



Amendments to Russian pledge law

This briefing discusses the recent amendments to the Civil Code of the Russian Federation (the Civil Code); Federal Law No. 2872-1 'On pledge' dated 29 May 1992, as amended (the Pledge Act); Federal Law No. 102-FZ 'On mortgage' (pledge of real property) dated 16 July 1998, as amended (the Mortgage Act); Federal Law No. 127-FZ 'On insolvency' (bankruptcy) dated 26 October 2002, as amended (the Bankruptcy Act); and certain other laws that have been recently introduced by Federal Law No. 306-FZ (the Amendment) to detail the procedure of pledge enforcement.

The Civil Code

The Civil Code has been supplemented with new provisions on security interest enforcement, specified in more detail in the Pledge Act and the Mortgage Act. In particular, the amendments:

- provide for the discharge of a claim secured by pledge by way of transferring collateral into a pledgee's ownership in cases and under the procedure established by law;
- provide for the right of a first-ranking pledgee in the case of enforcement of a second-ranking security interest in the same property to accelerate the unmatured obligations secured by the first-ranking pledge, and if the first-ranking pledgee does not exercise this right, an acquirer receives the property encumbered with the first-ranking pledge;
- prohibit pledge foreclosure if a debtor's breach of secured obligation is insignificant or the pledgee's claims are disproportionately small compared with the value of collateral (supplying criteria for these tests);
- supplement the list of cases in which out-of-court enforcement is prohibited, ie if the mortgaged property is living quarters owned by an individual, or if the procedure for the foreclosure is either not agreed between pledgee and pledgor or it is impossible to follow the procedure agreed by the parties.

The Civil Code provides that pledged movable property is to be foreclosed under the Pledge Act and mortgaged immovable property under the Mortgage Act. The Civil Code itself outlines the general framework for the sale of pledged movable property.

The Pledge Act

The Pledge Act has been supplemented with a pledge enforcement procedure that may now follow either through a court by way of a public sale, or out of court by way of a tender or through a sale under a commission agreement between the pledgee and a commission agent. Listed securities should be sold through a stock exchange.

Parties to a pledge may provide for out-of-court pledge enforcement in the pledge agreement or, alternatively, in a specific pledge enforcement agreement that may be entered into at any time. Under the Civil Code, if a pledgee is an individual, his written consent to out-of-court pledge enforcement should be obtained and certified by a notary. Pledge agreements or pledge enforcement agreements between legal entities and/or individual entrepreneurs securing obligations relating to their business activity may provide for either a transfer of the pledged property into the ownership of a pledgee, or, alternatively, a sale of such property to a third party without a tender, including through a sale under a commission agreement with the sale proceeds applied towards the discharge of the claim.

The foreclosure procedure is similar to the procedure established earlier by the Mortgage Act with certain modifications; for example, in relation to the process under which the pledgee is entitled to acquire the mortgage property after the public sale has been frustrated twice.

The Mortgage Act

The Mortgage Act has already provided for a foreclosure procedure. The Amendment has added certain new provisions, including some affecting the out-of-court enforcement procedure. For instance, under the Amendment:

- situations where out-of-court enforcement is prohibited have been supplemented with a number of additional scenarios (including if the mortgaged property is living quarters owned by an individual; or if it is a state or municipal property);
- a mortgagor's notarised consent (both for individuals or companies) is required for the execution of a mortgage enforcement agreement;
- if a composition agreement is executed by a mortgagor and its creditor(s), and unless otherwise provided in the agreement, the mortgagor's obligations that have been amended by such an agreement will be secured by the existing mortgage;
- all leases and other rights of use granted by a mortgagor on the mortgaged property without the mortgagee's consent after the execution of the mortgage will be terminated on mortgage enforcement.

The Bankruptcy Act

Changes to the Bankruptcy Act made as part of the Amendment provide for:

- the prohibition of an out-of-court security interest enforcement from the date on which the supervision stage of insolvency proceedings started;
- the court's powers to order, at a creditor's request, foreclosure during the 'financial rehabilitation' or 'external management' stage of the debtor's insolvency proceedings, unless the debtor proves that such foreclosure prevents the restoration of its solvency;
- specific procedure for the sale of property pledged by a debtor undergoing insolvency proceedings;
- specific procedure for the discharge of creditors' claims secured on pledged/mortgaged property (which, as before, are third in priority):
 - 70 per cent (80 per cent in case of claims under loan agreements) of proceeds from the sale of pledged collateral are applied to discharge

creditors' claims secured by the relevant pledge/mortgage);

- 20 per cent (15 per cent in case of claims under loan agreements) of such proceeds are applied to discharge claims of first- and second-priority creditors in case of insufficiency of other property in the bankruptcy estate); and
- the balance – towards court costs and certain other insolvency expenses.

Any balance remaining after the satisfaction of first- and second-priority creditors as per the above must be applied towards the satisfaction of claims secured by the relevant pledge or mortgage, if the latter remain not satisfied in full. The remaining balance should be then added to the debtor's estate and any outstanding claims may be discharged together with claims of unsecured third-priority creditors.

Please note that this briefing is not intended to represent transaction-specific advice and should not be relied on in relation to any particular matter without further advice.

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