



*Electronic resource **Mondaq** published a new article by Dmitry Sobolev covering the issues of taking security in the Russian Federation.*

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TAKING SECURITY IN RUSSIA: NEW OPPORTUNITIES FOR INTERNATIONAL AND DOMESTIC CREDITORS

Introduction

This article discusses three major issues of taking security under Russian law:

- pledge of future real property;
- extra-judicial foreclosure on pledged property;
- enforcement of pledge in bankruptcy.

Recent court practice shows that it is possible for a pledgor to assume a valid and enforceable obligation to give security over a building that is to be constructed in the future. This can give more comfort to construction lenders and reduce credit risk in project finance transactions.

Additionally, new legislation on extra-judicial foreclosure on pledged property made this procedure usable and creditor-friendly allowing the pledge creditor to foreclose both movable and real property

without the need to obtain court ruling. The new legislation was introduced by the Federal Law No. 306-FZ “On Making Changes to Certain Legal Acts of the Russian Federation in connection with Improvement of Foreclosure on Real Property” of 30 December 2008 (the Law).¹

Finally, the new bankruptcy rules on pledge foreclosure provided by the Law allow the pledge creditors to obtain the major part of the foreclosure sale proceeds independently of the orders of priority of other creditors of the bankrupt pledgor.

¹ The Law amended the following laws: (a) the Law No. 2872-1 “On Pledge” of 29 May 1992; (b) the Law No. 4462-1 “On Fundamentals of Russian Legislation on Public Notaries” of 11 February 1993; (c) the Civil Code of the Russian Federation; (d) the Federal Law No. 122-FZ “On State Registration of Rights to Real Property and Transactions Therewith” of 21 July 1997; (e) the Federal Law No. 102-FZ “On Hypothec (Pledge of Real Property)” of 16 July 1998; (f) the Federal Law No. 127-FZ “On Insolvency (Bankruptcy)” of 26 October 2002; and (g) the Federal Law No. 229-FZ “On Enforcement Proceedings” of 2 October 2007.



1. Pledge of future real property

Recent developments in court practice enable creditors to take security over real property that will be created and obtained by a pledgor in the future. This is important in project finance where construction funds are provided to the borrower against an asset which is yet to be constructed.

1.1 Perfection only for existing real property

The main obstacle to creation of pledge over future real property is that pledge of real property is perfected by the state registration of the pledge, and such registration is permitted only with respect to existing real property (which must also be registered in the Unified State Register of Rights to Real Property and Transactions Therewith (the Register) as an object of property rights). This rule makes registered pledge of future real property impossible and, consequently, the pledgee may enforce its pledge rights only on the basis of the registered pledge provided that the real property is already existing and registered in the Register.

This problem can be overcome by the use of either undertaking to perfect pledge in the future or preliminary pledge agreement.

1.2 Undertaking to perfect pledge in the future

The creditor and the pledgor can include in the pledge agreement an undertaking of the pledgor to register the real property in the Register when its construction is completed, and to take all necessary steps for the state registration of the pledge. When the obligations to register the title over and pledge of the real

property have been performed the creditor gains valid pledge over the real property.

The current court practice with respect to the undertaking to perfect pledge in the future is positive, and Russian courts enforce such undertaking in favour of the creditor by making order to the Federal Registration Service² to exercise the state registration of the pledge over the constructed real property.³

1.3 Preliminary pledge agreement

The creditor and the pledgor can enter into a preliminary pledge agreement under which they undertake to enter into a pledge agreement when the construction of the real property has been completed. When the parties enter into and register the pledge agreement it creates valid pledge over the real property.

The previous court practice declared preliminary pledge agreements invalid but it was overruled by the current court practice which is in favour of enforcement of such agreement. A preliminary pledge agreement is enforced by compelling the pledgor to enter into the pledge agreement.⁴

It should be noted that the court practice is still not entirely consistent and continues its development. In particular, care must be taken in the aspects of identification of the object of pledge. Where a future building can be identified by the land plot on which it will be constructed, the land plot itself may not be identified by means other than its description in the

² The competent state authority for the state registration of real estate and transactions therewith.

³ See, for example, the Decree of the Federal Arbitrazh Court of the North-West District dated 17 June 2008 (the case number A56-8929/2007).

⁴ See, for example, the Decree of the Ninth Appellate Court dated 01 February 2008 (the case number 09AP-17931/2007-GK).



state cadastre of real property.

2. Extra-judicial foreclosure on pledged property

2.1 Agreement on extra-judicial foreclosure

Previously the legislation on pledge permitted entry into an agreement on extra-judicial foreclosure on pledged real property only after an enforcement event had occurred. This made it virtually impossible to obtain the pledgor's consent to such procedure. In most instances the only way for the pledgee to foreclose on the pledged real property was to go through time-consuming court proceedings and subsequent enforcement of the court ruling. This resulted in significant delays in foreclosure on such property and impairment of creditors' interests.

Now it is possible for the parties to enter into an agreement on extra-judicial foreclosure on real property at any time and not only after the occurrence of an enforcement event. This means that the agreement on extra-judicial foreclosure may be entered into by the parties at the same time as the pledge agreement. The agreement on extra-judicial foreclosure may either form a part of the pledge agreement or be made as a separate document. The same rules apply to agreement on extra-judicial foreclosure on movable property.

To enter in an agreement on extra-judicial foreclosure on pledged real property it is necessary to obtain the pledgor's notarised consent to the extra-judicial foreclosure. Such consent can be given prior to entering in the pledge agreement.

Consumer lending products

Banks should take notice that to enter in an agreement on extra-judicial foreclosure on any property pledged by an individual it is necessary to obtain his or her notarised consent to the extra-judicial foreclosure.

2.2 Restrictions on extra-judicial foreclosure

General foreclosure restrictions

Any foreclosure on pledged property is prohibited if the breach of the secured obligation is extremely minor and the amount of the pledgee's claim is minor and obviously disproportional to the value of the pledged property. A breach is considered minor and obviously disproportional to the value of the pledged property if: (a) the amount of the principal debt is less than 5% of the appraisal value of the pledged property specified in the pledge agreement, and (b) the secured obligation is less than 3 months overdue.

Specific extra-judicial foreclosure restrictions

Extra-judicial foreclosure is prohibited by law in certain cases such as:

- The pledged property is owned by an individual and its pledge requires consent of a third party.
- The pledged property is residential premises owned by an individual.
- The pledged property is an enterprise as property complex.
- The pledged property is state or municipal property.



2.3 Enforcement notice

To initiate foreclosure the pledgor must send the pledgee an enforcement notice which must specify the pledged property, the sum of outstanding secured obligation, the means of foreclosure and the price (starting price if applicable) of the pledged property.

The pledged property can be foreclosed upon expiration of the earlier of 10 days from the receipt of the enforcement notice by the pledgor or 45 days from the sending date. However the sale of the pledged property can be made earlier if there is material risk of its damage, destruction or substantial reduction of its market price compared to the price specified in the notice.

2.4 Means of extra-judicial foreclosure

The parties may agree in an agreement on extra-judicial foreclosure on the following means of foreclosure:

- public sale;
- private sale; or
- retention of pledged property by pledgee.

Private sale and retention by pledgee of movable pledged property can be used only in commercial pledge entered into between legal entities and/or entrepreneurs and cannot be applied to a land plot.

For the purposes of foreclosure the pledgee is entitled to claim delivery of the pledged property from the pledgor if the pledgor retained possession of the pledged property for the duration of the security period.

2.5 Public sale

The law now expressly permits the pledgee to arrange public sale of the pledged property. For the purposes of sale the pledgee is entitled to enter into all necessary transactions, including engagement of a sale arranger and an appraiser, and sign all necessary documents.

Notice of public sale

Not later than 10 days prior to the commencement of the public sale the pledgee must send the pledgor and the debtor a notice which must specify the date, time and place of the sale. With respect to real property such notice must also include requisites of the pledge agreement sufficient for its identification, and description of the pledged real property.

In case of foreclosure on real property it is also necessary to make a published announcement of the sale. The announcement must contain the same information as the notice of the public sale and additionally a description of the sale procedure.

The starting sale price or the procedure for its determination may be specified in the pledge agreement or in the agreement on extra-judicial foreclosure.

Professional appraisal of pledged property

A professional appraiser must be engaged to establish the starting sale price if the pledged real property consists of:

- (a) leasehold;
- (b) participation rights arising from a cofinanced construction contract entered into in accordance with the Federal Law No. 214-FZ "On Participation in Cofinanced Construction of



Multi-Residential Buildings and Other Objects of Immovable Property and Making Changes to Certain Legal Acts of the Russian Federation” of 30 December 2004, as amended; or

- (c) property appraised at more than 500,000 rubles, as provided by the pledge agreement.

In certain cases a professional appraiser must be engaged to establish the starting sale price of the pledged movable property, particularly, with respect to:

- (a) Rights.
- (b) Property appraised at more than 500,000 rubles, as provided by the pledge agreement.

The pledged property is sold to the highest bidder. The sale proceeds are applied to the discharge of the debtor’s obligations and the remaining sum is returned to the pledgor.

If the sale is unsuccessful, the pledgee may retain the pledged property in satisfaction of the debtor’s obligations. To gain the property title over the pledged property the pledgee must notify the arranger of the sale about retention. From the date of such notice the pledgee becomes the owner of the movable pledged property and becomes entitled to register its property rights over the real pledged property.

2.6 Private sale

The pledgee may arrange private sale of the pledged property and apply the sale proceeds to the discharge of the debtor’s obligations. The private sale is conducted by an agent appointed by the pledgee.

The sale price of movable property must be determined in accordance with the report of a professional appraiser. It is not clear whether similar requirement is

applied to real property, but we believe there is strong probability that it will be imposed by courts.

2.7 Retention of pledged property

The pledgor may retain the pledged property in satisfaction of the debtor’s obligations.

Movable pledged property is retained for a market price. It is not clear whether similar requirement is applied to real property, but we believe there is strong probability that it will be imposed by courts.

2.8 Enforcement on the basis of a notary’s executive endorsement

If the pledgor does not perform its obligations under an agreement on extra-judicial foreclosure, the pledgee may enforce its rights on the basis of a notary’s executive endorsement without obtainment of a court ruling.

Notary’s executive endorsement is made on the transaction documents and confirms indisputable nature of the debtor’s obligations and the creditor’s right to foreclose on the pledged property. Notary’s executive endorsement can be made on the basis of the following documents:

- (a) notarised consent of the pledgor to extra-judicial foreclosure on the pledged property;
- (b) the principal agreement secured by the pledge agreement;
- (c) the pledge agreement;
- (d) the agreement on extra-judicial foreclosure (if separate from the pledge agreement);
- (e) calculation of the debt secured by the pledge, certified by the pledgee;



- (f) an appraisal report on the value of the pledged property or the pledgee's application to the notary to set the starting sale price of the pledged property in accordance with the agreement;
- (g) for the pledged property title to which is subject to state registration: (a) an extract from the Register confirming that the pledge is still in effect (if real property is pledged), or (b) an extract from the Russian Federation Shipping Register or Vessels Book if the pledged property is a vessel that has to be registered;
- (h) the hypothec certificate (if applicable).

The notary reviews the submitted documents and verifies if the pledgee's claims are indisputable. The notary must also notify the pledgor of the intended executive endorsement on the pledge agreement, and the pledgor has the right to submit objections in 7 days period. If the pledgor objects to the pledgee's claims, the notary must verify the nature of the pledgee's claims taking into account such objections. If the notary has any doubt as to the validity of such claims, he/she has the power to reject the executive endorsement.

If the endorsement is made, it must specify the starting sale price in accordance with the pledge agreement. The pledgee then submits the endorsed documents to a court marshal who is obliged to initiate foreclosure on the pledged property by way of public sale.

3. Enforcement of pledge in bankruptcy

In the bankruptcy of a pledgor the pledged property can be foreclosed for the benefit of the pledgee only pursuant to a court ruling. However the new bankruptcy legislation allows the secured creditors to obtain the

major part of the foreclosure sale proceeds independently of the orders of priority of other creditors of the pledgor.

In the liquidation procedure (*konkursnoye proizvodstvo*) the pledged property is sold by way of public sale and the sale proceeds are distributed as following:

- (a) 70% are applied to the satisfaction of the pledgee's claims with respect to payment of principal and interest under an instrument other than bank loan (80% in case of a bank loan);
- (b) 20% (15% in case of a bank loan) are applied to the satisfaction of claims of the creditors of the first and second orders of priority⁵ if the proceeds of sale of other property of the pledgor are not sufficient to discharge such claims; and
- (c) the remaining proceeds are applied to payment of court expenses, fees of the bankruptcy administrator and persons engaged by the bankruptcy administrator for the purposes of performing its duties.

If any proceeds are left out of the 20% (or 15%) reserved for the creditors of the first and second orders of priority, they shall be applied to the discharge of the relevant pledgee's claim. The remaining proceeds, if any, shall be included in the bankruptcy estate.

⁵ Pursuant to section 4 of Article 134 of the Federal Law "On Insolvency (Bankruptcy)" in the liquidation procedure claims for harm inflicted to health or life and claims for moral damages are satisfied in the first order of priorities, employment claims (wages and severance payments) and royalty claims are satisfied in the second order of priorities.