

Taking Security in the Russian Federation

Introduction

Types of security

There are six types of security expressly referred to in the list of security in the Civil Code of the Russian Federation (the "**Civil Code**"):

- pledge or mortgage;
- suretyship;
- bank guarantee;
- possessory lien;
- security deposit; and
- penalty.

Although this list is stated not to be exhaustive (for example, the Civil Code provisions on factoring contemplate an assignment of a claim by way of security), the legal status of other forms of security such as an assignment is not clear. Of the listed types of security, only the pledge or mortgage allows the creation of a non-possessory security interest in an asset, and affords a creditor the status of a secured creditor in the insolvency of the pledgor or mortgagor.

The aim of this briefing is to describe those types of security that are commonly used for cross-border financing transactions with a Russian element.

Why take security governed by Russian law?

Enforcement of security over assets located in the Russian Federation is likely to take place in the Russian Federation and may require the involvement of the Russian courts. This is particularly the case where the security provider is a legal entity registered in the Russian Federation.

It is therefore usually advisable to use Russian law when the secured property is located in the Russian Federation to avoid problems of inconsistency between the effect of the foreign law security interest and Russian law rules on the creation of interests in property and their enforcement. If the security provider is a Russian entity, it may also be preferable to take a Russian law security interest to ensure that priority will be recognised as against other creditors in Russia participating in insolvency, as the court-appointed administrator or liquidator is unlikely to recognise foreign law security as security giving the creditor priority ranking and other benefits provided to secured creditors under the law of the Russian Federation.

Even if there is no problem with recognition, it is likely that Russian courts will either impose Russian law enforcement requirements on the security, or refuse to enforce the security on public policy grounds (on the basis that foreign law has been chosen purely to avoid Russian law enforcement requirements)

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Furthermore, agreements in relation to immovable property (real estate) situated in the Russian Federation (including security over that property) must be governed by the law of the Russian Federation. It is also better if a pledge of shares in a joint stock company or participatory interests in a limited liability company is Russian law governed in view of perfection requirements established by the law discussed below.

Scope of Security

Russian law requires that a Russian law pledge agreement describes secured obligations in detail (i.e. parties to the obligations, nature, amount, tenor and other terms of the obligations). It is not clear in particular how much detail would have to be provided where obligations are cross-collateralised and each security interest secures the obligations of several obligors. Therefore it is usually preferable for Russian law security documents (e.g. pledge or mortgage agreement) to secure only the debtor's obligations and the obligations of a Russian company under an English law guarantee (which usually guarantees all obligations of all parties). The guarantee of a Russian company also gives a creditor a better chance of being recognised in an insolvency of such Russian company as a secured creditor as it will actually be a creditor of a Russian company (i.e. a person who has a monetary claim against the Russian company) rather than just the holder of a third party security granted by a Russian company.

Due to potential difficulties in enforcement of Russian law security (see further below), security packages may be structured taking Russian law security at the level of the Russian company for primarily defensive purposes (to prevent other creditors getting a prior claim over the asset), and taking foreign law security at the level of the non-Russian holding company (in the form of a share charge) where enforcement may be faster, easier, and more transparent.

Pledge and Mortgage

General

Taking a pledge or a mortgage over an asset is the most common way of taking security in the Russian Federation. A pledge ("*zalog*") can be created over almost any asset, including property and contractual rights (including future rights). Property withdrawn from circulation (e.g., goods of strategic importance), demands inseparably linked with the personality of the creditor (e.g., child support payments) and rights which cannot be assigned as a matter of law (e.g. rights granted under a licence) cannot be the subject of a pledge. A mortgage ("*ipoteka*") is a type of pledge creating security over real estate, ships and aircraft.

Importantly, as mentioned above, the Insolvency Law only recognises a pledge or a mortgage over an asset as security which affords the creditor the status of secured creditor. This entails the right for the creditor to have its claim satisfied out of the proceeds of sale of

such asset ahead of all other creditors' claims (with certain deductions for the benefit of court, and enforcement costs and tortious claims and employment claims).

The Supreme Arbitrazh Court of the Russian Federation has recently made some alterations to the rule of the accessory nature of a pledge or mortgage. According to the Civil Code, the existence of a pledge or mortgage depends upon the existence of the associated secured obligation. If the secured obligation terminates, or is invalid, the security is no longer effective. However according to the Plenum of the Supreme Arbitrazh Court, upon termination of the agreement under which the secured obligation arose, a pledge or mortgage continues to secure any outstanding obligations that may remain following that termination (such as the obligation to return the principal together with interest under a loan agreement). It was also clarified that a pledge agreement may stipulate that the pledge secures the claim of a pledgee to a debtor to claw back amounts received by a debtor under an agreement in the case of invalidity of such agreement.

A pledge or mortgage can be granted by the debtor itself or by a third party to secure the obligations of the debtor. It gives the holder the right to satisfy the secured debt out of the proceeds of sale of the secured property and in certain cases (described below) it allows the pledgee to obtain title to the secured property or receive income from such secured property to settle the debt.

As a result of changes introduced into the Insolvency Law in April and July 2009, pledgees under pledge agreements that are provided as security for the obligations of third parties now have the same rights as the secured creditors of that pledgor. At the same time there has not been sufficient clarification as to whether a person without a monetary claim against a pledgor can be considered as a "creditor" and what steps such pledgee should take in order to be treated in the same way as a secured creditor of a third party pledgor. Therefore, as noted above, it remains advisable to require an English law guarantee from such pledgor and to secure the obligations under the guarantee with the pledge.

A pledge may be possessory, if the pledge agreement so provides (i.e. involve the transfer of possession of the pledged asset to the pledgee). It is not widely used in cross-border transactions and in any event possessory security cannot be taken where a mortgage or a pledge of inventory is required. Although Russian legislation provides that a pledge of documentary securities is possible and it may be possessory unless the pledge agreement provides otherwise, this rule does not apply to pledge of shares in a Russian company since current securities legislation provides that Russian shares may be issued only in non-documentary form.

Perfection

There are few perfection requirements under Russian law and the most relevant ones for financing transactions relate to:

- (i) a mortgage (which, with the exception of certain mortgages arising by operation of law, requires registration in the appropriate state register¹);
- (ii) a pledge of shares (which must be noted in the share or custodial account of the pledgor with the share registrar or custodian); and
- (iii) a pledge of participatory interests (which must be notarised and recorded in the Unified State Register of Legal Entities).

Any such pledge or mortgage is not effective until appropriately formalised, and would cede priority to any subsequent pledge or mortgage so formalised ahead of it.

See further *Priority* below.

There is also a general requirement that a Russian pledgor maintains an internal record of all pledges granted by it, in the so-called "*pledge book*". The pledge book should be made available for public inspection. Although the pledgor is liable for any damages caused by its failure to maintain a pledge book, recording in the pledge book this is not considered a perfection requirement. However, as a matter of practice creditors usually require a pledgor to provide evidence of the recording of the pledge in its pledge book.

Perfection requirements for a specific asset are described in more detail below.

Priority

It is possible under Russian law for a single asset to be pledged to secure more than one debt. In this case, the pledges would rank in priority in the order of creation, and, where a pledge or mortgage has to be registered, its registration. Although not entirely clear, it is generally not thought possible for multiple pledges over a single asset to rank equally with one another, or for a single pledge to be given in favour of multiple creditors (see further *Transferability of Secured Obligations* below). According to a decision of the Supreme Arbitrazh Court of the Russian Federation an express prohibition in the initial pledge over movable property on the creation of subsequent pledges over the pledged asset does not invalidate any subsequent pledge as the Civil Code allows the initial pledgee to accelerate the secured obligation and enforce the pledge where a subsequent pledge is created in breach of contract. Pledgors are under a statutory obligation to inform pledgees of any

existing pledges, and are liable for any loss suffered due to failure to do so.

There is no public register of general encumbrances in Russia and with respect to certain assets it may be complicated to check whether the asset to be pledged is already encumbered without the pledgor's assistance. Prior to advancing funds, a creditor would usually require the pledgor to provide a recent extract from the relevant register showing no encumbrances over those assets over which the creditor intends to take security, if security over those assets is subject to registration.

Disposal of pledged movable property without the secured party's consent

The Plenum of the Supreme Arbitrazh Court of the Russian Federation has recently emphasised with reference to the provisions of the Civil Code that when a disposal of pledged movable property requires consent of a pledgee (i.e. either if so provided in a pledge agreement or, if a pledge agreement is silent in this respect, by operation of law), the disposal made by the pledgor without the pledgee's consent cannot be challenged by the pledgee. Instead the pledgee will be entitled to accelerate the debt and enforce the pledge.

However, as a separate point the Plenum of the Supreme Arbitrazh Court of the Russian Federation has specifically clarified that execution cannot be levied against pledged movable property purchased from a pledgor by a third party for a consideration, if such purchaser was not aware and could not have been aware that the purchased property was encumbered by a pledge, unless such property was in the possession of the pledgee and left such possession against the pledgee's will. In case of a dispute, the courts must assess the circumstances in which the pledged property was purchased and on the basis of which the purchaser could have assumed that it had acquired property subject to a pledge.

Specific Assets

According to the type of asset, a pledge or mortgage may have its own particularities. Below are descriptions of types of pledge or mortgage over assets that are usually taken as security, and where applicable some of their perfection requirements.

(1) Bank Accounts

There is considerable uncertainty as to whether rights over Russian bank accounts can be pledged. This is due to a number of court decisions, including those of the Supreme Arbitrazh Court, that funds deposited on a bank account cannot be pledged since such funds cannot be sold at a public auction. Although the amended legislation allows enforcement of a pledge other than through sale of the pledged property/rights at a public auction, there are also issues over remedies for self-help enforcement of account pledges since it is unlikely that an account bank would recognise the

¹ A mortgage over real estate is subject to registration with the Unified State Register of Rights to and Transactions with Immovable Property and mortgages over aircraft or ships are registered in separate respective registers. See further *Aircraft and Ships* below.

pledgee as the new account holder upon enforcement, and there is no mechanism preventing the pledgor from closing the secured account. Escrow arrangements over bank accounts are unlikely to be enforceable.

In financing transactions it is common to provide a creditor with rights to debit the debtor's bank accounts without the latter's consent for the amounts outstanding under the loan. Such rights are not security in the strict sense and do not give the creditor any priority in satisfaction of its claims in the case of the debtor's insolvency. However they do constitute a repayment mechanism intended to allow the creditor to take funds independently of the debtor and apply them against the secured obligation. Such rights are, however, potentially capable of unilateral termination by the debtor because as mentioned above, under Russian law an account holder may close its bank account at any time, and the Supreme Arbitrazh Court's view is that any prohibition on the ability of an account holder to close its bank account is invalid.

(2) Security Over Insurance

It is widely thought that it is not possible to assign rights under a Russian insurance policy, including property insurance. However, Russian law does give a pledgee of property a prior claim to any property insurance proceeds received by the pledgor. In addition, it is common practice for a pledgee to be named as sole beneficiary on the insurance policy to ensure it can receive the proceeds directly.

However, it is not, generally, possible to give a lender the benefit of business interruption insurance as Russian law provides that such insurance may only be for the benefit of the insured.

It is generally possible for a lender to be named as co-insured under a third party liability policy.

Russian law requires that the pledgor must obtain property insurance coverage only in respect of immovable property subject to a mortgage. For other types of property which may be pledged, the obligation to obtain insurance coverage can be imposed on the pledgor contractually.

If a lender is designated as the beneficiary under a property insurance agreement, it will be obliged to perform certain actions, including promptly disclose to and notify the insurer of (i) any information on circumstances known to it which may have material significance for determining the likelihood of the occurrence of an insured event and the amount of possible loss and any other information which may be material to the insurer, (ii) any material changes in the circumstances disclosed to the insurer at the time of the conclusion of the insurance agreement which may materially increase the insured risk and (iii) the occurrence of an insured event. In addition, when making a claim under the policy the beneficiary may be requested by the insurer to perform any obligations of

the insured person under the insurance agreement which have not been performed by such person.

Generally, the insured has the right to replace the beneficiary named in the insurance policy with any other person without consent of the beneficiary by notifying the insurer in writing thereof.

(3) Shares and Participatory Interests

Security over shares in joint stock companies and participatory interests in limited liability companies registered in the Russian Federation is generally taken by way of a pledge.

As mentioned previously, a pledge of shares of a joint stock company is subject to registration in the company's shareholders' register which can be maintained by a company itself, by a licensed professional registrar or, if the shares are registered in the name of a custodian, by that custodian. The record of a share pledge is evidenced by an extract from the shareholders' register or an extract from a *depo* account of the pledgor with a custodian.

Once a share pledge is registered, any operations with the pledged shares are subject to the consent of the pledgee unless otherwise agreed between the pledgor and the pledgee. In the case of shares registered with a custodian, amendments to this effect to the custody agreement must be made.

Unless otherwise provided in the company's charter a pledge of participatory interests in a limited liability company is subject to other participants' consent. Such consent is an additional requirement to the general corporate approval procedure that may apply.

As of 1 July 2009, all pledges of participatory interests should be certified by a notary. The pledge comes into effect from the moment of such notarisation. In the absence of notarisation the pledge agreement is deemed to be void. The new rules on notarial certification of pledges of participatory interests are silent as to the treatment of pledges of participatory interests entered into prior to 1 July 2009. Although such pledge agreements should not be invalidated simply because there is no certification by a notary, there is nonetheless a risk that a pledgee under a subsequently certified and recorded pledge over the same participatory interests would claim its pledge had priority over any such existing pledge.

In addition, as of 1 July 2009 all pledges of participatory interests should be recorded in the Unified State Register of Legal Entities. An obligation to notify the Unified State Register of Legal Entities of the pledge and its terms (on the basis of the pledgor's written application) within 3 days from the date of notarisation of the pledge agreement is vested in the notary certifying such pledge.

Upon the sale of participatory interests or shares in a closed joint stock company on enforcement of a pledge,

the pre-emptive purchase rights of other participants or shareholders of the company need to be considered.

The 2009 amendments to the Russian Arbitrazh Procedure Code introduced a set of rules concerning the resolution by the arbitrazh courts of so-called corporate disputes (which, among other things, include disputes concerning the creation of encumbrances over shares and participatory interests) that introduced an ambiguity as to whether disputes concerning the creation of a pledge over shares and participatory interests may be referred to commercial arbitration. At the present time, there is no established court practice which would clarify that issue.

(4) Land and Buildings

Land and land lease rights, as well as buildings and other constructions may generally be mortgaged to secure obligations.

A mortgage of a building or other construction is possible only if created together with a mortgage of the underlying land plot or land lease right.

The consent of the landowner (landlord) is required for the tenant to mortgage its rights under a land lease if the terms of the land lease expressly require this. However, there is currently some uncertainty as to whether consent is required where the lease is silent on this point. It appears that notification is sufficient if the lease has a term exceeding five years. On the other hand, if the lease has a shorter term, and in particular, if the landlord is the Russian state, regional or a municipal authority, then consent should be obtained. The absence of any such consent however should not invalidate the mortgage of a building or other construction located on such land plot.

As mentioned earlier, in order to be effective mortgage agreements are subject to registration in the Unified State Register of Rights to and Transactions with Immovable Property by a territorial division of the Federal Service for State Registration Cadastre and Cartography in the place of location of the mortgaged property. Registration is evidenced by an extract from the above register.

A mortgage can be notarised if the parties require, but it is not a perfection requirement. Sometimes notarisation is done to facilitate both registration and enforcement of the mortgage, as notarisation seems to provide the registration authority, the courts, and other third parties with increased confidence in the validity of the executed agreements although there is no legal justification for this.

Since the latest amendments to Russian legislation require that in order to facilitate an out-of-court enforcement of a mortgage a notarised consent of the mortgagor is required, where the mortgage envisages such enforcement it is advisable to notarise such mortgage. In this case no further notarised consent would be required from the mortgagor.

(5) Aircraft and Ships

Aircraft and ships are considered immovable property and security over them is taken by way of mortgage.

Aircraft flying in Russian air space are, for the purposes of determination of their nationality, subject to registration either in the State Register of Civil Aircraft of the Russian Federation or in a register of a country with which Russia has concluded an agreement on maintenance of continuing airworthiness (a "**Foreign Register**"). According to new legislation in force from 14 September 2009, transactions with aircraft (including encumbrances) are subject to registration with the Unified State Register of Rights to Aircraft and Transactions Therewith (the "**Aircraft Register of Rights**"). A mortgage over aircraft is effective only from the moment of its registration in the Aircraft Register of Rights. Although the Aircraft Register of Rights has now been established, because of the ambiguity of the regulations on registration of aircraft and in the absence of any clarifications and court practice in this respect, it remains unclear whether mortgages over aircraft registered in a Foreign Register ("**foreign aircraft**") are subject to registration in the Aircraft Register of Rights. As a result, it is difficult to make any conclusion as to the validity and enforceability of a mortgage over foreign aircraft when they fly in Russian airspace, are operated by a Russian airline, are physically located in Russia or are ascribed to a Russian base airport.

Security over ships may comprise:

- (i) a mortgage over a ship which covers (a) the integral parts of the ship and accessories to the extent such accessories belong to the owner of the ship, and (b) insurance claims for the benefit of the owner; or
- (ii) a mortgage over a ship under construction which covers (a) materials and equipment which are designated for the ship's construction, located at the place where the shipyard is located and clearly identified by way of marking, and (b) insurance claims for the benefit of the owner.

A mortgage over a ship must be registered in the ship register at the port of registry of the ship and a mortgage over a ship under construction must be registered in the register of ships under construction which is maintained at the port in the vicinity of the relevant shipyard.

Mortgages over ships which are not subject to registration in Russia include: (i) mortgages over ships temporarily permitted to fly the Russian flag; and (ii) mortgages over ships being constructed for a foreign party.

Claims secured by maritime liens existing by operation of law (such as claims for wages of the crew, claims for reward for the salvage of the vessel, claims for port, canal and other waterway dues and piloting dues) rank

prior to claims secured by registered ship mortgages and do not require registration. A maritime lien expires within one year from the date the obligations secured by it arise unless before the expiry of this term the ship is seized for subsequent forced sale.

(6) Receivables

Rights to receive funds can be the subject of a pledge. A pledge of future rights is expressly permitted in the Civil Code, provided such rights can be sufficiently identified in the pledge agreement. However, "future rights" are not defined and it is uncertain whether they include claims under future contracts or only claims arising in the future under existing contracts.

It is also not clear what would happen to the funds paid during the enforcement period or on insolvency of the pledgor. In addition it is unclear whether the approach of the Supreme Arbitrazh Court to pledges of bank accounts extends to pledges of other debt claims.

From a practical point of view it is also not clear how the pledgee can acquire (if the agreement provides for such type of enforcement) the pledgor's rights to receive funds and discharge a secured obligation accordingly where payment of such funds is not due at the time of enforcement or is insufficient, as well as what would be regarded as the market value of such rights.

The currency of the underlying contract must be roubles if such contracts are between Russian residents. Payments between a Russian resident and a non-resident, or two non-residents, may generally be made in roubles or foreign currency. In the case of export contracts entered into by a Russian exporter, security over export receivables would usually be taken under an English law security assignment.

(7) Inventory

Inventory such as commodity stocks, raw materials, semi-finished and finished products can be the subject of a pledge. Inventory always remains in the possession of the pledgor and can be replaced by other inventory provided that the total value of the pledged inventory does not fall below the value specified in the pledge agreement. The pledgor must record in its pledge book all changes in pledged inventory.

In the case of property that is co-mingled (e.g. oil in a pipeline) it may be difficult to ascertain the pledged asset and therefore to identify it sufficiently in order to take an effective pledge over it.

(8) Personal Assets

The Civil Code prohibits a pledge of personal assets against which execution cannot be levied. According to current legislation, real estate which constitutes the only dwelling of an individual and his or her family members, is no longer categorised as such an asset.

A pledge or mortgage (or any other Russian security) granted by an individual would usually require an acknowledgment (or consent) of such individual's spouse.

There is an argument to the effect that disputes involving an individual may not be referred to commercial arbitration, unless such person acts as entrepreneur or has entered into a contract in connection with a commercial transaction between two legal entities.

(9) Intellectual property rights

Only intellectual property rights which are transferable may be secured. As a result, the exclusive right to (i) the brand name of a company, (ii) a secret invention and (iii) the name of place of origin may not be pledged. In addition, a pledge of the exclusive right to a trademark, although generally allowed, may not be enforceable to the extent enforcement over such right may result in misleading a customer with respect to the goods or their producer.

Only rights which are reflected on the pledgor's balance sheet can be the subject of a pledge. A pledge can only be created for the term of the actual right being pledged.

In most cases registration of the pledge is required, depending on the type of right, in order for the pledge to become effective. Pledges over most intellectual property rights are to be registered with the Federal Service on Intellectual Property, Patents and Trademarks (Rospatent).

(10) Other types of property

Other considerations may apply to a pledge or mortgage, according to the particular secured asset. These include determining the relevant anti-monopoly position in relation to a pledge of shares or participatory interests, where Federal Antimonopoly Service permission may be required for enforcement; complying with licensing requirements in the case of the acquisition of an asset the operation of which requires a special permit; observing Russian land legislation upon the sale (and purchase) of land plots and addressing the pre-emption rights of state agencies in the case of security over precious metals.

Enforcement

A pledge or mortgage may be enforced only if the person whose obligations are secured by that pledge or mortgage fails to perform secured monetary obligations. Enforcement on the basis of an event of default arising on other grounds (breach of representations or certain financial covenants) is invalid; acceleration of the loan would permit enforcement and, in general, the secured creditor would not want to enforce without such acceleration.

The parties may agree that a pledge or mortgage be enforced through the court or without recourse to a court.

(1) Court Enforcement

A pledge or mortgage must be enforced through the court when, among other things: (i) it is not possible to enforce under the out-of-court enforcement procedure set out in the agreement; or (ii) it was granted by an individual over property in common ownership of spouses.²

If enforcement is carried out through the court, the secured property is sold at a public auction arranged by a specialised organisation engaged by court bailiffs.

Where the pledge is enforced through the court or otherwise, the court may refuse to enforce a pledge if the pledgor demonstrates that the failure to perform an obligation on which the enforcement is based is immaterial and disproportionate to the enforcement. The breach will be deemed immaterial (and the claim disproportionate) where the following criteria are met simultaneously:

- the amount of the payment in default is less than 5 per cent. of the value of the secured property; and
- such default has been outstanding for less than 3 months;

By way of exception to the above rule, and unless otherwise stipulated in the pledge, the secured creditor is nonetheless allowed to enforce its security in a situation where the secured obligations are payment obligations to be performed periodically or in instalments, and more than three of such periodic payments or instalments are overdue over a twelve months period even if each overdue amount is not significant.

A court can postpone for up to one year the sale of the secured property upon request of the pledgor, provided the pledgor has a legitimate reason to seek a deferral. The legislation does not provide guidance as to how the court should exercise this discretion, although certain restrictions of this right apply. In any event, the deferral does not affect the rights of the parties under the secured obligation, and the pledgor must compensate for losses suffered as a result of the deferral, in addition to default interest due on the amount of the secured obligation.

(2) Out-of-court Enforcement

An agreement to enforce without recourse to a court may be entered into at any time (at closing, prior to an event of default or thereafter). If an out-of-court

enforcement agreement is entered into under a separate document, it should be executed in the same form as the pledge or mortgage agreement (i.e. notarised and/or registered if the original agreement was so formalised).

In the case of the out-of-court enforcement procedure, the secured property:

- (i) may be sold at an auction;
- (ii) may be sold by way of private sale (including under a commission agency arrangement); or
- (iii) the secured creditor can obtain title to the secured property or sell such property to a third party.

If the security provider rejects the agreed out-of-court enforcement procedure, the security may still be enforced without recourse to a court, unless otherwise provided by law, by way of a notary's executory endorsement ("*ispolnitelnaya nadpis notariusa*"). If a notary executes such endorsement, court bailiffs are engaged to enable the secured property to be seized from the security provider and (i) transferred to the secured creditor for realisation, or (ii) upon request of the secured creditor, sold by the court bailiffs (presumably at a public auction).

The entry into an out-of-court enforcement agreement does not preclude the secured party from enforcing the security through the court.

(3) Subsequent Pledge

As mentioned above, even if a subsequent pledge is not allowed by the initial pledge such prohibition should not invalidate a subsequent pledge.

If a subsequent pledge over the property is enforced, the security holder under an initial pledge over the same property may (i) claim early performance of the obligation secured by the initial pledge; and (ii) enforce the initial pledge to discharge the claims secured by such initial pledge even if such claims would not otherwise be due. If the initial security holder does not exercise this right, the subsequent pledge is enforced separately and the secured property is sold to discharge the claims secured by the subsequent pledge subject to the initial pledge which follows the property into the ownership of the purchaser. The law is silent as to whether the similar rule applies where a subsequent pledge does not enforce simultaneously.

However, the risk of the *bona fide* purchaser of the movable property outlined above in *Disposal without the secured party's consent* should be considered by the security holder under the initial pledge and the subsequent pledge.

In addition, in the case of simultaneous enforcement of the initial and subsequent pledges or mortgages over

² Recent clarifying directive of the Plenum of the Supreme Arbitrazh Court of the Russian Federation No. 10 of 17 February 2011.

the same property, the recent Plenum of the Supreme Arbitrazh Court of the Russian Federation has stressed that any secured creditor under any of the pledges may enforce its security without recourse to the courts only if the secured creditors under both the initial and subsequent pledges have sent a joint enforcement notice to the security provider.

(4) Realisation

As mentioned above, the recent changes to the Russian legislation now allow out-of-court enforcement not only by way of sale at an auction but also by way of a private sale or retention of title to the secured property by the secured party. However in practice the secured party can benefit from the new regime (including by taking control over and operating the secured property) only where possession over such property is vested in the secured party initially or where the security provider is cooperative and ready to transfer the secured property to the secured party to settle the debt. Where the security provider has agreed to enforcement without recourse to a court and obstructs the secured party's rights upon enforcement, the involvement of a notary, court bailiffs or a court may be required to oblige the pledgor to comply with out-of-court enforcement.

The main issues which arise with realisation of certain types of secured property, depending on the method of realisation, are listed below.

Auction

- If the secured property is sold at an auction, the bidder offering the highest price is the winner, and a memorandum confirming the results of the auction is signed with the winner;
- The legislation does not clarify whether any pre-emptive purchase rights are terminated in the case of an auction sale of an asset.
- Special rules on reduction of the initial value of secured property and rights of the security holder to purchase such property apply if the auction fails for the first and, in certain cases, the second time.
- A sale of listed securities can be effected only at an auction by a professional securities market participant. It is unclear whether the regime permitting the transfer of title to the secured party upon enforcement without realisation through an auction may apply in the case of a pledge of listed securities.
- An auction can be organised by the security provider, secured party or by a specialised organisation, which in some cases should possess a licence for sale of specific property (such as real estate or shares).
- All the proceeds from the sale of the secured property (save for those used to cover the costs of the public auction, which have priority over the sale

proceeds) should be paid to the secured party to discharge the secured obligations.

- Russian legislation limits the right to deduct fees due to an auctioneer or a commission agent (as appropriate) from the proceeds of sale of the secured property up to 3 per cent. of the sale proceeds. Any excess fees under an agreement between the secured party and such auctioneer or commission agent are for the account of the secured party.

Private Sale

If a pledge is enforced without recourse to court by way of sale under a commission agency agreement between a secured party (as client) and agent, the latter must sell the secured property on its own behalf at the expense of the client, at a market price that is based on the evaluation of an appraiser.

Other issues

As mentioned before, depending on the nature of the pledged asset, it may be necessary for the purchaser of such secured property to comply with certain notification or consent requirements (e.g., antimonopoly consent in the case of purchase of shares in a company with a certain turnover, or sale and purchase of industrial facilities where certain thresholds are met), and potential purchasers will be subject to any general Russian law restrictions on ownership of that type of asset. There may be certain tax implication connected with acquisition by a secured party of the secured property.

(5) Particularities of a Mortgage

The general rules of enforcement described above apply to enforcement of mortgages as well as pledges. The following differences apply to mortgages:

- A mortgage can be enforced only through the court if, among other things:
 - (i) the mortgagor is an individual mortgaging residential premises;
 - (ii) the mortgaged property is an historic building or agricultural land; or
 - (iii) the owner of the mortgaged property is a federal, regional or municipal authority.
- The out-of-court enforcement option where the mortgaged property can be acquired by the mortgagee for itself (and arguably for a third party) is not applicable in the case of a land plot or leasehold rights to a land plot, save where (according to the recent Plenum of the Supreme Arbitrazh Court) a building or other construction located on such land plot is mortgaged simultaneously with such land plot or leasehold

rights to such land plot in favour of the same mortgagee.

- The notarised consent of the mortgagor is required for an agreement on out-of-court enforcement of a mortgage. Such consent may be given before entry into the mortgage agreement.
- A deferral of enforcement of a mortgage may be granted on a claim of a mortgagor only where (i) the mortgagor is an individual or (ii) the mortgaged property comprises agricultural land. The court must make sure that at the time the deferral ceases the amount claimed from the mortgagor does not exceed the value of the mortgaged property determined by an independent appraiser.
- Upon the first public announcement of an auction on sale of mortgaged real property, the mortgagor is prohibited from carrying out any transactions concerning such property (save for transactions with the mortgagee with a view to discharging the secured obligations) and all transactions entered into in violation of such prohibition may be set aside.
- A ship mortgage (including a mortgage over a ship under construction) can be enforced only through the courts by way of a sale of the vessel at a public auction.

As clarified recently by the Plenum of the Supreme Arbitrazh Court of the Russian Federation:

- (i) a disposal of mortgaged property without the consent of a mortgagee (where such consent is required); and
- (ii) the creation of a subsequent ranking mortgage without the consent of a mortgagee (where a subsequent mortgage was prohibited by the initial mortgage)

can be declared invalid if challenged by the mortgagee. A subsequent mortgage can be declared invalid irrespective of whether the mortgagee under a subsequent mortgage knew of the prohibition on granting a subsequent mortgage, provided that the mortgagee under the initial mortgage can prove that the subsequent mortgage prejudices its rights and interests.

Suretyship and Guarantee

According to the Civil Code, guarantees can be provided only by banks, other finance institutions and insurance companies. Corporates (including banks) or individuals can enter into suretyship agreements. As a matter of practice, it is usual in a cross-border transaction for a Russian company to give a guarantee governed by foreign (English or New York) law. In rare cases a Russian law suretyship or a guarantee may be provided.

Suretyship

A suretyship must be executed in writing by both parties and contain a description of the underlying obligation. The invalidity of the underlying obligation results in the invalidity of the suretyship.

If the secured obligation is amended without the consent of the surety and such amendments increase the liability or create other unfavourable consequences for the surety, the suretyship terminates.

A suretyship can terminate if during the term stipulated in the suretyship the creditor does not bring an action in court against the surety. If a term is not provided in the suretyship, it terminates if the creditor fails to bring an action against the surety within one year from the date when the secured obligations become due.

Bank guarantee

The giving of a bank guarantee is a banking operation under the Law On Banks and Banking Activity, and is mainly the preserve of licensed banks or finance institutions.

A bank guarantee is an independent obligation separate from the secured obligation to which it relates, and this distinguishes it from other methods of securing obligations such as pledges, mortgages and suretyships.

A bank guarantee terminates on the making of the guarantee payment, the expiration of its term, or the waiver by the beneficiary of its rights under the guarantee.

The guarantor can refuse to satisfy the demand of the beneficiary if the demand to pay or documents filed with the guarantor do not conform to the guarantee. The guarantor is also entitled to refuse the demand, if it is presented after the expiration of the term of the guarantee.

The guarantor's obligations to the beneficiary are limited to the amount specified in the guarantee. If the guarantor delays performance of its obligations under a guarantee it can be required to pay interest on the overdue payments.

A bank guarantee may be required for an M&A transaction where an offer to purchase company's shares is made by a potential purchaser pursuant to the Russian companies legislation (e.g. in the case of a voluntary or mandatory takeover offers).

Security Assignment

Factoring

The Civil Code recognises an assignment as a form of security for the purposes of factoring arrangements only (financing against assignment of a monetary claim). Such assignments allow assignee ("finance agent") to

receive the proceeds under the assigned claims without going through the procedure required for the enforcement of a pledge or mortgage.

Assignability of rights

There are a number of issues under the law of the Russian Federation regarding assignability of rights in general. For example the Russian courts have tended to take the view that it is not possible to assign future rights, or rights under executory contracts (where the existence of the right is subject to the future performance by the assignor of an obligation). Although the Supreme Arbitrazh Court has expressed its opinion that future claims under certain types of contracts are capable of being assigned, it is still unclear whether rights under executory contracts may be assigned. In addition the Supreme Arbitrazh Court has not expressed its view on whether such an assignment can be used as a type of security. There are also some uncertainties as to both the insolvency and VAT treatment of an assignment.

Based on the above the most straightforward way of taking security over a revenue stream is still by way of a pledge of rights to receive funds. Where the revenue derives from an asset, such as lease revenues, the revenue can be pledged together with other rights under that asset. However, due to the reasons outlined above, though a pledge (other than a pledge of bank accounts) does enable the pledgor to step in and collect the revenues, in practice the law is unclear as to how collected revenues should be treated by the pledgor (or its administrator) during the enforcement period or on insolvency of the pledgor.

Transferability of Secured Obligations

General

As Russian law security is generally accessory to a secured obligation it will follow the secured obligation, subject to the consent of the security provider, upon transfer of the secured obligation itself (this is generally obtained in advance, in the relevant Russian security documents). Thus, an assignment of a secured obligation will result in an assignment of the relevant security (although a novation of the loan, e.g., such as under a transfer certificate, would result in a new obligation and hence the termination of the original security).

Due to the above concern and issues with the sharing of Russian law security among multiple creditors, syndicated loans secured by Russian law security generally employ a mechanism for allowing the security to be held on behalf of the lenders by a single entity whose identity does not change when the loan is transferred. This is most commonly achieved through the use of a conduit (single lender of record with sell-down under risk or funded participation agreements), trust, parallel debt structure or structures based on the joint and several creditors concept.

Parallel Debt

(1) Trust versus Parallel Debt

Generally only the trust and the parallel debt structures allow the lenders to participate directly in the loan, although neither has been tested before the Russian courts. However, there is a further concern with the trust structure that a Russian court might not enforce the security given to the trustee on behalf of the lenders, because the trustee is not itself a creditor; as noted above, under Russian law security is accessory to the debt and implies that the holder of the security should also be the creditor whose debt is being secured. In addition, the concept of English law trust where the trustee as owner holds funds/property for finance parties/lender has no equivalent in Russian law. The Russian law concept of trust management where the trust manager holds the funds/property on behalf of the owner is more like an agency arrangement.

(2) Nature of Parallel Debt

The parallel debt structure seeks to address the above concern by having the borrower covenant in the facility agreement to pay the trustee sums equivalent to all amounts owing to the lenders from time to time. The covenant to pay is worded so to make it clear that the covenant is to pay to the trustee in its own right, and not as an agent or other representative of the syndicate. It is generally accepted that such a covenant to pay creates a valid debt as a matter of English law. The Russian law security secures this covenant to pay, so that the trustee is clearly the legal owner of both the secured debt (the covenant to pay) and the security for that debt.

(3) Enforceability of Parallel Debt

Although the parallel debt structure has not to date been tested before the Russian courts, the court should recognise a foreign arbitral award on the validity of the debt unless it considers the parallel debt to contravene mandatory norms of Russian law or Russian public policy. Were the court itself to determine the validity of the parallel debt (for example, in the absence of a valid foreign arbitral award), it should apply English law in doing so, and could apply Russian law only if unable to determine the content of English law within a reasonable time frame, or again, if it considered the parallel debt to contravene mandatory norms of Russian law or Russian public policy. Although the Supreme Arbitrazh Court has in recent times interpreted public policy in a broader manner than previously expected, there are no reasons to believe that a parallel debt structure contravenes either Russian mandatory norms or Russian public policy. However, were a court to find to the contrary and hold the parallel debt invalid on the grounds that the parallel debt holder does not have a material claim to file to the court without the other lenders joining the proceedings, this would also invalidate any security supporting the parallel debt.

(4) Record of Transfer

As mentioned above the consent of the security provider is required for a transfer. No amendments are generally required to the Russian security documents for the transfer. However, in the case of a registered security such as a mortgage or a pledge of shares, it will be necessary to amend the register to reflect the new mortgagee or pledgee in order to perfect (or, in the case of a mortgage, effect) the transfer of the security.

Joint and Several Creditors

(1) Nature of Joint and Several Creditors

Under this structure, which is explicitly recognised by Russian law, all lenders are made joint and several creditors of the borrower which means that (i) any joint and several creditor is entitled to claim from the borrower the full amount of the facility owed to all the joint and several lenders; (ii) the borrower is entitled to pay any amount of the facility due to such lenders to any joint and several lender and such payment will discharge the borrower's obligations owed to all lenders to the extent of payment; and (iii) the recovering lender must share the proceeds among other joint and several lenders on a *pari passu* basis.

Such joint and several creditors can be secured by a single security interest and in order to implement this it should be possible to create a similar concept under English law (and where the facility agreement is governed by foreign law other than English, it should be considered whether similar concepts could be used under such law).

The security is structured in a way that it is granted only in favour of one of the joint and several lenders appointed by the other lenders as an agent holding Russian security (being either joint and several with each particular lender or a joint and several with all other joint and several lenders) and will secure the borrower's obligations for the amount of the facility owed to the agent holding Russian security as a joint and several lender.

(2) Enforceability of Joint and Several Creditors Structure

This structure would be easier to present in a Russian court as a structure familiar to and recognised by Russian law thus eliminating the risks of (i) being considered somewhat artificial and (ii) raising an argument that the holder of security does not have a material claim to file in court and therefore that all lenders will need to participate in the proceedings/bankruptcy filing, which are inherent in the parallel debt structure. However, this structure to our knowledge has never been tested before the Russian courts.

As the security will be created in favour of the agent holding Russian security only, all other lenders should be able to transfer their shares in the facility without any

impact on the security. However, the agent holding Russian security should (i) be a "real" lender, i.e. having not a nominal (e.g. not one dollar) participation in the facility; and (ii) remain as lender and not transfer its participation in the facility to any other party during the whole life of the facility.

The agent holding Russian security will have an actual (not artificial) secured claim against the borrower for the full amount of the facility and will effectively hold the security on behalf of all joint and several lenders. As a result, although the claim of each individual lender would be commercially considered as secured, only the agent holding Russian security will be able to file a secured claim against the borrower on behalf of itself and other lenders, while each individual lender will be able to make only an unsecured claim against the borrower. Only the agent holding Russian security could enforce the security and must share the proceeds on a *pro rata* basis among all the lenders.

It should be noted that the lenders should be prepared to take the credit risk of non-performance by the agent holding Russian security and/or other lenders in case of bankruptcy proceedings against it. Moreover, if the agent holding Russian security is a Russian entity, it will not be able to hold the proceeds on trust.

Security in Insolvency

Segregation of Secured Property

In the case of the Russian security provider's insolvency, once insolvency proceedings are commenced, there is a general moratorium on the levying of execution against the property of the insolvent company. Pledged and mortgaged assets are segregated from the other assets and may not be sold without the consent of the pledgee.

With the changes to the Insolvency Law, secured creditors can now enforce their security at the early stages of bankruptcy (financial rehabilitation and external administration). However, such enforcement may only be through court proceedings. Enforcement against secured property will be allowed unless the debtor can prove that such enforcement would make it impossible to restore its ability to pay its debts.

If the enforcement takes place during financial rehabilitation or external administration, such enforcement is generally made in accordance with the rules described above. However:

- (i) the auction can be organised only by a court-appointed administrator or a specialised organisation;
- (ii) only after the second auction fails can the secured creditor acquire the secured property. Such acquisition is made at a price 10 per cent. less than the second auction starting price and the secured creditor is obliged to return the

difference (if any) between the amount at which the acquired property was valued and the amount of claim which was secured by that property,

- (iii) there is no limitation on the amount of the auctioneer's fees that are deducted from the sale proceeds (value of the acquired property).

If the security is enforced during liquidation, the sale of the secured property is effected by a liquidator and the sale proceeds due to the secured creditor are subject to a 20 per cent. deduction in favour of the first and second priority creditors and on the account of certain current claims.

If the secured creditor has acquired the secured property and offset the value at which such property was acquired against the secured obligations it is still obliged to return 20 per cent. of the price at which the secured property was acquired, to be allocated between the first and second priority creditors and current claim payments.

Parallel Debt

Under a parallel debt structure, the trustee would be the only finance party entitled to register its claim as a secured creditor (on the basis of the parallel debt). Given the unfamiliarity of Russian courts with such a structure, it may be advisable to seek a foreign arbitral award on the validity of the parallel debt as a matter of English law and then ask the Russian court to register the trustee's claim on this basis.

Alternatively, time constraints may necessitate approaching the Russian court directly, in which case it would be necessary to assist the court in understanding

the debt and its parallel nature. If a joint filing is made by the trustee and the lenders (e.g., to give the lenders direct standing in the insolvency process), the court would also need to determine how to reflect the parallel nature of the debts in the register so as to avoid any suggestion of double liability.

Ultimately, as the analysis as to the best strategy for an insolvency filing or the registration of a claim is complex, it is something that would need to be determined in the light of the particular circumstances of the claim and the insolvency.

Joint and Several Creditor Structure

Although the agent holding the Russian security will be the person entitled to file a claim in the Russian court against the borrower on behalf of itself and the other lenders in the case of insolvency of the borrower (for the purposes of the lenders being treated as secured creditors), from a practical perspective (in order to speed up the filing) it may be necessary for all other lenders to join the filing and to file with the court along with the agent holding Russian security. The most appropriate means of filing will depend on the circumstances of the particular transaction.

Other Important Issues

It should be noted that a Russian company that is providing security in order to secure a financing transaction, would in most cases, need to obtain a directors' (or shareholders') resolution to enter into the security documents. Whether or not a resolution is needed would depend on the value of the company's assets and whether it is connected with an entity whose obligations are secured or with an entity which is a party to a security document.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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