

# Supreme Arbitrazh Court clarifies Russian pledge legislation

This client briefing outlines clarifications of the VAS on the main issues of application and interpretation of the pledge and mortgage legislation contained in the VAS clarifications and discusses the benefits and drawbacks of these clarifications for secured assets located in Russia.

## Introduction

On 11 March 2011 a clarificatory directive of the Plenum of the Supreme Arbitrazh Court of the Russian Federation (Visshiy Arbitrazhnyi Sud or VAS) No. 10 of 17 February 2011 "On certain aspects of application of pledge legislation" was published. The VAS clarifications were much awaited in order to resolve the issues of interpretation of some ambiguous provisions of the substantial amendments to the pledge legislation adopted at the end of 2008<sup>1</sup>, relating mainly to out-of-court enforcement of Russian pledges and mortgages. Apart from the issues connected with out-of-court enforcement of Russian security, the VAS has also clarified some other issues concerning application of pledge legislation, which had not received consistent interpretation by Russian courts.

## Brief overview of key VAS clarifications

Amongst other things, the VAS provided the following clarifications to be applied by the courts of lower instance when considering a dispute:

- with respect to a mortgage, an out-of-court agreement must stipulate one and only one method of out-of-court enforcement for this agreement to be effective; otherwise, enforcement of a mortgage is possible only through the court;
- with respect to a pledge of movable property, more than one method of out-of-court enforcement may be agreed by the parties and the particular method may be selected by the pledgor at the time of enforcement, unless the parties agreed otherwise;
- a delay on the part of a secured creditor to realise secured property in the course of out-of-court enforcement within the agreed period of time does not deprive the secured creditor of its right to enforce the security,

although gives the security provider the right to claim damages from the secured creditor to compensate it for any losses suffered as a result of such delay;

## Key issues

- Effectiveness of out-of-court enforcement agreements
  - Availability and eligibility of out-of-court enforcement of pledges and mortgages
  - Valuation of secured property in out-of-court enforcement
  - Consequences of inappropriate enforcement and disposal of secured assets
  - Particular issues of out-of-court enforcement options
  - General issues on pledges and mortgages
- an out-of-court enforcement agreement must be in the same form as the pledge or mortgage agreement to which it relates (e.g. notarised form) and is to be registered if the pledge or mortgage agreement requires registration;

<sup>1</sup> Please refer to our client briefing of January 2009 "Russia Develops the Rules on Enforcement of Russian Security".

- an out-of-court enforcement agreement does not deprive the pledgee of the right to enforce through a court;
- if a pledge or mortgage was enforced inappropriately, the security provider may either (i) recover the alienated secured property from the person who acquired it, or, if recovery is impossible or was not claimed, (ii) to claim damages (including the value of the pledged property) from the secured creditor;
- an increase in the secured obligations or extension of the maturity of the secured debt does not result in termination of the pledge or mortgage agreement which continues to secure the debt for up to the original amount set out in the pledge or mortgage agreement;
- upon termination of an agreement under which the secured obligations arose, a pledge or mortgage does not terminate and continues to secure outstanding obligations to return principal together with interest thereon;
- a mortgage survives separation of a mortgaged land plot and rearrangement of mortgaged land plots.

Below we provide a more detailed analysis of the above and some other VAS clarifications.

## General issues on enforcement of security

### Effectiveness of out-of-court enforcement agreements

#### Mortgage of immovable property

According to the VAS, the method of out-of-court enforcement over mortgaged property is an 'essential term' ('suschestvennoye usloviye') of an out-of-court enforcement agreement relating to a mortgage, for the agreement to be effective. The VAS has further clarified that if the parties have not specified a particular method of realisation or stipulated several methods of realisation of the mortgaged property in an out-of-court enforcement agreement, the agreement is ineffective and therefore enforcement of the mortgage will be available only through a court.

Given that the VAS clarifications apply to any disputes to be heard by the courts after the date of official publication of such clarifications, this interpretation should be followed by the courts of lower instance even if an out-of-court enforcement agreement was entered into before the adoption of the VAS clarifications.

#### Pledge of movable property

The VAS has clarified that apart from a mortgage, in the case of a pledge, the method of out-of-court enforcement of pledged movable property is not an 'essential term' ('suschestvennoye usloviye') for an out-of-court enforcement agreement to be effective. If the method of out-of-court enforcement is not agreed by the parties, the VAS has specified the

following methods to be used in out-of-court enforcement of pledges:

- (a) in the case of listed securities, sale on the relevant stock exchange; and
- (b) for other types of movable property, sale at an open auction.

The VAS has further clarified that if several methods of out-of-court enforcement are included in the out-of-court enforcement agreement, the agreement is effective, but the election of the method is to be made by the pledgor, unless the agreement provides otherwise.

Unfortunately the VAS has not clarified whether listed shares can be sold otherwise than on a stock exchange if so agreed by the parties.

#### Form of out-of-court enforcement agreements

As clarified by the VAS, if an out-of-court enforcement agreement is entered into under a separate document (i.e. is not a part of the pledge or mortgage agreement), it should be executed in the same form as the pledge or mortgage agreement. Accordingly if the pledge or mortgage agreement is subject to state registration (as currently is the case for mortgage agreements), the out-of-court enforcement agreement must also be registered. The VAS has further clarified that if a mortgage is created by operation of law (e.g. in favour of a creditor financing construction project), an out-of-court enforcement agreement related to such mortgage must also be registered.

#### Unavailability of out-of-court enforcement

According to the VAS clarifications a pledge granted by an individual over any property in common ownership

(e.g. common ownership of spouses) can be enforced only through a court, on the grounds that jointly owned property can only be disposed of by a co-owner with the consent of the other co-owner(s), and that pledges which can only be granted with the consent of another person can be enforced only through a court. The VAS' clarification appears to mean that the prohibition on the use of out-of-court enforcement applies to a pledge of any movable property in common ownership of spouses, irrespective of whether such consent under the Family Code is implied or express. In addition to retail secured lending, this clarification will primarily affect transactions involving pledges of shares granted by married individuals if, for example, such assets are not excluded from the common ownership regime by way of a marriage contract.

Similarly the VAS has clarified that a pledge of participatory interests in a limited liability company, granted by one of the participants who is an individual can be enforced only through a court on the similar grounds that such pledge requires consent of a meeting of the participants. Arguably, if an individual is the only participant of a company, the pledge of participatory interest can stipulate an out-of-court enforcement procedure subject to certain general limitations concerning the methods of out-of-court enforcement available for pledges granted by individuals .

#### **The right to enforce through courts**

Prior to the VAS clarifications it was not entirely clear whether having entered into an out-of-court enforcement agreement, the pledgee or mortgagee still had the right to enforce the pledge or mortgage through the court and, if available,

when this right could be exercised. The VAS has clarified that the entry into of an out-of-court enforcement agreement does not preclude the secured creditor from enforcing the security through the court. However, if enforced through the court, the court must order the secured creditor to pay all court expenses, unless:

- (a) the secured creditor proves that it has tried, but failed, or it is impossible for any other reasons, to enforce without recourse to a court; or
- (b) the possibility of enforcement through the court was expressly provided for in the pledge or mortgage agreement.

#### **Importance of the period within which out-of-court enforcement realisation is to be completed**

The VAS has confirmed the view that failure by a pledgee to complete the realisation of pledged property within a certain period of time (either provided for in a pledge agreement or, if not agreed, within a reasonable period) does not preclude the pledgee from continuing out-of-court enforcement of the pledge under the initially elected method of realisation.

However, according to the VAS if realisation occurs after expiry of such period, a pledgor is entitled to claim damages from the pledgee caused by failure of the pledgee to complete enforcement within the relevant period. The VAS further specified that such damages could include the difference between the proceeds actually received from sale of secured property and proceeds which could have been received if the sale was made within the relevant period.

Damages could include the amount of interest, default interest and losses

accrued after the expiry of the relevant period and discharged by the pledgee from the sale proceeds. The practical effect of this rule is that the amount of interest and losses accrued after the expiry of the relevant period would not be secured by the pledge if the court so determines. But this would not mean that these amounts cannot be recovered as an unsecured claim.

The VAS has also extended, by invoking the principle of 'analogy of law', the same principles to mortgage agreements where the parties agreed the period for completion of realisation of mortgaged property.

#### **Remedies against inappropriate enforcement of security**

If property was purchased by a third party as a result of the secured creditor enforcing a pledge or mortgage over such property without recourse to a court in circumstances where the secured creditor did not have a right to such out-of-court enforcement, according to the VAS the following remedies will be available:

- (a) the security provider will be entitled to recover its property from the purchaser or, if appropriated by the secured creditor, from the security provider; additionally the secured creditor will be obliged to reimburse the security provider its expenses connected with remedying the breach of rights and indemnify against any other losses connected with such breach; and
- (b) the security provider will be entitled to claim damages from the secured creditor (including the value of the secured property) caused by

such disposal, if (a) the property disposed of cannot be recovered (in particular, if a purchaser did not know or could not have known that the secured creditor was not entitled to sell the secured property (i.e. a bona fide purchaser) and provided that the secured property did not leave the possession of the security provider against its will) or (b) the security provider does not exercise its right to recover the property.

#### **Disposal of the secured property without the secured creditor's consent**

##### *Disposal of pledged movable property*

The VAS has 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 VAS 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.

##### *Disposal of mortgaged immovable property*

With respect to mortgaged real estate, the VAS has specifically noted the provisions of law which expressly state that (i) 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. The VAS has further clarified that 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.

#### **Valuation of the secured property**

According to the VAS clarifications, if in a disposal of the secured property in the course of out-of-court enforcement of a pledge or mortgage otherwise than by auction, the rules on valuation of the secured property were breached, the transaction can be held to be invalid on the petition of an interested party (such as the security provider, for example) if a purchaser of such property knew or should have known that (i) such property was sold in the course of enforcement of security over such property; and (ii) the rules applicable to valuation of such property were breached. In addition, as a separate remedy, the security provider is

entitled to claim from the secured creditor damages caused by such breach.

The VAS has further clarified that when the pledged property is subject to a mandatory valuation by a valuer for the purposes of an out-of-court enforcement sale at an auction, the starting price of the property for the sale should not be less than 80% of its market value as determined by the valuer.

#### **Availability of partial enforcement**

The VAS has clarified its position with respect to the possibility of enforcing against a part of the secured property. According to the VAS, if a pledge agreement refers only to the aggregate value of a number of movable items (rights to property or claims) or immovable items subject to pledge or mortgage, enforcement and subsequent sale must be conducted against all movable or immovable property as a whole to which the aggregate value was assigned.

According to the VAS, a court may enforce a pledge with respect to a part of the pledged property, provided that the pledgor (i) proves that proceeds from enforcement against a part of the pledged property would be sufficient for full discharge of the secured obligations; and (ii) provides evidence of the market value of each item comprising the secured property (rights to property or claims) against which the pledgor proposes to levy execution.

It appears that the VAS by its clarification was seeking to restrain attempts by the courts of lower instance to declare invalid pledges or mortgages that do not state the value of each secured item. However, in case of a conservative interpretation of the above clarifications there may

be a risk that Russian courts will prohibit or stay partial out-of-court enforcement of security not only when a set of interconnected items was secured, but also with respect to such assets as shares or participatory interests if pledge agreements do not contain the value of each particular batch of shares or portion of participatory interest against which execution may be levied. This may be irrespective of provisions in the pledge agreements explicitly contemplating (i) the possibility of enforcement in parts and (ii) the obligation to provide a market valuation of each part of shares or participatory interest subject to enforcement before the enforcement sale.

It also remains unclear how the above clarification can be reconciled with the provisions of the Law on Pledge expressly permitting partial enforcement at the pledgee's discretion. In our view, the position of the VAS is in need of further clarification here.

#### **Possibility of out-of-court enforcement under initial and subsequent pledges**

In case of simultaneous enforcement of the initial and subsequent pledges or mortgages over the same property, the VAS has stressed that any secured creditor under any of the pledges may enforce its security without recourse to the court only if the secured creditors under both the initial and subsequent pledges have sent a joint enforcement notice to the security provider.

#### **Competence of notaries in out-of-court enforcement**

As clarified by the VAS, when applying to a notary in the case of a pledgor's failure to perform an out-of-

court enforcement agreement (in particular, in the case of a refusal by the pledgor to make the pledged property available to the pledgee for its subsequent sale), any objections raised by the debtor or the pledgor regarding the secured obligations or enforcement should be treated as amounting to a dispute between the pledgor and pledgee and therefore should preclude the notary from making an executory endorsement. The above clarifications effectively mean that in the case of the pledgor failing to cooperate with the pledgee, the continuation of the out-of-court enforcement or new enforcement would be available only with the involvement of the courts.<sup>2</sup>

## **Out-of-court enforcement options**

### **Acquisition of mortgaged property**

The Law on Mortgage contains a prohibition on the acquisition of mortgaged property (on account of a mortgagee or for a third party) as a method of out-of-court enforcement of a mortgage over a land plot. The VAS has clarified that such prohibition does not apply to situations when a land plot is mortgaged together with a building located on such land plot in favour of the same mortgagee. Therefore acquisition as a method of

out-of-court enforcement will not be available only if a land plot (and arguably the leasehold rights to a land plot) without any buildings located thereon is subject to a mortgage.

The VAS emphasised that when using the acquisition of mortgaged property as a method of out-of-court enforcement, no separate sale and purchase agreement is to be entered into, but the mortgagee's notice to the mortgagor on acquisition of the mortgaged property must contain the acquisition price of the mortgaged property. The VAS has also confirmed that in the course of such an acquisition, ownership of the mortgaged property is considered to be transferred to its acquirer upon recording such transfer in the state register (as is common for transfers of ownership to any real estate) and the mortgagor as the owner of the mortgaged property is not required to file any application for the purposes of such registration. As a result, following such clarification no cooperation on the side of the mortgagor appears to be required for registration of such transfer and for completion of the out-of-court enforcement under the acquisition option.

However, there may still be issues with exercising the acquisition option, as according to the VAS, the mortgagee is obliged to present to the registration authorities, amongst other things, documents confirming that the mortgage was eligible for out-of-court enforcement. Apart from a mortgage agreement containing a notary's executory endorsement which is referred to in the VAS clarifications as an example of the documents to confirm such eligibility, it is difficult to see what other documents may confirm the eligibility of enforcement without involvement of the mortgagor.

<sup>2</sup> To continue out-of-court enforcement the pledgee would need to petition the court to order the transfer of the secured property or making it otherwise available to the pledgee for its further realisation.

As a result, out-of-court enforcement of mortgages may still encounter practical difficulties.

### Appropriation of pledged movable property

The VAS took the view that when under the applicable law, pledged property is eligible for a private sale or appropriation by a pledgee, the exercise of these options is possible only when the pledged property is in the possession of the pledgee. If the pledged property is not in the possession of the pledgee (and this is usually the case), the pledgee or a third party purchaser obtains ownership to such pledged property only upon obtaining possession over such property. In other words, if the pledged property remains in the possession of the pledgor during an out-of-court enforcement process, sending a pledgee's notice to a pledgor on appropriation of the pledged property, or the entry by a pledgee into a sale and purchase agreement with a third party will not result in the transfer of ownership to the enforced property until the property is actually handed over or otherwise made available to its acquirer.

### Appropriation of contractual rights

With respect to the appropriation of contractual rights by a pledgee as one of the means of out-of-court enforcement, the VAS has confirmed the previously existing view that the rights are treated as having been transferred to a pledgee upon receipt by a pledgor of a pledgee's notice to that effect, provided that the notice was sent after sending an enforcement notice to the pledgor.

The VAS has further clarified that for completion of a transfer of pledged rights, the debtor which owes the corresponding obligations to the pledgor must be notified in writing of the transfer or otherwise performance of the obligations by the debtor to the pledgor may be treated as proper performance which discharges the obligations.

## General issues on pledges and mortgages

### How does an increase in secured obligations affect the pledge?

The VAS has brought to an end the debate concerning the consequences for a pledge of the change of the value or the maturity of the secured obligations (e.g. as a result of a change in interest rate or maturity of a facility). As opposed to the position of some Russian courts of lower instance, the VAS has clarified that such changes must not result in termination of the pledge and mortgage. Further in the case of an increase in the rate of interest under a facility without amendments to the pledge agreement reflecting such increase, the pledge will continue to secure the main obligation as if such increase in the interest rate had not been made (i.e. as set out in the pledge agreement). However, according to the VAS, the parties may agree in the pledge agreement that in the case of an increase in the secured obligations the pledge will cover the increased obligations up to the agreed value (i.e. the value up to which the secured obligations can be

increased and still be secured should be stated in the pledge agreement).

The VAS has further clarified that in the case of an extension to the maturity of the secured obligations without a corresponding amendment to the pledge agreement, the limitation period applicable to the claim on enforcement of the pledge is to be determined by reference to the expiry of the limitation period for the claim under the secured obligations by reference to the original maturity date.

The VAS also stated that failure to refer to the amount of interest and/or interest periods under a secured facility in a pledge agreement should imply that the pledge secures only the principal, but should not result in the pledge agreement being ineffective.

It should be noted that the above rules should, according to the VAS, apply both when the borrower secures its own obligations by pledge over its assets and when a third party pledgor secures obligations of a debtor.

In our view, in the case of a conservative interpretation of the above provisions by the courts of lower instance, pledge agreements which do not contain a sufficient description of the interest (and similarly any other obligations such as fees) in the context of the secured obligations may be considered by the courts as not securing such interest (fees).

### Altering the accessory nature of pledges

According to the VAS, upon termination of the agreement under which the secured obligations have arisen, the pledge securing such obligations does not terminate and

continues to secure any outstanding obligations remaining following termination (such as the obligation to return the principal together with interest under a loan agreement).

In addition, the VAS has stated that a pledge agreement may stipulate that the pledge secures the claim of a pledgee to the debtor to claw back amounts received by a debtor under an agreement in the case of invalidity of such agreement.

### **Survival of a mortgage over a land plot in the case of land separation**

The VAS has clarified one of the most critical issues constantly arising in connection with separation and rearrangement of a mortgaged land plot. The VAS has stated that the mortgage survives separation of a land plot and rearrangement of land comprised in several land plots, and extends to each new land plot established as a result of separation or rearrangement of the mortgaged land plot or plots. Moreover, the state registrar must record in the real estate register the mortgage over each new land plot formed from the mortgaged land plot and no separate application to the registrar nor payment of any state duty is required for such recording. Unfortunately, it still remains unclear whether the above would apply to a mortgage of leasehold rights to a land plot.

According to the VAS the same principles on survival of the mortgage and recording of encumbrances without the need for a separate application to the registrar should be applicable to a situation when premises are separated from a mortgaged non-residential building.

### **Mortgage over non-residential premises**

According to law, in order to be effective, a mortgage over a building should be granted together with a mortgage over the land plot or leasehold rights to the land plot on which such building is located, under the same mortgage agreement. The VAS has clarified that when creating a mortgage over non-residential premises, the right to a land plot (whether ownership or leasehold) does not need to be mortgaged under the same mortgage agreement. As a result the mortgage of non-residential premises will be valid without a separate mortgage of the land plot on which the building is located and an acquirer of the mortgaged premises upon enforcement will have the same rights to use the land plot beneath the building as the mortgagor had before.

### **No requirements for notarisation of pledges of certain assets**

The VAS has confirmed that the provisions of the Law on Pledge requiring a pledge over aircraft, ships, rolling stock and objects intended to be launched into space to

be certified by a notary, do not apply as they contradict the special laws regulating those assets.

## **Conclusion**

Although most of the clarifications made by the VAS evidently were aimed to restore the regime regulating rights of secured creditors that was undermined by a number of decisions of lower instance courts and sometimes appear to be progressive, the position of the VAS on some issues is not in favour of secured

creditors, especially in relation to pledge and mortgage agreements and out-of-court enforcement agreements entered into before the adoption of the VAS clarifications. For these agreements, the clarifications may have retroactive effect as they were not intended to change the law and carry the implication that the law always was as now interpreted by the VAS. We note that certain provisions of the pledge legislation that raised issues of interpretation and application in practice still remain unclear and are either in need of legislative clarification, or the position of the courts still needs to be determined.

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