

Amendments to Russian Civil Code on pledge – Wind of change

At the end of 2013, long-expected changes were finally adopted to the chapters of the Civil Code on pledges and to the transfer of rights and obligations, representing another set of amendments in the course of the reform of the Civil Code¹. The changes will come into force on 1 July 2014. Whereas the list of new concepts and some principal provisions remained as under the initial draft, the particular wording and essence of many of them are significantly different from those of the initial draft adopted at the first reading and available to the general public. At the same time the vast majority of the amendments reinforce the approaches developed by the courts and, in particular, by the Supreme Arbitrazh Court so far.

Although regulation on pledge was subject to overall revision and the list of changes is extensive, the following new concepts and key changes are of the most importance:

- making numerous changes to the general provisions on pledges aimed at decreasing unnecessary formalities for the creation and validity of pledges, providing better protection of the rights of bona fide pledgees and addressing certain deficiencies in the existing regime on pledges;
- introduction of a concept of *pari passu* ranking of pledges over a single asset in favour of multiple creditors;
- introduction of a prohibition to restrict contractually the creation of a subsequent ranking pledge;
- incorporation in the Civil Code of a regime for the registration of pledges over property other than immovable property introduced previously (with deferred effect) by amendments to other laws;
- introduction of the concept of security agent, intended to deal with security to be created in favour of multiple creditors, primarily in syndicated financing;
- amending the rules on the enforcement of pledges over different types of moveable property (in particular, out-of-court enforcement) to replace the provisions of the Law on Pledge which from 1 July 2014 will be repealed;

Key issues

- Registration of pledges of moveable property will be launched
- *Pari passu* ranking security will be available
- A concept of security agent holding pledge in favour of multiple creditors is introduced
- A pledge of bank ("secured") accounts will be available
- A pledge of contractual claims will be regulated in detail

¹ Federal Law No. 367-FZ "On amendments to Part I of the Civil Code of the Russian Federation and abolishment of certain laws (provisions of certain laws) of the Russian Federation" dated 21 December 2013.

- introduction of a pledge of rights over bank accounts setting out special rules for the regime of a secured account, and a special mechanism for the enforcement of such pledge;
- introduction of some rules regulating the pledge of participants' and shareholders' rights in a limited liability company and a joint stock company.

We set out below a preliminary overview of the key changes and amended provisions that may have implications for the taking of security over moveable property, contractual claims and receivables, bank accounts and securities under Russian law. We also highlight the areas which may give rise to questions of interpretation and therefore will require further clarification from draftsmen and the courts.

General rules on pledge

Additional rights granted to the pledgee

In addition to the rights of a pledgee arising by operation of law over insurance proceeds payable to the pledgor by reason of loss or damage to the pledged assets, a pledgee will also be entitled by operation of law to claim (i) the amounts payable to the pledgor as a result of the use of the pledged property by third parties; and (ii) the property due to be transferred to the pledgor under contracts which were pledged, in each case to be applied in or towards satisfaction of the secured claim². The pledgee will have a right to claim the proceeds and property directly from the pledgor's counterparty (such as an insurer, a lessee or supplier/seller of the property).

Pledge arising from a court injunction

A creditor in whose interests the court issues an injunction restricting the disposal of assets by the creditor's debtor will "acquire the rights and obligations of a pledgee" with respect to those assets³. The attachment of a security interest to the assets is effective on the date a court decision in favour of the creditor comes into force (i.e. when the obligations effectively secured by the immobilised assets are confirmed by the court). However, priority of the claim secured on these assets will be determined by reference to the date when the immobilisation of the assets in question is deemed to occur. Therefore, the security

interest will automatically arise as soon as the debt is acknowledged by the court and will date for priority purposes from the date of the grant of the injunction. It is not entirely clear to what extent the registration of a registrable security interest would affect the priority of a pledge arising under an injunction and its enforceability against a bona fide acquirer.

Protection of a bona fide pledgee

The amendments provide for the preservation of a pledge created by an unauthorised pledgor (for example, if the pledgor was not the proper owner of a pledged asset or otherwise was not duly authorised to act on behalf of the owner of the asset) in favour of a bona fide pledgee (being a person that did not know nor could be expected to know of a defect in capacity or authority of the pledgor)⁴. However, this rule does not extend to cases when the pledged asset was removed from the owner's possession against its will.

Formalities for the pledge agreement to be effective

The Amendments abolished the formal requirements for certain matters to be reflected in the pledge agreement as a condition for its effectiveness.

Value of the pledged property

There will be no longer a requirement to specify the value (*ocenka*) of the pledged property in the pledge agreement for the agreement to be considered as entered into⁵.

Under the new provisions regulating the value of pledged property⁶ as a general rule such value (*stoimost'*) will be determined by an agreement between the parties to the pledge agreement and, unless otherwise provided by law, an agreement between the parties or a court order on enforcement must be treated as the starting price for realisation of the pledged property in the course of enforcement.

Description of the secured obligations

Irrespective of whether a pledge secures a debtor's own obligations or those of a third party, under the amendments a reference in a pledge agreement to the agreement constituting the secured obligations would be sufficient for a

² Art. 334 of the revised Civil Code (hereinafter the references are made to the articles of the revised Civil Code)

³ Art. 334(5)

⁴ Para. 2 of Art. 335(2)

⁵ Art. 339

⁶ Art. 340

pledge agreement to be considered as entered into⁷. Under the current regime a description of the nature, size and the term of the secured obligations must be included in the pledge agreement itself or alternatively the agreement constituting the secured obligations is attached to a pledge agreement.

According to the amendments, if the pledgor engages in commercial activity, the description of the secured obligations may be less precise, provided that it permits the secured obligations to be identified at the date of enforcement, including by reference to all current and/or future secured obligations up to a certain amount.

Description of the pledged property

The draftsmen attempted to introduce a concept similar to the English law floating charge by providing that pledges granted by entities engaged in commercial activity may describe the pledged property so that it can be identified at the time of enforcement. It is specifically stated that the description may refer to all property of the pledgor or certain types or generic features of the pledged property.

However, in our view, without elaborating more detailed regulations to distinguish this type of security from other types of pledges which are subject to general rules, it is possible that this concept will not be used in practice. It may be that additional rules will be introduced since the provisions above will become effective only from January 1, 2015.

Registration and perfection requirements

The amendments introduce certain new registration requirements for pledges and new perfection requirements for pledges over certain types of assets other than immovable property in the form of recording notices of pledge in a register which is to be established.

Registration

With effect from 1 July 2014 in addition to the necessity to register encumbrances over property the title to which is subject to registration (such as immovable property like land and buildings), when participants' rights in a limited liability company become subject to pledge the amendments require a pledge over participatory interests to be registered. Such pledges will arise only upon their registration.

Perfection requirements for a pledge over moveable property

The amendments incorporate into the Civil Code the key principles of recording of certain pledges in the register of notices of pledge over moveable property established by earlier legislation⁸. Such register of notices is expected to be held through the unified information system of notaries.

In particular, a pledge over any property, other than immovable property and property for which the law prescribes another form of perfection⁹ may, with effect from 1 July 2014, be recorded through a notary in the register of notices.

Although the registration of pledges in the register of notices will not affect the enforceability of the pledge between the parties or against unsecured creditors of the pledgor, the absence of registration means the pledge will not be enforceable against a person acquiring the pledged property from the pledgor in the absence of the knowledge of the existing pledge, or against another secured creditor with a registered pledge over the same property¹⁰. According to the amendments, the priority of creditors' claims is to be determined by the date of registration in the register of notices so that the earlier registered pledge will have priority over a later registered or non-registered one¹¹.

There is an argument to the effect that a pledge of contractual claims will also fall within the registration requirements. At the same time it remains unclear whether and how the registration requirements will apply to a pledge over assets described in a generic way (as in the case of the floating charge described above), a pledge over future assets or a pledge arising under a court injunction.

Another issue may arise in relation to pledges of participatory interests in the absence of transitional provisions in the amended legislation relating to previously created pledges. Although registration of pledges of participatory interests in a limited liability company has been a legal requirement since July 2009, the consequences of such registration were not entirely clear, including whether such registration affected the priority of

⁸ Art. 339¹(4)

⁹ In particular, for a pledge over property subject to state registration (as mentioned in *Registration* above), a pledge of shares, a pledge of participatory interests and a pledge of rights to bank accounts the law specifies other perfection requirements.

¹⁰ Para. 3 of Art. 339¹(4)

¹¹ Art. 342¹(10)

⁷ Art. 339

pledges as against other secured creditors with a registered pledge.

Although since 2009 we have advised that pledges of participatory interests should be registered, there may be certain pledges either created before July 2009 or created by operation of law that have not been registered. Although their validity, in our view, should not be questioned, their priority after 1 July 2014 may be affected.

Protection of a bona fide purchaser of pledged property

The amendments introduce the rule that upon acquisition of the pledged property for value by a purchaser in good faith (i.e. who was not aware or could not have been expected to be aware of the existence of a pledge) the pledge terminates¹². As a result, if a registrable pledge was not registered and the pledged assets were acquired by a purchaser in good faith without notice of the existing encumbrance, the pledge will automatically terminate.

There are no "grandfathering" provisions dealing with pledges created before the registration requirement becomes effective and which are not registered as soon as the amendments become effective (i.e. 1 July 2014) to mitigate any risks of a third party purchaser in good faith acquiring the pledged property without notice of the existing pledge¹³.

Restrictions on the disposal of pledged property

Disposal of pledged property

Similar to the current regime, the pledgor is prohibited by law from disposing of title to the pledged property to third parties without the pledgee's consent¹⁴. In breach of this prohibition the pledge will follow the property into the ownership of the third party. However, the amendments provide general protection to a bona fide purchaser of the pledged property for value in the form of a rule to the effect that if the purchaser was not aware or could not have been expected to be aware of such encumbrance the pledge then terminates.

¹² Point (2) of Art. 352(1)

¹³ For more details regarding consequences of disposal of the pledged assets to a bona fide purchaser refer to *Priority of Secured Claims*

¹⁴ Art. 346

Transfer of pledged property into temporary possession or use

As a new general rule, the transfer of pledged property by the pledgor into the temporary possession of or use by a third party will be allowed without the consent of the pledgee, unless expressly restricted by contract or any other law¹⁵. Under the current regime for such a transfer the consent of the pledgee was required by law, unless the pledge agreement provided otherwise.

At the same time, according to the amendments, a right of possession or use of the pledged property acquired by any third party without the consent of the pledgee will be automatically terminated in the event of enforcement of the pledge. Arguably third party rights to the pledged property will terminate irrespective of whether consent of a pledgee for transfer to or use by a third party was required under a pledge agreement.

Substitution of the pledged property

The Amendments provide that a pledge is to be automatically extended to property arising as a result of processing or other changes to the pledged property¹⁶. In addition, in the case of a pledge of rights under a contract, the property (other than receivables) received by the pledgor as a result of performance of the obligations of the debtor under such contract will become subject to the pledge from the moment the pledgor acquires title to that property. However, if an interest in the pledged property is subject to state registration, a pledge over the newly acquired property should only arise at the moment when the relevant state registration is completed¹⁷.

Granting security in favour of multiple creditors

The amendments have clarified the rules applicable to the priority of pledges and introduced a concept of *pari passu* ranking of security as well as a concept of security agent acting on behalf of multiple creditors.

¹⁵ Art. 346(3)

¹⁶ Art. 345

¹⁷ Art. 345(5)

Prior and subsequent ranking pledges

Restrictions for subsequent ranking pledges¹⁸

Under the new rules a subsequent pledge may be prohibited only by law and not by a prior ranking pledge. However a prior ranking pledge may stipulate the terms and conditions on which subsequent pledges may be entered into. A breach by a subsequent pledge of the restrictions set out in a first-ranking pledge will entail the following consequences:

- (a) the first-ranking pledgee will be entitled to claim damages from the pledgor;
- (b) if the pledgee under a subsequent pledge was or should have been aware of the requirements in the prior ranking pledge on subsequent pledges, the obligations towards that pledgee will be discharged subject to such requirements;
- (c) as under the current regime, the pledgee under the prior ranking pledge will be entitled to accelerate the secured obligations and if they are not discharged, enforce the first-ranking pledge; however, under the amended law this right can be waived by the parties to the subsequent pledge¹⁹.

Another novelty is that the priority of pledges can be varied by agreement between the pledgees and/or the pledgor.

Priority of secured claims²⁰

As under the current regime, the priority of creditors with pledges secured over the same assets will be determined by the order of creation of the respective pledges.

For registered security (i.e. security over assets the rights to which are subject to registration as described above) the date of registration will determine the priority.

In the case of security over assets subject to registration in the newly created register of notices²¹, the priority will be determined by the date of entries made in the register, so that a registered pledge will have priority over earlier non-registered pledge and over a later registered one²².

As an exception of the general rule, the amendments provide that if at the moment of creating the pledge the pledgee knew or could have been expected to be aware of

the existence of a prior ranking pledge, the claim of such pledgee will rank behind the claim of the existing pledgee.

It should be noted that according to the transitional provisions²³, the priority of security subject to registration in the register of notices and created before July 1, 2014 and registered from July 1, 2014 until February 1, 2015, will be determined by reference to the date of execution of the pledge agreement and not the date of registration. The law lacks any grandfathering provisions for pledges created before the launch of the register of notices and not registered during the above grace period, in the event the secured assets were acquired by a bona fide purchaser for value after the launch of the register that gives rise to the risk of termination of such non-registered pledges.

Consequences of enforcement for a prior ranking pledge and a subsequent ranking pledge

The Amendments finally deal with the consequences for a subsequent ranking pledge when a prior ranking pledge is enforced²⁴ which are as follows:

- the pledgee under a subsequent ranking pledge will be entitled to accelerate the obligations secured by a subsequent pledge and if the debtor fails to discharge the secured obligations, join in the enforcement initiated by the pledgee under a prior ranking pledge;
- if the pledgee under a subsequent ranking pledge fails to accelerate and to join in the enforcement initiated by the first-ranking pledgee, the subsequent pledge will terminate, save for when the secured property remaining after enforcement of the first-ranking pledge would be sufficient to cover the obligations secured by a subsequent ranking pledge.

It should be noted that the right to accelerate the obligations secured by a subsequent ranking pledge may be waived by agreement of the pledgor with the subsequent ranking pledgee²⁵. If this is the case, following enforcement of the first-ranking pledge, the subsequent pledge also terminates.

The consequences for a prior ranking pledge as a result of enforcement of a subsequent ranking pledge remain the same as under the current regime. If the pledgor under a first-ranking pledge does not accelerate the secured obligations and enforce its pledge, in enforcement of the subsequent ranking pledge the first-ranking pledge will

¹⁸ Art. 342

¹⁹ Item (1) of Art. 351(2)

²⁰ Art. 342¹

²¹ Refer to *Registration and Perfection Requirements* with respect to the procedure and consequences of such registration

²² Art. 342¹(10)

²³ Item 6 of Art. 3 of the Federal Law № 367-FZ of 21.12.2013

²⁴ Art. 342¹

²⁵ Art. 342¹(2)

follow the pledged property into the ownership of the person acquiring it.

Allocation of proceeds of realisation between multiple pledgees

The amendments introduce new rules establishing mandatory priority for satisfaction of claims under which the main secured obligations such as principal and interest, and arguably enforcement costs, have priority over claims arising from a breach of obligations²⁶. In practice this would mean that the proceeds of realisation of the pledged property must go towards the discharge of the amount of default interest, losses and damages due to all secured creditors only after satisfaction of the main secured obligations of all secured creditors enforcing their claims. Within each order of priority, the claims of each secured creditor will be discharged according to the ranking of its security. Any other order of priority for claims arising from a breach of obligations will only be possible if permitted by special laws regulating securities.

Pari passu ranking of security

The amendments introduced a concept of equal (*pari passu*) ranking of security over a single asset in favour of multiple creditors to secure different debts owed to such creditors²⁷. This concept is also aimed at securing obligations owed to joint and several creditors as well as several creditors.

Under this concept each co-pledgee will be entitled to exercise its rights independently of the other co-pledgees, unless otherwise provided by law or agreed between co-pledgees. In the event of enforcement by one of the co-pledgees, the other pledgees will be entitled to join the enforcement proceedings. As a general rule, the proceeds of the enforcement of a *pari passu* pledge will be distributed among the co-pledgees *pro rata* to their claims. If the co-pledgees fail to join the enforcement proceedings, the consequences will be the same as those applicable to a first-ranking pledge in the event of enforcement of a subsequent ranking pledge. In other words, the pledge in favour of the non-participating pledgees continues to exist and will follow the property into the ownership of a purchaser.

A concept of security agent holding security on behalf of multiple creditors²⁸

In an attempt to create a legal structure to facilitate granting Russian law security over a single asset in favour of multiple creditors so eagerly demanded for further development of a Russian syndicated financing market, the amendments have introduced a concept of a security manager acting for a fee on the basis of an agreement entered into with multiple lenders.

Unfortunately the version adopted in the final reading is based on underlying principles different from those suggested in earlier versions of the amendments. As a result, in our view, the concept appears to add practically nothing new to the structures that market practitioners have already developed for security under syndicated financing agreement using the existing legal concepts of Russian law.

Although at a first glance it may appear to represent progress that in addition to any of the creditors having a claim against a debtor, any other person engaged in commercial activity can be appointed as a security manager, even if it is not a creditor of the borrower under the syndicated facility agreement, on closer examination of the status of a security manager this has limited benefit. The security manager must act in the interests and on behalf of the creditors (i.e. not in its own name) and in this capacity will (i) enter into a pledge agreement with the pledgor; and (ii) exercise the rights and perform the obligations of a pledgee (including enforcing security on behalf of the secured creditors). According to the amendments, the secured creditors are prohibited from exercising their rights as pledgees independently and must do so through the security manager unless the security management agreement is terminated.

In essence, under this concept a *pari passu* security interest is created in favour of multiple co-pledgees who are not permitted to enforce their security individually and are entitled to act only through the security manager. However the security manager acts simply as an attorney authorised by the secured parties to act on their behalf and in their interests. In practice this would mean for a registered security that each secured creditor will need to appear as a registered co-pledgee in the register and any new creditor would need to be registered as a co-pledgee upon transfer

²⁶ Art. 342¹(8)

²⁷ Art. 335¹

²⁸ Art. 356

of any part of a secured debt for the purposes of priority and/or enforceability (depending on the type of the pledged asset). However, the necessary registration of each co-pledgee could be effected by the security manager.

In the event of enforcement of security, the security manager will not become the owner of the proceeds of realisation of the pledged property, nor the owner of the pledged property in the event of enforcement by way of appropriation. According to the amendments, the secured creditors become joint and several owners of such proceeds or property *pro rata* to their share in the secured obligations. Therefore there is a strong argument that in case of bankruptcy of the security manager the enforcement proceeds should not go into the bankruptcy estate of the security manager and the creditors should be able to claim such proceeds or property outside the bankruptcy procedure. In the event of enforcement of the security by way of appropriation, it is expressly provided that such property must be sold at the request of any of the secured creditors.

The amendments prescribe that other well-established concepts under the current Civil Code are to supplement the provisions regulating the relations between secured creditors and the security manager. Given that such concepts were not initially developed for such purpose, and that the rules governing the relations between the creditors and security manager are quite vague, there is a risk that in the proposed form the concept of security manager will not be widely used in practice unless developed by court practice or further legislation.

Enforcement of pledge

The most significant change relating to the enforcement of pledges is the repeal of the Law on Pledge and the incorporation of the provisions dealing with enforcement into the Civil Code. At the same time, the existing rules have been refined to address shortcomings and resolve ambiguities. The general rules on enforcement have not therefore been substantively altered.

However, it is now not entirely clear how and to which extent the revised rules on the enforcement of pledges as well as any other rules applicable to pledges apply to mortgages over immoveable property. This concern is driven by a new rule providing that the rules on pledge should apply to mortgages in a supplementary manner to the extent not covered by the general provisions on rights *in rem* and the regulation set out in the law on mortgage. However, a section on the rights *in rem*, which should

include new rules on mortgages, was supposed to be significantly reformed, but amendments have not been adopted yet. The law on mortgage also has not been amended to bring it in line with the amendments on pledge. In our view, the unified approach could not be developed at the moment and the question on which rules would prevail (the revised rules on pledges or special regulations on mortgage) should be determined on a case by case basis (by reference to each particular provision of law).

General Rules on Enforcement

- The grounds for enforcement of a pledge remain the same and, as previously, the right to enforce will be subject to the materiality of default by reference to the value of the pledged property. The criteria of the amount of default (less than 5% of the value of the pledged property) and the period for which the default is outstanding (less than 3 months) for a default to be presumed as non-material remained the same²⁹.
- As under the current law, a pledge can be enforced either through the courts and, if agreed between the parties in writing, without recourse to the courts.
- Among the innovations the pledgee and other persons authorised to realise the pledged assets in enforcement are obliged to ensure sale of the pledged property at the best price. Any loss caused to any party by a failure to get the best price may be claimed from the persons in breach of such obligation³⁰.
- An agreed out-of-court enforcement procedure will not deprive the pledgee of the right to enforce a pledge through court. However, if enforced through the courts, the pledgee will bear the additional costs of enforcement as a result of application to the courts, unless it is proved that out-of-court enforcement failed for actions of the pledgor or third parties³¹.
- If under the current regime the out-of-court enforcement procedure was not available when (i) prior and subsequent ranking pledges stipulate different enforcement procedures or different ways of realisation of the pledged property; or (ii) a pledge over a single asset secures obligations owed to different creditors, according to the amendments the out-of-court enforcement procedure will be available if pledgees under a prior and subsequent ranking pledge agree

²⁹ Art. 348

³⁰ Art. 349(1)

³¹ Art. 349(1)

otherwise or the parties agree a unified out-of-court enforcement procedure, as appropriate³².

Enforcement through courts

As under the current regime, enforcement through the courts is a fall-back option and the sale must take place by way of a public auction to be conducted in accordance with the rules of the Civil Code and civil procedure legislation. However, if the pledgor is engaged in a commercial activity (as under the existing regime) the parties may agree when enforcing through the courts the methods of realisation available for out-of-court enforcement (see *Out-of-court Enforcement (item 2)* below)³³. The courts will still be entitled to postpone the sale of the pledged property for a period of up to 1 year, with the loss and accrued interest, including default interest, being indemnified during this suspension period.

The rules of sale at a public auction do not generally differ from those under the current regime.

Out-of-court enforcement procedure

Essential terms of an out-of-court enforcement agreement:³⁴ As under the current regime, under the amendments an out-of-court enforcement agreement should specify:

- the method of sale of the pledged property and may stipulate several methods, with the pledgee having the right to choose one at its discretion; and
- the value (starting price) of the pledged property or the method to determine such price.

Methods of out-of-court realisation: Similar to the current regime, the realisation of pledged property in an out-of-court enforcement may be effected:

1. by sale at an auction according to the rules provided for by the Civil Code or as otherwise agreed by the parties;
2. if the pledgor is engaged in commercial activity, in one or a number of the following ways which may be agreed by the parties in writing:
 - (a) appropriation of the pledged property by the pledgee;
 - (b) private sale without an auction by the pledgee,

in each case at a price not less than the market value.

It is noteworthy that the mandatory requirement to engage an independent appraiser to determine the market value of pledged property for the purposes of realisation, as well as the limit for the starting price at an auction to be not less than 80% of the market value determined by an independent appraiser, ceased to apply under the amendments. A sale through a commission agent is no longer mentioned as a method of sale.

Seizure of secured assets for the purposes of realisation: It is still not entirely clear whether, for the purposes of realisation in out-of-court enforcement, the secured property needs to be transferred into the possession of the pledgee. The amendments prescribe the moment of transfer of title only in the event of appropriation by the pledgee upon failure to sell at an auction and only for situations when the pledgee has the secured property in its possession; in this case title to the secured property is transferred to the pledgee upon receipt by the pledgor of a notice of appropriation of the secured assets³⁵.

When the pledged property is not in possession of the pledgee under any method of out-of-court enforcement it appears that, as under the current regime, before commencement of realisation the secured assets must be transferred into the possession of the pledgee. The amendments authorise the pledgee to claim the secured assets from the possession of the pledgor and any other third party and upon refusal to meet such claim the pledgee is expressly entitled to seize such assets through a notary by obtaining the notary's executory endorsement³⁶. Arguably, access to the notary for the purposes of such seizure is only available if the pledge agreement has been certified by a notary.

However, the approach may differ depending on the type of secured assets.

Enforcement through notaries: As under the current regime, out-of-court enforcement through a notary (by obtaining a notary's executory endorsement) will be available only under pledge agreements containing a condition on out-of-court enforcement which were executed before a notary³⁷.

³² Art. 349(3)

³³ Art. 350

³⁴ Art. 349(7)

³⁵ Art. 350²(5)

³⁶ Art. 350¹(4)

³⁷ Art. 349(6)

Right of courts to cease out-of-court enforcement: In case of breach, or a significant risk of breach, of the rights of the pledgor during out-of-court enforcement, the court will be entitled to cease out-of-court enforcement and order enforcement through a sale at public auction³⁸.

Pledge over different types of assets

Pledge of goods (stock) in turnover

The amendments facilitate the way in which stock subject to a pledge may be identified in a pledge agreement by permitting a reference to generic features of the assets and to their location in specified buildings, premises and even on specified land plots. In addition, notaries may be engaged for attachment of the secured stock by certifying the fact of location of the pledged stock in a precise place at certain time.

Pledge of contractual claims

General provisions: As under the current regime only property claims (i.e. rights to payment of a sum of money (receivables) and claims to receive property (e.g. usually under supply or sales contracts)) can be subject to a pledge. The amendments also expressly specify that not only existing claims but also claims which will arise in the future both under existing and future contracts whether in whole or in part may be subject to pledge.

There is an argument that a pledge of contractual claims falls within the requirements on registering pledges in the register of notices. However, it remains unclear how such registration can be effected, especially with respect to a pledge over future claims under future contracts. It is also not clear whether notification of the debtor is necessary upon entry into the pledge to preserve priority against any subsequent pledgee.

To create a valid pledge over contractual claims, no consent of the debtor under the underlying contract is required, unless a prohibition on pledge or assignment is contained in the underlying contract. However, according to the amendments a pledge of claims under a contract relating to commercial activity and containing a prohibition on pledge or assignment in the absence of the debtor's consent will not result in the pledge being invalid nor will it serve as a ground for termination of the pledged contract.

However, the debtor will have a remedy for breach of contract against the pledgor (in practice, a claim for damages)³⁹.

Pledgee's recourse to the debtor: The Amendments contain rules entitling the pledgee to direct the pledgor's debtor to perform its obligations under the underlying pledged contract to the pledgee on account of the secured obligations⁴⁰. In addition, as a general rule the pledgor will be obliged upon request from the pledgee to transfer receivables obtained under the underlying contract to the pledgee again on account of the secured obligations. In case of a failure to perform any of the above obligations directly to the pledgee, the pledgee will be entitled to accelerate the secured obligations and upon the pledgor's failure to perform such obligations, enforce the pledge⁴¹.

Enforcement procedure: In addition to levying execution by way of sale at an auction (whether under a court or an out-of-court enforcement procedure), the parties to the pledge may also agree (as a method of realisation for both the court and out-of-court procedure) the transfer of the pledged contractual rights to the pledgee or to a third party upon the pledgee's request. The amendments do not provide any mechanism to ensure transfer of such rights in an out-of-court enforcement without cooperation of the pledgor. If the pledgor refuses to effect such transfer, the pledgee may claim such transfer through the court or through a notary and claim damages from the pledgor for refusal to transfer⁴².

Pledge of rights to bank accounts

The amendments introduced long-expected regulations enabling the creation of a pledge over bank accounts, which will take the form of a pledge of rights under the bank account agreement.

General provisions: The concept of a pledge over bank accounts suggests that a special secured account (*zalogovy schet*) is to be opened with a bank and the rights with respect to this account are to be subject to pledge.

As a general rule, a pledge will be created with respect to the whole amount standing to the credit of the secured account at any time after execution of the pledge; alternatively it would be possible to stipulate a pledge of rights to a bank account agreement with respect to a fixed

³⁸ Art. 350¹(3)

³⁹ Art. 358²

⁴⁰ Art. 358⁶

⁴¹ Art. 358⁷(1)

⁴² Art. 358⁸

amount below which the balance should not decrease while the pledge is in force.

Perfection requirements: A pledge will arise on notice to the account bank of the pledge, with a copy of the pledge agreement.

If a pledge is created in favour of the account bank where a secured account is opened, the pledge arises as of the date of execution of the pledge agreement.

Regime of a secured account: Unless otherwise stated in a pledge agreement, before an enforcement event the pledgor will have the right to use the funds in the secured account without restriction (or to the extent the balance remains above the fixed limit set by a pledge agreement). Upon receipt of a pledgee's notice of default, the account bank will be prohibited by law from performing any instructions from the pledgor as a result of which the balance on the secured account would fall below the amount of the secured obligations specified in the pledge agreement.

In addition to the above, the pledgee has the right to receive from the account bank on request certain relevant information about the secured account without this being expressly provided or authorised in the documentation.

Without the pledgee's consent, a secured bank account agreement may not be amended or terminated.

Enforcement procedure: Enforcement both through the courts and without recourse to the courts is by way of debiting the secured account on the instructions of the pledgee and crediting the funds to the account specified by the pledgee.

Implications: Arguably, for a pledge over bank accounts to be available, further banking regulation (i.e. adopted by the Central Bank of the Russian Federation) is required at least for a secured account to be opened.

Recognition in bankruptcy: The legislation on bankruptcy applicable to companies (but not banks) has been amended to ensure a pledge over bank accounts will survive in the pledgor's insolvency. Such amendments also envisage specific enforcement rules for this particular type of security in a pledgor's bankruptcy. These amendments will become effective on 1 July 2014, simultaneously with coming into force of the provisions on a pledge of bank accounts.

Pledge of shareholders' and participants' rights

The amendments envisage specific rules for a pledge of the rights of shareholders or participants in a joint stock company or a limited liability company. These rights, according to the common understanding, include all rights granted by shares or participatory interests such as the right to dividends or distributed profit and other property interest upon liquidation of a company, voting rights, challenging corporate decisions and transactions of a company and receiving information on the activity of a company.

According to the amendments, a pledge of such rights is created by way of a pledge of shares or participatory interests. It is expressly stated that unless otherwise agreed, the shareholders' rights in a joint stock company during the life of the pledge are to be exercised by the pledgor (shareholder). During the life of a pledge of participatory interests in a limited liability company the rights of a participant are to be exercised by the pledgee, unless this right under a pledge agreement remains with the pledgor. When shareholders' or participants' rights are exercised by pledgees, the parties should take into consideration other related issues that may arise in this respect, such as antimonopoly requirements that may need to be complied with, including obtaining consent from or providing notification to antimonopoly bodies. As mentioned before, a pledge of participants' rights in a limited liability company is subject to state registration in order to become effective.

Pledge of securities

The new regulation provides only certain details with respect to a pledge of securities. Among notable provisions are the following:

- As under the current regime, a pledge over book entry securities will arise upon recording such pledge in an account of the holder of securities (i.e. the pledgor) or, if provided by law, in an account of the other person;
- In a pledge over securities it will be possible to agree that the pledgee will exercise either all rights vested in a pledgor by such securities or all rights other than a right to receive income (dividends, coupon, etc.) and for exercise of such rights no power of attorney in favour of the pledgee will be required;
- Upon conversion of pledged securities into other type of securities or other property, the pledge will extend to such new securities or property.

Conclusion

This note is not intended to be a comprehensive survey of all amendments to the pledge legislation. We have confined our attention to those which in our view constitute a significant development for secured financing, or which may have a material impact on existing and future security. We have highlighted a number of areas where the legislation is unclear, and more may come to light as the legislation is applied. These are likely to be resolved as further legislation is introduced and the courts and practitioners gain familiarity with this legislation and its implementation. The analysis will vary according to the circumstances of each particular transaction and this note should not be treated as a substitute for taking legal advice.

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