

Stanislav Veselov
ALRUD, Moscow
sveselov@alrud.com

Galina Kulikova
ALRUD, Moscow
gkulikova@alrud.com

Bondarenko,
Ksenia
ALRUD, Moscow
kbondarenko@
alrud.com

Don't be trapped in lease agreements

Due to the current economic environment in Russia, no tenant of commercial real estate is hedged against the situation when one needs to terminate a lease agreement. The problem is that, on the one hand, landlords during pre-execution negotiations tend not to give termination rights to tenants, and, on the other hand, tenants do not always insist on such provisions and rights to be present in a contract. The issue currently remains real, especially in the view of attempts of tenants to optimise their lease expenses (mainly in case of foreign currency rent rates in long-term leases), which may lead to the problem of terminating a burdensome lease relationship.

In this article, I focus on several problematic issues related to the termination of lease contracts under Russian law due to recent changes to civil legislation and the current economic environment.

Is there a way out?

Russian civil law does not provide grounds for early unilateral extrajudicial termination of a lease contract by either party only judicial termination is possible unless otherwise provided for by the lease contract. So unless parties agreed on specific unilateral termination triggers and respective procedures, the courts will only satisfy a claim on termination under either: lease-specific termination grounds stated in the Civil Code of Russia for both parties;¹ or general material grounds, particularly in the event of the material violation of the agreement² or a material change of circumstances.³

Established practice shows that the courts tend to keep contractual relations and not release parties from obligations; however, ongoing economic crises challenge the stability of courts' positions, and 2016 was rich in remarkable judgments.

Foreign currency lease agreements

Before 2014, market practice (at least in Moscow and St Petersburg) was to fix rent rates in United States dollars or euros with payment in roubles according to the official exchange rate which, due to the devaluation of the rouble, resulted in a major increase of rental payments (generally by nearly 100 per cent).

The economic crisis in 2014 caused a new wave of claims from tenants on early termination of agreements, which referred to 'significant change of circumstances'. Generally, the courts followed earlier established practices – the devaluation of Russian currency does not constitute 'significant change of circumstances'; parties shall rely on and bear their own business risks when consenting to foreign currency rent payments. However, at the beginning of 2016, Arbitrazh Court of Moscow⁴ unprecedentedly established a currency band of 30–42 roubles per US\$1 with regard to lease agreement that was entered into in 2009 and had rent rates fixed in dollars. In its reasoning, the first instance court referred to Article 1 of the Civil Code of Russia, which prohibits advantaging from unlawful and inequitable conduct, and referred to the principle of good faith.

Nonetheless, the second and third instance court upheld the position of established court practice and cancelled this decision of the Arbitrazh Court.

Early vacation of premises

Sometimes, especially when conditions of foreign currency lease agreements cannot be changed through negotiations, tenants vacate premises in advance by sending prior notification to landlords (in violation of termination procedure prescribed by lease agreement or the law).

Under the Civil Code of Russia, premises shall be returned to landlords under the acceptance act upon expiry of the lease or termination. Courts adhere to the position expressed by the Presidium of the Supreme Arbitrazh Court of Russia⁵ that even if the landlord does not respond to the tenant's letters on the termination of the lease and does not accept premises from the tenant, the tenant's obligations to pay rent remain until the acceptance of the premises by the landlord.

In 2016, another tenant attempted to justify a fair vacation of premises without acceptance by the landlord, which was supported by the courts in three instances. But the Supreme Court of

Russia overruled these controversial decisions and resolved that early vacating of premises neither releases the tenant from paying rent nor terminates the lease agreement,⁶ and does not release the tenant from the payment of penalties for delays of rent payments.⁷

Other defects of the lease agreement

Under the Civil Code of Russia, a long-term lease agreement is subject to state registration (and is deemed concluded once registered).

As the Plenum of the High Arbitrazh Court of Russia interpreted,⁸ a non-registered long-term lease is binding for parties if they agreed on all material conditions, the property was provided and accepted without objections, and if the agreement regarding rent and other terms was reached and performed by the parties.

Lack of state registration in such cases only leads to an inability to oppose such an agreement the third parties (eg, in the case of an implementation of the pre-emptive right to conclude an agreement for a new term; or following lease rights to the property in the event of owner change).

This position was widely referred to in 2016 court judgments.

In 2016, the Supreme Court kept development of the legal regime for non-registered long-term lease contracts. In particular,⁹ the court supported the position that the assignment of rights under such non-registered contracts is not possible.

Contractual termination provisions

Referring to the above, the courts would most likely be reluctant to support a tenant's termination claim if the tenant did not make enough effort during the contract drafting and negotiating stage to obtain contractual termination options.

We strongly believe that tenants should focus not only on commercial terms but should also advocate termination rights. Our practice shows that having any provision on termination is better than nothing.

The options are various:

- penalty (compensation) for early termination (supported by recent changes to civil legislation and the position of the Supreme Court of Russia);¹⁰
- it is beneficial to negotiate a termination right upon the expiry of certain years of the lease; and
- termination for cause could also be useful,

but it is recommended to be precise when describing key criteria such as 'materiality' of violation – this will increase the chances of terminating an agreement, otherwise it would be up to the court to decide.

Certain termination issues

Despite the termination options well detailed, notification procedure and post-notification obligations would also play a major role. The party may have the door to exit, but it needs to be clear what should be done and what would be the financial implications (security deposit, required fit-out works, compensations, etc).

Here, I outline two issues that, according to our practice, arise at the termination stage and are worth attention.

Return and offset of the deposit payment

As a rule, the tenant's obligations under a lease agreement are secured by a security deposit.

As practice shows, disputes arise when tenants intend to terminate agreements in advance and request an offsetting deposit payment against rent for the last month(s).

Under Russian law, offsetting is possible once both obligations are due. In other words, if the tenant has ongoing obligations to pay rent and the landlord is only obliged to return the deposit after the termination date, there would be no formal right to offset for the tenant as the landlord's obligations would not be due at that moment. The parties may agree otherwise but, of course, the landlord needs to agree to return the deposit earlier, which is a rare case.

Another thing is that, under Russian law, the deposit shall be returned unless agreed otherwise by the parties. We do strongly recommend paying attention to the contractual language as it is quite often said that the deposit is returned provided the tenant did not have any defaults during the lease period, or other provisions making the return of the deposit conditional (which would mean that the deposit could be lost).

Also, it is often said that in the case of the tenant's default, the landlord withholds the deposit as a penalty. Thus, in the situation where the tenant stops paying rent for the last months and refers to the deposit that should be used to cover the payments, this results in a loss of the deposit (as a penalty) and claim for rental payments (as they are due anyway).

Cancellation of the registration record upon the termination of a lease agreement

Parties to registered lease agreements should keep in mind the question of the cancellation of the registration record. This is especially true for landlords, as a non-cancelled lease record may affect potential new lease agreements or even prevent a future sale and, therefore, constitute a 'trap' for landlords. From the tenant's perspective, it does not make much difference whether or not the lease record stays in the public register, as in the case of a termination, the tenant's obligations would end irrespective of the public records.

Russian court practice recognises several ways of cancelling a record in the case of a termination of the lease:

- *On the ground of the termination agreement.*
In this case, the termination agreement is registered in the title register as an independent deal under the application of one of the parties.
- *On the ground of a court decision* upon the application of a relevant party (when the lease agreement is terminated in a judicial order or in the case of a recognition of lease agreement invalidity).
- *On the ground of the unilateral application of a party* that exercises its termination right, provided that such a right is specified in the agreement and is fully unconditional. A party initiating a termination in such a case should provide the registering authority proof of notification of the other party about the termination, and the registering authority may request a mutually signed act of return of the leased premises to ensure the counterparty's awareness of the termination.
- *On the ground of the mutual application(s) of both parties* of the lease agreement when the unilateral termination of the lease agreement is caused by actions of the other party (violations of the lease agreement) or other circumstances that are subject to verification. If in such a case, the other party refuses to file such mutual application(s), the counterparty has the right to apply to court for a claim to recognise a terminated agreement.

The key instrument of pressure on tenants is the fourth option. The trap here is with the registration of a termination. The landlord making a decision to unilaterally terminate should be prepared to potentially go to court for a judgment to recognise the agreement

as terminated, resulting in the possibility of removing the lease record unilaterally. Again, proper drafting could mitigate this by, in particular, establishing the specific obligation to apply for a cancellation of the record and a specific penalty related to that.

Conclusion

We would recommend that parties carefully negotiate lease terms at the very first stage, requiring termination rights for any possible conditions because the economic situation is testing lease market participants and requires more responsibility for possible business risks.

Notes

- 1 Art 5 619–620.
 - 2 Art 450.
 - 3 Art 451.
 - 4 Case No A40-83845/2015.
 - 5 In its letter, No 66, dated 11 January 2002.
 - 6 Decision of the Supreme Court of Russia dated 1 September 2016 on case No A55-28556/2014.
 - 7 Resolution of Plenum of Supreme Court of Russia No 66 dated 24 March 2016.
 - 8 In its Decree No 73 dated 17 November 2011 (as amended in 2013).
 - 9 Via its ruling dated 10 May 2016, No 310-ES15-7612.
 - 10 Issued in its Overview of court practice dated 13 April 2016, according to which, commercial entities may establish the loss of a paid security deposit by the tenant as the termination penalty and respectively, returning of double the security deposit as a termination penalty for the landlord.
-