

# **FINANCING TRANSACTIONS IN RUSSIA**

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## ABSTRACT

*The thesis analyzes Russian laws of security and insolvency and reviews common legal issues arising in cross-border financing transactions. To aid better understanding of up-to-date Russian law, the analysis includes historical information.*

*The thesis concludes that Russian law traditionally did not adopt a regime favorable to lenders and that the law of security was inefficient. In addition, commercial practice suffered from the inflexible approach of courts to innovations. Statutory law was not appropriate for commercial, as opposed to retail, transactions. This situation may be partially attributed to the recent transition from planned to market economy and, hence, relatively short history of modern Russian law.*

*The thesis highlights recent Russian legal reforms and their impact on lending practices. At the thesis shows, the respective changes provided more comfort and protection to the lenders and increased certainty in business transactions. In this way laws of security and insolvency were elevated to new levels and this demonstrated the changing approach of legislators and courts.*

*This originality of this work is in that it combines the study of the original Russian sources of law with the perspective of financial transactions in the international markets. It also includes a comparative element: where appropriate rules of Russian law are contrasted with their counterparts in English law. Furthermore, Russian security and insolvency laws are often reviewed through the prism of their practical application and effect on lending practices. Thus, the link between law and economy is also exposed.*

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# INTRODUCTION

*“The judicious operations of banking, by providing, if I may be allowed so violent a metaphor, a sort of waggon-way through the air; enable the country to convert, as it were a great part of its highways into good pastures and corn fields, and thereby to increase very considerably the annual produce of its land and labour”*

*An Inquiry into the Nature and Causes of the Wealth of Nations*

Adam Smith

This work analyses Russian laws of security and insolvency as they may be applicable in the international banking markets.

The motives for the analysis are not just legal, but also economic. Arguably, money and credit are the lifeblood of any modern economy. Should the system fail to, or inefficiently, function, this would affect the other businesses at large. Nowadays, banks fulfill many functions, but the core banking role is the intermediation of money: banks transfer cash from those with its surplus to those who require it. Rarely a modern business can continue to operate, all the more expand, without credit. Large projects, in infrastructure, energy, oil and gas, *etc.*, all require substantial investments and the use of borrowed funds. Generally, cheaper credit means more investment and, consequently, wealth and employment. The price for credit, the interest rate, reflects risk. Legal risk is one of the risks that affect interest rates: lower legal risk manifests itself in a lower interest rate.

From a certain perspective, bank lending can be divided into domestic and international. Not all borrowers have access to international markets; however, those who do have thereby access to more sophisticated products, larger commitments and cheaper interest rates. Some projects, due to their size and the inherent potential large exposure of an individual bank, may be funded only in the international markets by syndicate of banks. Thus, it is important that a given country has at least the potential to borrow in the international markets.

There are certain areas of law, which are more relevant for banking than others: “loan” law itself; security law; and insolvency law. In international banking it is customary to use one of the long-established law systems to govern the loan “part” of the transaction, *e.g.*, English or New-York law. As a matter of law of the jurisdictions involved, this is usually possible. The

parties' freedom to apply security law and insolvency law of their choice is, however, restricted: law of the jurisdiction where the secured assets are located and the borrower (or other relevant entity) is incorporated apply, respectively.<sup>1</sup> Thus, in an international banking transaction, involving Russian economic interests, the parties are bound by certain rules of Russian law. Such rules can either facilitate or impede international lending. This work researches into Russian law of security and insolvency in order to establish how they may affect cross-border financing transaction.

Russia is a country with a continental law system and, as other such systems, is primarily based on codification and other statutory law. For the purposes of this work the most relevant code and statutes are: the Civil Code of the Russian Federation, Parts I-IV (the "**Civil Code 1994**");<sup>2</sup> the Law of the Russian Federation No. 2872-1 "On Pledge", dated 29 May 1992 (the "**Law on Pledge**"); and the Federal Law No.127-FZ "On Insolvency (Bankruptcy)", dated 26 October 2002 (the "**Law on Insolvency 2002**").<sup>3</sup> Other relevant statutes will be introduced along with the discussion below.

It is often assumed that judgments are not sources of law in continental systems. Though this may be technically correct, judgments of higher Russian courts have, at least, persuasive nature.<sup>4</sup> Thus, relevant Russian "case law" is also discussed in this work.

The Russian Federation in its modern form is a relatively young State: it is the successor to the Russian Socialist Federative Soviet Republic, a part of the Union of the Soviet Socialist Republics, which ceased to exist only in December 1991.<sup>5</sup> The declared policies of the U.S.S.R. were socialism and state planning in the economy. Lending in the U.S.S.R. was based on the directives of the State and not on the assessment of risks. Soviet law was an expression of these policies and was unfit for market practice in general and banking in particular. Arguably, the Soviet legal tradition, having existed for over seven decades, influenced modern Russian law. Thus, a review of Soviet law provided in Chapter Chapter 1 will help a better understanding of the current position of Russian legislators and the courts. Such a review will also highlight the "revolution" in Russian law: the shift from direct state regulation to free market principles. Soviet law is discussed in Chapter 1 *Soviet Law* below.

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<sup>1</sup> See *Security, Insolvency and Conflict of Laws* on p.68 below.

<sup>2</sup> The Civil Code 1994 was adopted in stages: Part I (No.51-FZ) was adopted on 30 November 1994; Part II (No.14-FZ) – on 26 January 1996; Part III (No.146-FZ) – on 26 November 2001; and Part IV (No.230-FZ) – on 18 December 2006. The articles of the Civil Code 1994 are numbered consecutively throughout all parts, and, thus, references to parts are, generally, omitted here. The "1994" in the definition is used to distinguish the modern code from the earlier Soviet civil codes, adopted in 1922 and 1964.

<sup>3</sup> Unless the contrary follows from the context, the legislation is stated herein as current on 1 April 2010.

<sup>4</sup> See *Sources of Law* in Annex *Modern Russian State and Law* on p.219 below.

<sup>5</sup> See *Transitional Period* on p.36 below.

Chapter 2 *Security Law* reviews current Russian law of security, as it may be encountered in a cross-border financing deal. As *Security Law* will show, most Russian forms of security would not be recognized as such in English law; at best they could be characterized as *quasi* security. The major part of the chapter analyzes the difficulties that Russian law may pose with respect to certain aspects of security, *e.g.*, security over future assets and for future obligations. A particular emphasis is made on the court's approach to security: Russian courts adopt a very active approach and judgments in this area are of no lesser importance than the respective statutes.

Chapter 3 *Insolvency Law* analyses the post-Soviet law of insolvency as it is applied with respect to a general commercial company incorporated in Russia. The history of Russian insolvency law is quite controversial and is also reviewed in the chapter. In fact, the Law on Insolvency 2002 is the third-generation insolvency statute adopted since the collapse of the U.S.S.R. And, for example, the infamous second-generation law, the Law "On Insolvency (Bankruptcy)" adopted in 1998 had defects, which allowed it to be used in *mala fide* as a tool for hostile takeovers. In review of insolvency law particular attention is given to the treatment of security on insolvency of the debtor and other available mechanisms to obtain recovery.

The discussion of Russian security and insolvency laws requires a basic understanding of the modern Russian State and its legal system. Though ordinarily a cross-border financing transaction is not immediately concerned with these matters, they are nevertheless relevant. Thus, their brief review is included into this work as Annex *Modern Russian State and Law*. It may be useful to refer to the Annex before proceeding to Chapters 2 and 3.

*Modern Russian State and Law* covers: the system of Russian federative organization (*i.e.*, the relationship among the federal powers and constituencies – the "local" authorities); the separation of powers among the executive, legislative powers and judiciary; main sources of law, as may be relevant for a cross-border financing transaction; and the system of courts (including the status and nature of court "case law").



# Chapter 1. SOVIET LAW

The history of Russia in the twentieth century is rich in dramatic events: during the period of only a hundred years, the country experienced four changes in, or attempts to change, its constitutional organization (revolutions, “revolution” here is used in its broad meaning).

The twentieth century started with the uprising of 1905, which was sparked by the Imperial Guard opening fire at a workers’ demonstration in Saint Petersburg. As a result, the first Constitution of the Russian Empire was adopted and a parliament – the State Duma – was created. Arguably, the Russian Empire became a constitutional monarchy.<sup>6</sup>

Later, 1917 was a year of not one, but two revolutions. The first, the February (March)<sup>7</sup> Revolution often receives less attention than the successive October (November) Revolution. As the result of the first revolution, the socialist Provisional Government came to power;<sup>8</sup> and as the outcome of the second revolution, the Bolshevist<sup>9</sup> Government, having overthrown the Provisional Government, took over the reins of power.

The Union of Soviet Socialist Republics (the “**U.S.S.R.**” or “**Soviet Union**”) was formed in 1922. The Soviet Union initially included four republics:<sup>10</sup> the Belorussian Socialist Soviet Republic, the Russian Socialist Federative Soviet Republic (the “**R.S.F.S.R.**”), the Transcaucasian Socialist Federative Soviet Republic<sup>11</sup> and Ukrainian Socialist Soviet Republic. In the following decades, the U.S.S.R. grew to include eventually 15 republics.<sup>12</sup>

The Bolshevist Government and later, the Communist Party of the Soviet Union (the “**CPSU**”), saw as their main objective the construction of a communist society. In this light, some five decades later, the Constitution of the U.S.S.R. 1977 declared in its preamble that a

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<sup>6</sup> The political weight and the role of the Duma changed in the period of 1906-1917; however, the description of such changes is beyond the scope of this work.

<sup>7</sup> Before 1918 Russia used Julian calendar. A difference of 13 days exists between the now widely used Gregorian calendar and Julian calendars for the period described; therefore, two dates (Julian and Gregorian) are often given for events in Russia occurring before 1918. As a consequence of the 13-day difference, the “October” 1917 revolution was officially celebrated in Russia on the 7<sup>th</sup> of November.

<sup>8</sup> Russian Tzar Nicholas II abdicated on 2 (15) March 1917.

<sup>9</sup> Bolsheviks were a faction in the Russian Social Democratic Labor Party. The party played a significant role in the earlier Provisional Government.

<sup>10</sup> A “republic” was an “immediate” (in terms of hierarchy) constituency of the Soviet Union with a degree of autonomy and own government.

<sup>11</sup> Transcaucasian Socialist Federative Soviet Republic at that time included Armenia, Azerbaijan and Georgia.

<sup>12</sup> Armenia, Azerbaijan, Belorussia, Estonia, Georgia, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. Technically, in 40-50s, there were 16 republics in the Soviet Union; that is until in 1956 the status of the Karelo-Finnish S.S.R. was demoted.

socialist society had been built in the U.S.S.R. and that the state was progressing further on the road to communism.

In the U.S.S.R. political views had a direct effect on the social and economic spheres: Soviet law, in particular, also was a derivative of the state's policy. In a conference taking place on 16-19 July 1938, the following definition was given:

*“Soviet law is a complex of rules of behavior, set in a legislative [manner] by the authority of laboring [people], expressing their will and the application of which is secured with the whole of the coercive power of the socialist state with the objectives of protection, cementing and development of relationships and practices beneficial to, and desired by, the laboring [people], full and ultimate destruction of capitalism and its relics in the economy, life and consciousness of people, construction of a communist society.”*<sup>13</sup>

It is worth mentioning here that one of the cornerstones of the Bolsheviks' and CPSU's policies was the abolition of private property on means of production. For example, chapter two of the Constitution of the R.S.F.S.R. 1918 declared, *inter alia*, that private ownership of land was abolished and that first steps (in the same direction) were taken in respect of other means of production.

The implications of the absence of private property were crucial for the purposes of this work. Suffice it to say that as a consequence neither (domestic) commercial financing transactions – in the western sense of this expression – occurred, nor a developed banking system existed.<sup>14</sup> Furthermore, the U.S.S.R. was a state with a planned economy, where the state directed the production and consumption and regulated the prices; and (free) market trade was generally prohibited.<sup>15</sup>

The attitude towards private property in Russia and U.S.S.R. evolved with time. Private property was “allowed” to exist, albeit with restrictions, under the rules of the Civil Code of the R.S.F.S.R. 1922;<sup>16</sup> private property was abolished and “replaced” with “*personal*

<sup>13</sup> See V.Eleonskii, “Pages of History: A Citizen and the Theory of Soviet Law”, *Citizen and Law*, No.6, 2008.

<sup>14</sup> As is explained in this chapter, the approach to “private property” in Russia and U.S.S.R. evolved with time. For example, private property was allowed to “exist” in the U.S.S.R. Constitution 1922; however, “private property” was “replaced” with “personal property” in the U.S.S.R Constitution 1977.

<sup>15</sup> On provisions related to state planning of the economy, see for example Article 11 of the U.S.S.R. Constitution 1936 (p.19 below).

<sup>16</sup> It must be noted that though private property existed under the Civil Code 1922, “[e]ven after the introduction into the statized economy of certain limited elements of market economy (known as NEP – New Economic Policy) that “we recognize no private property. The economy is publicly owned, not privately”. In a secret letter, he insisted that the new civil legislation be introduced to allow “the state to interfere more freely in the relation of ‘private ownership’ and to expand the right of state to annul private contract...”. Consequently, the Soviet Civil

*property*” under the Constitution of the U.S.S.R. 1936;<sup>17</sup> the same approach was retained in the Constitution of the U.S.S.R. 1977; and U.S.S.R. legislation adopted during the early reform years of the 1980s<sup>18</sup> relaxed restrictions on the private ownership of the means of production.

Nevertheless, it is a mistake to assume that prior to the reforms of the 1980s the Soviet government completely failed to recognize any economic incentives except for the (administrative and criminal) liability for non-compliance with the obligations imposed by the directives of the state plan. In particular, Soviet law at times promoted the use of economic incentives related to profit or turnover.<sup>19</sup>

The mid-1980s in the U.S.S.R. are known for their, although apparently still socialist, far-reaching political and economic reforms. Along with the process, in December 1991, the Soviet Union collapsed. And after the dissolution of the U.S.S.R., rather radical, free-market economic reforms were implemented in Russia.<sup>20</sup>

The period beginning with the second revolution of 1917 and ending with the dissolution of the Soviet Union in 1990 will be referred below to as the “**Soviet period**”. The objective of the chapter is to follow the development of laws of the U.S.S.R. and R.S.F.S.R. on property

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*Code of 1922 [...] had limited effect and [was] applied in circumstances of [its] total dependence on bases of public directive and on (often arbitrary) administrative discretion.”, from S.Alekseev, “On some Tendencies in World Legal Development and the Russian Legal System”, 27 Review of Central and East European Law No.4, 2001, pp.569-70.*

<sup>17</sup> Though “small private economy” was still allowed to exist by the U.S.S.R. Constitution 1936, see p.19 below.

<sup>18</sup> See, for example, the description of the Law of the U.S.S.R. on Individual Labor Activity 1986, on p.54 below, and *Law on Cooperatives* on p.38. below. At this point it also must be noted that the Soviet Union’s economic policy and legislation underwent fundamental transformation during the reforms of the 1980s; and, it appears, that in the course of such reforms, private property on means of production was allowed to “creep in” slowly into the soviet economy, although, arguably, in a disguised.

<sup>19</sup> See, for example, references to “economic accountability” in the Civil Code 1964 (on p. 29 below).

Generally, it appears that it had been difficult for a foreign observer to identify changes in Soviet law: “*The changes in the USSR were difficult to measure [...]. Change was so gradual that many observers questioned whether there were any changes of significance going on at all; in the Soviet system there was little change of the kind that democratic, market-oriented scientists have experienced in the twentieth century (especially in the post-WWII period). True, change within the USSR was seen by domestic observers, e.g., in the move from the 1936 Constitution to the 1977 Constitution. Foreign observers, on the other hand, were often forced to examine the minutiae in comparing these document to find something that they could quantify as change since the big picture remained constant and state and party policy unswerving in their course*”, from “A Measure of Change: Legal Reform in the CIS”, W.Simons, 26 Review of Central and East European Law 2000, No.4, p.453. As will be shown in below, changes did occur in the Soviet Union; however, the leading role of the state and the CPSU in the economy remained the defining characteristic of the system throughout.

<sup>20</sup> For example, on the “rule of law” aspect of the reforms in the CIS, see F.Feldbrugge, “The Rule of Law in the European CIS States”, 26 Review of Central and East European Law 2000, No.3, pp.213-230; see also W.Simons, “A Measure of Change: Legal Reform in the CIS”, 26 Review of Central and East European Law 2000, No.4, pp.453-458. See also D. Avramova, “The Wind of Change: the Emergence of Democratization in Bulgaria and the USSR” in “Overview of the Establishment and Evolution of Commercial Law In Bulgaria and Russia from the Beginning of the Twentieth Century – Part I”, *International Company and Commercial Law Review*, 2009 (I.C.C.L.R. 176).

and finance during the Soviet period with a view to show what implications it may have had on the current law of finance in Russia.

In addition to the Soviet period, this chapter also covers post-soviet years with respect to privatization. Early privatization<sup>21</sup> started in the U.S.S.R. in the 1980s and was continued in the Russian Federation (*i.e.*, outside of the Soviet period). Perhaps, privatization during the Soviet period and in the post-December 1991 years could be analyzed separately. However, such an artificial dissection would not be helpful.

For practical reasons, it is necessary to limit the scope of the review below to the most important documents of the Soviet period and privatization. Thus, the review will start with constitutions: the first Constitution of the R.S.F.S.R. and the subsequently adopted Constitutions of the U.S.S.R.<sup>22</sup> Constitutions were officially known in Russia and the Soviet Union as the “*foundation laws*” of the state. Constitutions, *inter alia*, set forth the framework and rules related to administrative organization of the state, judicial powers and property.

According to professor Hazard, “[a] primary element of [Russian legal] tradition was codification of law. Beginning with the *Russkaia Pravda* and continuing through *Ulozhenie* and the many great charters and codes that were to follow into the nineteenth century when that tradition was vastly strengthened by borrowing from the Romanist “West”, was shaped in the Empire, not by judges as in the common law world, but in written form by the Supreme Authority, the Tsar.”<sup>23</sup> “[C]odification plays an important role in the development of law in general and [codification] is the most radical method of systematization of legislation, [and] a distinct kind of lawmaking.”<sup>24</sup> In other words, Russian law traditionally adopts a pandectist approach.<sup>25</sup> The most relevant branch of law<sup>26</sup> for the purposes of this work is civil law, and thus, the next reviewed documents are the civil codes of the R.S.F.S.R.

Arguably, a civil code occupies a most prominent position in the body of Russian commercial law. Probably, it is the first document that a transactional lawyer refers to when considering a particular commercial transaction (including a financial transaction). During the Soviet

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<sup>21</sup> The term “early” privatization generally refers here to privatization occurring until and including the years 1994-1995; on stages of privatization see *Privatization and Market Reforms*, p.53 below.

<sup>22</sup> Subsequently, during the Soviet period, other constitutions of the R.S.F.S.R. were adopted; however, the primacy, arguably, rested with the U.S.S.R. constitutions (once the Soviet Union was established) and, hence, only the first constitution of the R.S.F.S.R. will be considered here.

<sup>23</sup> *Russian Law: Historical and Political Perspectives*, William E. Butler (ed.), Sijthoff, Leyden, 1977, p.237.

<sup>24</sup> D.Medvedev (ed.) – at that time the First Deputy Chairman of the Government of the Russian Federation, *Codification of Russian Civil Law*, Statut, Moscow, 2008.

<sup>25</sup> See for example, *The Genesis of the Code* in “The New Civil Code of the Russian Federation”, 21 *Review of Central and East European Law* 1995, No.3/4, pp.237-9.

<sup>26</sup> See *Branches of Law* on p.218 below.

period, two civil codes were adopted in the R.S.F.S.R. In addition, the U.S.S.R. authorities adopted documents of a similar nature (the Foundations of Civil Legislation of the Union of the S.S.R. and Republics). In 1991 a new version of the Foundations of Civil Legislation of the Union of the S.S.R. and Republics was adopted; this document was ratified by the R.S.F.S.R. authorities to be used as a “bridge” before a new Russian civil code was adopted. The Foundations 1991, due to its unique role in the development of modern Russian law, are also reviewed below.

Finally, the reforms of the 1980-90s brought into being other major legislative acts on privatization, property, *etc.*, that provided the foundation for the modern Russian law; and the most important of such documents are also discussed below.

## 1.A. Constitutions

### (i) *R.S.F.S.R. Constitution 1918 and Decrees on Courts*

The Constitution of the Russian Socialist Federative Soviet Republic (Foundation Law) 1918 (the “**R.S.F.S.R. Constitution 1918**”) was adopted shortly after the 1917 October Revolution.<sup>27</sup> Article 1 of the R.S.F.S.R. Constitution 1918 declared that the Russian Republic was a State of Soviets of Workers', Soldiers', and Peasants' Deputies.<sup>28</sup>

Article 2 is crucial for an understanding of the policy of the Bolshevik government. In just a few paragraphs, the R.S.F.S.R. Constitution 1918 dealt with such issues as ownership of land, expropriation of the means of production, foreign borrowing and banks:

*“a. In order to establish the 'socialization' of land, private ownership of land is abolished; all land is declared national property, and is handed over to the laboring masses, without compensation, on the basis of an equitable division giving the right of use only. ...*

*c. As the first step toward the complete transfer of factories, works, shops, mines, railways, and other means of production and of transport to the ownership of the Workers' and Peasants' Soviet Republic, and in order to insure the supremacy of the*

<sup>27</sup> Adopted by the V<sup>th</sup> All-Russian Congress of the Soviets on 10 July 1918.

For a historical account of the adoption of the R.S.F.S.R. Constitution 1918, see O.Chistyakov, *Constitution of the R.S.F.S.R. 1918*, 2<sup>nd</sup> ed., Zertalo-M, Moscow, 2003.

<sup>28</sup> It is interesting to note that this formula narrows the “scope” of the State to only three “classes”. The reference to “soldiers” has been excluded in the later, 1936, U.S.S.R. Constitution (Article 1, see p.18 below); the 1977 U.S.S.R. Constitution, however, took the route of widening the scope of the state to also include “*intelligentsia* and all working people”, see p.22 below.

*laboring masses over the exploiters, the Congress ratifies the soviet law on workers' control of industry and on the Highest Council of Peoples' Economy.*<sup>29</sup>

*d. The III<sup>rd</sup> All-Russian Congress of Soviets considers the soviet law repudiating the loans contracted by the government of the Tsar, the landlords, and the bourgeoisie as a first blow at international financial capitalism; and it expresses its conviction that the Soviet government will continue firmly in this direction until the complete victory of the international revolt of the workers against the yoke of capitalism.*

*e. The Congress ratifies the transfer of all banks to the ownership of the workers' and peasants' government as one of the conditions insuring the emancipation of the toiling masses from the capitalistic yoke.”*<sup>30</sup>

Characteristically, the Constitution of the R.S.F.S.R. 1918 provided that *“The financial policy of the [R.S.F.S.R.] ... to this end [...] sets forth as its task the supplying of the organs of the soviet power with all necessary funds for local and state needs of the Soviet Republic, without regard to private property rights”* (Article 79).

The Constitution set forth the political organization of the State as follows: the All-Russian Congress of Soviets was the supreme power of the state (Article 24), and the All-Russian Central Executive Committee was the supreme legislative, executive and controlling body (Article 31) and the Council of People's Commissars was the general *“management”* authority (Article 31).<sup>31</sup> It is clear that the functions of the state authorities did not follow the

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<sup>29</sup> The nationalization of business enterprises was carried out in stages: on 14 November 1917 the Decree of the Central Executive Committee and the Council of People's Commissars *“On Workers' Control”* was adopted. According to the decree, *“workers' control”* over the production, purchase, sale of goods and raw materials, their storage (by/at the enterprise) was introduced; in addition, *“workers' control”* was established in relation to the financial *“side”* of an enterprise. Interestingly, the decree also provided for criminal liability for the absence from the workplace without cause. The Soviet authorities initially issued decrees on nationalizing enterprises on a case by case basis; this approach then gradually was transformed into nationalizations of whole industries. See B.Topornin (ed.), *The Establishing and Development of Constitutional Legislation of Soviet Russia, 1917-1920*, Moscow, 1987, pp.59 and 63.

<sup>30</sup> According to an earlier Decree *“On Confiscation of Share Capitals of Former Private Banks”*, dated 26 January 1918, adopted by the Council of People's Commissars, share capitals of private banks were *“transferred”* to the State Bank of the Russian Republic on the basis of full confiscation.

<sup>31</sup> There was a degree of overlapping between the role of the Central Executive Committee and the Council of People's Commissars. According to B.Topornin (ed.), *The Establishing and Development of Constitutional Legislation of Soviet Russia, 1917-1920*, Moscow, 1987, p.55, the Central Executive Committee was designated in a number of legal documents as a highest authority of the state; however, the Council of People's Commissars also acted as the highest state authority in certain cases, which was accountable to the Central Executive Committee. In Directive dated 17 November 1917, adopted by the Central Executive Committee, it was stated that *“All legislative acts, and equally, orders of major all-political significance are submitted for approval to the Central Executive Committee”*. There was also a resolution of the Central Executive Committee, dated 4 November 1917, that allowed the Council of People's Commissars to adopt urgent matters without their submission and approval by the Central Executive Committee.

theory of the separation of powers,<sup>32</sup> and to some extent, created bodies were charged with similar tasks (the Council and Committee).

The Constitution omitted to make a single reference to judicial power. Documents, which related to the judiciary in the newly established Soviet Republic, were promulgated in the form of decrees, of which there were three main decrees adopted within a period of less than a year. According to the Decree "On Courts" (No.1),<sup>33</sup> "*all pre-existing judicial establishments [were] abolished, including, inter alia: district courts and court chambers, ... commercial courts, ..., replacing all such establishments with courts elected on democratic principles.*" Justices of the peace were replaced by "*local judges*", who were initially intended to be elected on the basis of (general) "*direct democratic elections*", and until such elections took place, by the respective Soviets of the Workers, Soldiers and Peasants' Deputies. However, elections by the Soviets perpetuated despite the initial intention of changeover to the general elections.<sup>34</sup> The Decree "On Courts" (No.1) also created the infamous "*revolutionary tribunals*".<sup>35</sup> Revolutionary tribunals were charged with the task of suppressing counter-revolution and "*abuses*" by the traders, manufactures, etc. Thus, the Decree "On Courts (No.1)" created two parallel court systems.<sup>36</sup>

Court investigators, prosecutors and advocates were also abolished. According to the Decree "On Courts" (No.1), prosecution and defense could have been conducted by all "*untarnished*" citizens.

In the making of their decisions, the local courts had to follow the laws of the "*deposed*" (*i.e.*, previous) governments only to the extent that they were not annulled by the revolution and did not contradict to the "*revolutionary [and legal] consciousness*".<sup>37</sup>

<sup>32</sup> For a modern analysis of implementations of separation of powers see "The "newest" separation of powers: semipresidentialism" (and on Russia therein - 4.3). C.Skach, "Postcommunist Russia", *International Journal of Constitutional Law*, 2007 (I.J.C.L. 93).

<sup>33</sup> Adopted by the Council of People's Commissars on 24 November 1917.

<sup>34</sup> B.Topornin (ed.), *The Establishing and Development of Constitutional Legislation of Soviet Russia, 1917-1920*, Moscow, 1987, p.68.

<sup>35</sup> "*Chairpersons of such tribunals, having not even the elementary juridical knowledge and receiving [wide] powers, engaged in mayhem, which was called "revolutionary legal consciousness"*". From A.Gus'kova and A. Shamardin, *Law Enforcement Bodies (Judicial System)*, Jurist, 2005.

For a comparison between the French *tribunal révolutionnaire* and Russian revolutionary tribunals, see A.Melekhin *Specific Legal Regimes of Russian Federation*, prepared for, and available in, *ConsultantPlus*, 2007.

<sup>36</sup> See O.Chistyakov, *History of National State and Law. Part II*, 3<sup>rd</sup> ed., Jurist, 2002.

<sup>37</sup> In W.Butler (ed.), *Russian Law: Historical and Political Perspectives*, Sijthoff, Leyden, 1977, Professor J.Hazard, p.237, it appears, interprets the reference to "*consciousness*" as a step away from the pandectist system in Russian law (perhaps, towards judge-made law). However, it seems that the legislator was compelled to refer to "*consciousness*" out of necessity, rather than out of desire to alter the pandectist foundations of the Russian legal system: there simply was no body of laws, not to mention codes, that the Soviet government could rely upon at that time. In addition, the judges had to *refuse* to apply the old laws if they were contrary to the "*revolutionary*

The Decree “On Courts” (No.2)<sup>38</sup> created a higher-standing system of courts: district courts.<sup>39</sup> Unlike in the Decree “On Courts” (No.1), no provision at all was made for the general elections of district courts; district courts’ members were elected by the Soviets of the Workers, Soldiers, Peasants and Cossacks’ Deputies.

The Decree “On Courts” (No.2), provided that pre-trial investigations were conducted by special commissions and created a “[panel] of persons who devote themselves to [legal representation] in the form of prosecution or defense” and certain restrictions were put in place on participation in court trials of non-members of the panel. This was a reversal from the approach adopted by its predecessor, the Decree “On Courts” (No.1).

The R.S.F.S.R. Constitution 1918 and the mentioned Decrees on Courts (Nos.1 and 2) were not particularly complex and lacked detail. And this was natural in the circumstances: with these documents the nascent government was solving, and carrying out, most urgent problems and reforms. Even so, the documents made it clear that an attack on private property had begun, that the banking system was not a private, but a public matter, and that the courts were an instrument of policy, rather than justice.

## **(ii) U.S.S.R. Constitution 1924**

The Foundation Law (Constitution) of the Union of the Soviet Socialist Republics (1924) (the “**U.S.S.R. Constitution 1924**”) was adopted on 31 January 1924.<sup>40</sup> The U.S.S.R. Constitution 1924 consisted of two main parts: (i) the Declaration “On the Establishment of the Union of the Soviet Socialist Republics”; and (ii) the Agreement “On the Establishment of the Union of Soviet Socialist Republics”.<sup>41</sup>

As can be expected, the U.S.S.R. Constitution 1924 included socialist political declarations. Its main objective was to set forth the organizational structure and authority of the Soviet

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*consciousness*”; this, arguably, should not be read to imply that the judges were *creating* laws based on the “*revolutionary consciousness*”.

<sup>38</sup> Adopted by the All-Russian Central Executive Committee on 7 March 1918.

<sup>39</sup> Decree “On Courts” (No.2) set forth the system and the procedure for seeking redress after a decision of district courts were made in the higher, “cassation” proceedings in “regional courts”. In addition, “judicial control” – a body with the task to streamline the decisions of cassation instance – was created in Moscow.

<sup>40</sup> See the Resolution of the II<sup>nd</sup> Meeting of the Soviets of the Union of the Soviet Socialist Republics “On Approval of the Foundation Law (Constitution) of the Union of the Soviet Socialist Republics”, dated 31 January 1924.

The dating of the U.S.S.R. Constitution 1924 is subject to dispute. The text was adopted by the Central Executive Committee of the Soviet Union on 6 July 1923; and prior to the adoption of the U.S.S.R. Constitution 1936, the respective state holiday – Constitution Day – was celebrated on 6<sup>th</sup> of July (from O.Chistyakov, *Constitution of the U.S.S.R. 1924*, Moscow, Zertalo-M, 2004).

<sup>41</sup> In reality, the (actual) Agreement on Establishment of the Union of Soviet Socialist Republics was adopted by the I<sup>st</sup> Meeting of the Soviets of the Union of the Soviet Socialist Republics on the 30 December 1922. The text of the “agreement” included into the U.S.S.R. Constitution 1924 and the agreement adopted in 1922 differed significantly.

The Declaration fulfilled exactly the role of a mere declaration (or a preamble, though technically it was not a preamble); and it was the Agreement that carried the legal weight.



Union and its constituent Republics.<sup>42</sup> Matters related to property or finance received little attention.

According to the U.S.S.R. Constitution 1924, the powers of the Union (level) included, *inter alia*: the direction of foreign trade and the establishment of the system of domestic trade; the foundations for, and the general planning of, the people's economy of the Soviet Union; concession agreements; the direction of a single monetary and credit system; and matters related to land.

The U.S.S.R. Constitution 1924 set out the basic rules with respect to the administration of the Union. In particular, it provided that "*the Presidium of [the Central Executive Committee] of the [Soviet Union], in periods between the sessions of the [Central Executive Committee] of the [Soviet Union], is the highest legislative, executive and administrative state authority of the [Soviet Union]*".<sup>43</sup> The reader will note here the Bolsheviks' attitude to the classical *trias politica* doctrine: the Presidium of the Central Executive Committee had at least two of the three powers (between sessions of the Central Executive Committee of the Soviet Union), with the exception of only one "power": judicial power. In turn, all decrees, resolutions and directives, issued by the Central Executive Committee (of the Soviet Union) were mandatory throughout the U.S.S.R. (Article 18). The Presidium of the Central Executive Committee also had the power to issue decrees, resolutions and directives (Article 33); and the Council of People's Commissars of the Soviet Union (the "Government") had the power to issue decrees and resolutions mandatory throughout the U.S.S.R. within the authority granted by the Central Executive Committee and on the basis of the respective Regulation On the Council of People's Commissars.

Unlike the R.S.F.S.R. Constitution 1918, the U.S.S.R. Constitution 1924 included provisions on the judiciary. According to Chapter VII, "[w]ith a view to the assertion of revolutionary legitimacy<sup>44</sup> on the territory of the [Soviet Union], the Supreme Court is established within the (framework of the) [Central Executive Committee]..." Perhaps, the reference to the "assertion of revolutionary legitimacy" is a good illustration of the role of courts in the nascent state.

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<sup>42</sup> There is considerable amount of interesting detail with respect to the formation of the Soviet Union and the history of the U.S.S.R. Constitution 1924. See, for example, *Constitution of the U.S.S.R. 1924*, O.Chistyakov, Moscow, Zertalo-M, 2004 *passim* and *History of Soviet Russia*, Vol 1, sections *The Bolshevik Revolution, 1917-23* and *Socialism in One Country 1924-26*, Edward Hallett Carr, Macmillan, 1978.

<sup>43</sup> Article 29 of the U.S.S.R. Constitution 1924.

<sup>44</sup> The word used in the original text is "zakonnost'", which may be translated also as "law"; however, it seems that "legitimacy" conveys the meaning slightly better given the context.

Pursuant to Article 7 of the U.S.S.R. Constitution 1924, a single (U.S.S.R.) citizenship was established for the citizens of the Soviet Republics.

The role of the U.S.S.R. Constitution 1924 is primarily in that it re-casted the (international) agreements “on” a single state – the U.S.S.R. – into the Constitution of that State. As with the R.S.F.S.R. Constitution 1918, the U.S.S.R. Constitution 1924 had certain political objectives and commercial relationships were not high on the agenda at that time – thus, the lack of the respective provisions. However, some references (*e.g.*, the mentioned reference to “*revolutionary legitimacy*”) confirm again the role that the law played: that of an instrument of socialist policy, rather than anything else.

### **(iii) U.S.S.R. Constitution 1936**

In December 1936 a new constitution of the Soviet Union was adopted.<sup>45</sup> The new constitution was called in the press the “*Stalin’s constitution*”<sup>46</sup> and covered the economic and legal foundations of the soviet society in greater detail when compared to its predecessor, the U.S.S.R. Constitution 1924. The U.S.S.R. Constitution 1936 provided, *inter alia*, that:

- *the Union of Soviet Socialist Republics is a socialist state of workers and peasants (Article 1);*
- *the socialist system of economy and the socialist ownership of the means and instruments of production firmly established as a result of the abolition of the capitalist system of economy, the abrogation of private ownership of the means and instruments of production and the abolition of the exploitation of man by man, constitute the economic foundation of the U.S.S.R. (Article 4);*
- *socialist property in the U.S.S.R. exists either in the form of state property (the possession of the whole people), or in the form of cooperative and collective-farm property (property of a collective farm or property of a cooperative association) (Article 5);*
- *the land, its natural deposits, waters, forests, mills, factories, mines, rail, water and air transport, banks, post, telegraph and telephones, large state-organized agricultural enterprises (state farms, machine and tractor stations and the like) as*

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<sup>45</sup> Work on the Constitution started in 1935; however, it was initially intended that the U.S.S.R. Constitution be simply amended: see S.Avak’yan, *Constitution of the U.S.S.R. 1936 Constitution of the R.S.F.S.R. 1937 in Constitution of Russia: Nature, Evolution, Modern Age*, 2<sup>nd</sup> ed., Sashko, Moscow, 2000.

<sup>46</sup> See “Toward “Constitutionalism” in Russia: the Russian Constitutional Court”, *International and Comparative Law Quarterly*, Vol. 42, July 1993, p.674 and S. Avak’yan, “Political Relationships and Constitutional Regulation in Modern Russia: Problems and Perspectives”, *Journal of Russian Law*, No.11, 2003.

*well as municipal enterprises and the bulk of the dwelling houses in the cities and industrial localities, are state property, that is, [they] belong to the whole people (Article 6);*

- *public enterprises in the form of collective farms and cooperative organizations, with their livestock and implements, the products of the collective farms and cooperative organizations, as well as their common buildings, constitute the common socialist property of the collective farms and cooperative organizations. In addition to its basic income from the public collective-farm enterprise, every household in a collective farm has for its personal use a small plot of land attached to the dwelling and, as its personal property, a subsidiary establishment on the plot, a dwelling house, livestock, poultry and minor agricultural implements in accordance with the statutes of the agricultural artel (Article 7);*
- *the land occupied by collective farms is secured to them for their use free of charge and for an unlimited time, that is, in perpetuity (Article 8);*
- *alongside the socialist system of economy, which is the predominant form of economy in the U.S.S.R., the law permits the small private economy of individual peasants and handicraftsman based on their personal labor and precluding the exploitation of the labor of others (Article 9);*
- *the right of citizens to personal ownership of their incomes from work and of their savings, of their dwelling houses and subsidiary household economy, their household furniture and utensils and Articles of personal use and convenience, as well as the right of inheritance of personal property of citizens, is protected by law (Article 10);*  
and
- *the economic life of the U.S.S.R. is determined and directed by the state national economic plan with the aim of increasing the public wealth, of steadily improving the material conditions of the working people and raising their cultural level, of consolidating the independence of the U.S.S.R. and strengthening its defensive capacity (Article 11).<sup>47</sup>*

The U.S.S.R. Constitution 1936 set forth the principles that would underpin the legal and political system until 1977 (when a new constitution was adopted).

From the quoted above text of the U.S.S.R. Constitution 1936, the reader may note that: private property was abolished (Article 4) and displaced in favor of, mainly, state property

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<sup>47</sup> At the time of writing, the English translation of the 1936 constitution is available online at <http://www.departments.bucknell.edu/russian/const/1936toc.html>.

(Article 5); “*farming*” property was directly regulated with respect to what could have been owned by individuals (Articles 6 and 7); personal property for a tradesman was allowed only to the extent that such property was used personally by that tradesman (Article 9); “*personal*” property was allowed – that is property that was held for “personal” use (Article 10);<sup>48</sup> and that instead of the market forces of supply and demand, the economy was to be governed by “*state national economic plan*” (Article 11).<sup>49</sup>

The U.S.S.R. Constitution 1936 further provided that the jurisdiction of the Soviet Union, as represented by its highest bodies of state authority and government bodies, covered, *inter alia*, the administration of the banks, industrial and agricultural establishments and enterprises and trading enterprises of all-Union importance and the direction of the monetary and credit system.<sup>50</sup>

The organization of the powers within the state was also significantly revised. In particular, the new Constitution provided that the legislative power of the U.S.S.R. was exercised exclusively by the Supreme Soviet of the U.S.S.R. (article 32).<sup>51</sup>

Furthermore, the role of the Presidium was changed. The Presidium of the Supreme Soviet of the U.S.S.R. was empowered, *inter alia*, to:

- interpret the laws of the U.S.S.R. and to issue decrees; and
- annul decisions and orders of the Council of People's Commissars of the U.S.S.R. if such decisions and orders did not conform to law.

Under the U.S.S.R. Constitution 1936, the Council of People's Commissars of the U.S.S.R. was the highest executive and administrative body in the Soviet Union (Article 64); its decisions and orders were binding throughout the U.S.S.R. (Article 67).

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<sup>48</sup> Personal property was “*strictly of consumption nature and was derived from socialist property ... Legal possibilities to increase personal property were limited to receiving wages at enterprises and establishments*” from *On Right of Private Property in Russia (Critical Essay)*, Andreev A., Wolters Kluwer, 2007. Perhaps, the author is narrowing down the scope of personal property to an unnecessary degree: personal property could have been created in other ways, *e.g.*, if a farmer made tools for his own use at his garden and ultimately for non-commercial purposes (*i.e.*, harvest could not be later offered for sale). However, the quote is a good illustration of the concept of personal property. Personal property could only be used for consumption by an individual himself (and, to a degree, by his relatives) and not of extraction of profits.

<sup>49</sup> Perhaps, the reader may also find interesting the following quotes from Article 12 of the U.S.S.R. Constitution 1936:

*“In the U.S.S.R. work is a duty and a matter of honor for every able-bodied citizen, in accordance with the principle: “He who does not work, neither shall he eat.””*

*“The principle applied in the U.S.S.R. is that of socialism: “From each according to his ability, to each according to his work.””*

<sup>50</sup> Article 14 of the U.S.S.R. Constitution 1936.

<sup>51</sup> The Supreme Soviet thus was analogous to a parliament. The Supreme Soviet consisted of two chambers: the Soviet of the Union and the Soviet of Nationalities (Article 33).

<sup>52</sup> The Council of People's Commissars of the U.S.S.R. was the Government of the U.S.S.R. (article 56).

Rules related to courts were revised, too. Article 102 provided that *“justice in the Soviet Union is administered by the [courts]”*. The reference to *“revolutionary legitimacy”*<sup>53</sup> disappeared. The inclusion of the first mentioned reference and the deletion of *“revolutionary legitimacy”*, which earlier allowed to officially “justify” any excesses and outright violence on the part of state authorities, were clearly positive developments in Soviet law. Furthermore, the U.S.S.R. Constitution 1936 declared that *“[j]udges are independent and subject only to the law”* (Article 112), which could be treated as evidence of a degree of distancing of the judges from the politics (at least on paper).

Another provision of the U.S.S.R. Constitution 1936, which demonstrates that property was not a private, but rather a public matter, was Article 131: *“it is the duty of every citizen of the U.S.S.R. to safeguard and strengthen public, socialist property as the sacred and inviolable foundation of the Soviet system... Persons committing offenses against public, socialist property are enemies of the people”*.

Compared with the U.S.S.R. Constitution 1924, the U.S.S.R. Constitution 1936 was a more “modern” document. The U.S.S.R. Constitution 1936, in spite of not following the classical theory of separation of powers among state authorities, recognized that state functions differed (with reference to executive, legislative and judicial functions/powers).<sup>54</sup> The courts were declared *“independent”*; however, the “executive” body of the legislature – the Presidium – could interpret laws. The declaration of the independence of courts was, in all likelihood, a political statement that was not implemented in practice, as was evidenced, for example, by the so-called Moscow (Show) Trials of 1936-38.<sup>55</sup>

The proper executive – the Council of People's Commissars – was declared the highest administrative body; however, since its decisions and orders were binding throughout the U.S.S.R., and no specific limitation on its authority was provided for, it essentially had jurisdiction to promulgate (quasi-)laws. In turn, decisions and orders of the Council of People's Commissars could have been annulled by the Presidium (which was, technically, a part of a legislative body).

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<sup>53</sup> See information on U.S.S.R. Constitution 1924 above, p.17.

<sup>54</sup> Cf. U.S.S.R. Constitution 1924, under which Presidium was *“the highest legislative, executive and administrative state authority”*, see p.17 above.

<sup>55</sup> For information on the Moscow Trials, see N.Leites, *Ritual of Liquidation. The Case of the Moscow Trials*, Free Press, Glencoe, 1954.

**(iv) U.S.S.R. Constitution 1977**

In October 1977 a new Constitution of the U.S.S.R. was adopted.<sup>56</sup> Its preamble declared that “[f]or the first time in the history of mankind a socialist society was created” and that “the aims of the dictatorship of the proletariat having been fulfilled, the Soviet state has become a state of the whole people”. Furthermore, this was a “... a natural, logical stage on the road to communism”. The U.S.S.R. Constitution 1977 also revised the reference to “state of workers and peasants” to read “of all people, expressing the will and interests of the workers, peasants, and intelligentsia, the working people of all the nations and nationalities...”<sup>57</sup> This was an important development: to finally recognize that the Soviet society also included other classes, in addition to workers and peasants.

With respect to the political system, the new constitution generally followed its predecessor. The highest body of state authority was the Supreme Soviet of the U.S.S.R., which was empowered to deal with all matters within the jurisdiction of the Soviet Union (Article 108). In line with the U.S.S.R. Constitution 1936, the Presidium of the Supreme Soviet was accountable to the Supreme Soviet and exercised the functions of the highest state authority between sessions of the Supreme Soviet, within the prescribed limits.

The Presidium retained powers to interpret laws and revoke decisions and ordinances of the (then) Council of Ministers of the U.S.S.R. if they did not conform to law (Article 121). The Presidium, between the “sessions” of Supreme Soviet of the U.S.S.R. (*i.e.*, during the periods when the Supreme Soviet was not convened), could amend (subject to subsequent confirmation) existing legislative acts of the U.S.S.R. “when necessary” (Article 122) and as before, adopt decrees and decisions (Article 123).

With respect to the soviet economy, the U.S.S.R. Constitution 1977 characteristically declared that the foundation of the economic system was the socialist ownership of the means of production in the form of state property (“belonging to all the people”), and collective farm-and-co-operative property. No one had the right to use socialist property for

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<sup>56</sup> The Constitution is sometimes referred to as “Brezhnev’s” constitution. Leonid Brezhnev was the Secretary of the CPSU in 60-70s.

Work on a new constitution for the Soviet Union started as early as 1962: the Supreme Soviet of the U.S.S.R. adopted a resolution on the establishment of a commission on 25 April 1962. “In the development of the draft Constitution everything was centered on the [type of] society that we had or were building during the new stage. To stay on the position of the dictatorship of the proletariat, as the essence of the society and authority, was impossible: there was no “class struggle” at that time, and, therefore, there were not even contrived grounds to give priority to one social [class] ahead of others or to consider some [classes] as if standing in the background. ... [Hence,] the concept of a matured, developed socialist society was born” from S.Avak’yan, *Constitution of the U.S.S.R. 1977 and Constitution of the R.S.F.S.R. 1978 in Constitution of Russia: Nature, Evolution, Modern Age*, 2<sup>nd</sup> ed., Sashko, Moscow, 2000.

<sup>57</sup> Cf Articles 1 of the 1936 and 1977 Constitutions

personal gain or other “*selfish ends*” (Article 10). As can be expected, the state owned the “major”<sup>58</sup> means of production in the industry, construction, and agriculture; means of transport and communication; the banks<sup>59</sup>, etc. (Article 11).

Similar to the U.S.S.R. Constitution 1936, the 1977 document regulated “personal property” in detail. According to Article 13, labor-derived income was the foundation for the personal property; and personal property could include articles of everyday use or for personal consumption and convenience, tools and other objects typical to a small-holding, a house, and labor-derived savings.

The Constitution declared that the State pursues a constant policy of raising citizens’ pay levels and real income through the increase in productivity (Article 23).<sup>60</sup> This confirmed the leading role of the state in determining the fortunes (or, misfortunes, as the case could have been) of its citizens.

With respect to the judiciary, the U.S.S.R. Constitution 1977 provided that “[j]ustice is administered in the U.S.S.R. only by the courts” (Article 151). The document then set out the hierarchy of courts in the U.S.S.R. with an important addition of a type of body – “*state arbitrazh*” – which was *prima facie* outside the definition of a court, but in practice performed functions that were similar to those of courts.

“*State arbitrazh bodies*” considered economic disputes between enterprises, institutions, and organizations (Article 163). The U.S.S.R. Constitution 1977 made a specific reference to a law on State Arbitrazh. In turn, the Law<sup>61</sup> provided that objectives of State Arbitrazh were, *inter alia*, to: (i) ensure the protection of rights and lawful interests of enterprises, establishments and organizations in the settlement of economic disputes; and (ii) actively influence enterprises and organizations so as to ensure their compliance with socialist law and timely entry into economic agreements. State Arbitrazh’s objectives also encompassed the fight against manifestations of parochialism and departmentalism in economic activities, application of statutory or contractual civil penalties to breaches of state discipline with respect to the carrying out of [state] plan assignments and contractual obligations.<sup>62</sup>

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<sup>58</sup> “*Osnovnye*” in Russian, perhaps, a better English equivalent is “long-term” or “capital”.

<sup>59</sup> State monopoly on banking was dispensed with in the Law on Cooperatives 1989. See *Law on Cooperatives* on p.38 below.

<sup>60</sup> This provision is *per se* quite intriguing in that that it demonstrates that the Soviet state acknowledged the role of money in the economy. Generally, money did not conform well with early socialist theories developed in Russia/U.S.S.R.

<sup>61</sup> The Law On State Arbitrazh in the U.S.S.R., dated 30 September 1979, Article 1.

<sup>62</sup> The State Arbitrazh organs were the predecessors of the modern Russian Arbitrazh Courts. Generally, Arbitrazh Courts are in charge of considering disputes between commercial entities. Litigation in the context of a financing transaction is likely to end up in Arbitrazh Courts, that is, of course, if any Russian judicial body was to be

State Arbitrazh was not new to the Soviet legal system at that time. Its history dates back to the Arbitrazh Commission with the Soviet of Labor and Defense and arbitrazh commissions with the district and governorate economical conferences created in 1922.<sup>63</sup> What the U.S.S.R. Constitution 1977 achieved with respect to State Arbitrazh was to put it on constitutional footing.

An apparent inconsistency in the approach of the U.S.S.R. Constitution 1977 to State Arbitrazh is that it did not refer to it as a “court”. On the one hand, according to the letter of the Constitution, justice was to be administered in the U.S.S.R. by the courts. State Arbitrazh was outside of the court system, yet performed similar functions. On the other hand, the functions of the State Arbitrazh were wider than of an “ordinary” court. State Arbitrazh had to: ensure that enterprises “*entered into economic agreements [in a] timely [manner]”; “fight parochialism”; and apply penalties. Historically, however, arbitrazh bodies were referenced to as “courts” in official Soviet documents. For example, according to the Regulation on Judicial System (1922),<sup>64</sup> the above-mentioned arbitrazh commissions were referred to as “special courts”.<sup>65</sup> In modern Russian legal theory, arbitrazh courts (which generally consider disputes between commercial entities) are considered to be courts “proper”; and this approach correctly reflects the nature of Arbitrazh.<sup>66</sup>*

Finally, it must be noted here that “State Arbitrazh” bodies was a misleading choice of title. The word “arbitrazh” may lead to an (erroneous) conclusion that State Arbitrazh was a “Soviet” form of an arbitral tribunal. It was not: State Arbitrazh were official state bodies with administrative and quasi-judicial powers over disputes with limited “jurisdiction” over disputes between socialist entities (not involving individuals). Thus, State Arbitrazh often had to consider cases with higher value and more complex set of facts, which led to State Arbitrazh becoming a more specialized and professional system of adjudicating on disputes.

From a socio-political perspective, the time of the adoption of the U.S.S.R. Constitution 1977 is often referred to as the “stagnation” period; and in fact, the new constitution was largely a continuation of its predecessor and had no “revolutionary” provisions.

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involved. Arbitrazh Courts’ judges are generally considered to be more verse in commercial transactions (and, hence, more “professional”) than their counterparts in the other system of courts – the courts of general jurisdiction.

<sup>63</sup> The Resolution of the All-Russian Executive Committee and the Council of People’s Commissars, dated 21 September 1922.

<sup>64</sup> The Resolution of the All-Russian Executive Committee, dated 11 November 1922.

<sup>65</sup> The source for the discussion of the history of State arbitrazh is M.Kleandrov, *Economic Justice in Russia: the Past, Present and the Future*, Wolters Kluwer, 2006.

<sup>66</sup> See *Arbitrazh Courts* on p.227 below.



## 1.B. Civil Codes

The traditional Russian legal approach is to codify<sup>67</sup> the main branches (areas) of law.<sup>68</sup> Of various codifications, those of civil law are most significant for the purposes of this work. In the period after the 1917 November revolution and until the current Civil Code was adopted in 1994,<sup>69</sup> the following civil law codifications existed: the Civil Code of R.S.F.S.R.,<sup>70</sup> adopted in 1922 (the “**Civil Code 1922**”),<sup>71</sup> the Foundations of Civil Legislation of the Union of S.S.R. and Union’s Republics adopted in 1960, the Civil Code of the R.S.F.S.R., adopted in 1964 (the “**Civil Code 1964**”),<sup>72</sup> and the Foundations of the Civil Legislation of the Union of the S.S.R. and Republics, adopted in 1991.<sup>73</sup> The reader may note that two of the above documents were adopted at the level of the U.S.S.R. and the other two were adopted at the level of the Russian Federative Republic. Both U.S.S.R.-level documents have in their title the word “*foundations*”; and this is a good description of their role – the idea behind the system was to create a hierarchy of laws, where the U.S.S.R.-level legislation received more specific implementation at the level of the republics.<sup>74</sup> Thus, and so as to avoid duplications, the republic-level codifications are considered below.<sup>75</sup>

The discussion will generally be limited to that of the declared objectives of the legislation, proprietary rights, rules related to contracts, credit/loan law and law of security.

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<sup>67</sup> D.Medvedev, *Codification of Russian Civil Law*, Statut, Moscow, 2008.

<sup>68</sup> See *Branches of Law* on p.218 below.

<sup>69</sup> See *Sources of Law* on p.219 below for information on the Civil Code currently in force.

<sup>70</sup> R.S.F.S.R. was the official acronym for “Russian Soviet Federative Socialist Republic”.

<sup>71</sup> See the Resolution of the All-Russian Central Executive Committee “On Entry into Force of the Civil Code of the Russian Federation”, dated 11 November 1922.

<sup>72</sup> See the Law of R.S.F.S.R. “On Approval of the Civil Code of the R.S.F.S.R.”, dated 11 June 1964 and Decree of the Presidium of the Supreme Soviet of R.S.F.S.R. “On the Order of Entry into Force of the Civil and Civil Procedure Codes of the R.S.F.S.R.”, dated 12 June 1964.

<sup>73</sup> The Resolution of the Supreme Soviet of the U.S.S.R. No. 2212-I “On Entry into Force of the Foundations of the Civil Law of the Union of the S.S.R. and Republics”, dated 31 May 1991.

The Foundations of the Civil Legislation of the Union of the S.S.R. and Republics, adopted in 1991, are reviewed here as a part of the market reforms of the 1990s, see *Civil Foundations 1991* on p.46 below.

<sup>74</sup> “An attempt to eliminate the evident contradiction between the forming unity of the civil regulation of the economy and the Constitution, that kept civil legislation, in its main part, within the ambit of the authority of the [republics] was made in 1936, when the new Constitution of the U.S.S.R. provided that a “Civil Code” was in the competence of the U.S.S.R. [...] in this way, the first attempt to ensure that not only factual, but also constitutional, uniform civil-law regulation corresponded to the uniform economic [regime] of the state. The attempt turned out to be unsuccessful”, from A.Makovskii, “Civil Legislation in the Soviet Planned Economy and Market Economy of Russia”, *Journal of Russian Law*, No.9, 2005.

<sup>75</sup> However, the U.S.S.R. Foundations 1991 are considered as a part of the review of the Russian reforms of the 1990s, see *Civil Foundations 1991* on p.46 below.

**(i) Civil Code 1922**

The first Civil Code of the Soviet Republic was adopted in November 1922,<sup>76</sup> five years after the second 1917 Revolution.<sup>77</sup> Perhaps, civil legislation was not high on the priorities' list of the Bolshevik government.

The following quote is helpful in understanding the context of the Civil Code 1922:

*"[F]ollowing the civil war and intervention, Lenin and the Bolshevik leadership concluded that the only practical way to consolidate political power, ... was to restore the devastated economy to at least prewar levels. ... Lenin allowed much of industrial and agricultural production to be returned to private hands. Labeled the New Economic Policy, or NEP (1921-1928), this seeming sacrifice of basic Marxist principle allowed a significant proportion of the economy to be organized around an essentially free market."*<sup>78</sup>

According to the Resolution accompanying the Civil Code 1922, no civil disputes with respect to legal relationships that came into existence before 7 November 1917 were to be considered by judicial, or other authority, of the Russian Republic.<sup>79</sup> This effectively approved in the eyes of the law any "transaction"<sup>80</sup> that occurred during and after the second 1917 revolution, if, for example, the title to property was initially acquired, or the agreement was entered into, before the revolution.

<sup>76</sup> The Resolution of the All-Russian Central Executive Committee, dated 11 November 1922.

<sup>77</sup> "The first Russian Civil Code was adopted in the year 1922, at a period when socialisation was temporarily suspended and elements of private enterprise were being temporarily encouraged. The Code was rather hurriedly prepared, at a time when it was too early to systematise the effects of the Revolution on law or to utilise the lessons of experience of life under socialism. The concepts and terminology used were based on those of the civil law systems of Western Europe and the reader was seldom aware that he was not reading a standard codification of a capitalist system of civil law. There was an air of unreality about the 1922 Code, which did not prevent it being made the basis of the Codes of other Republics and of much of the law of the Soviet Union, when the U.S.S.R. came into existence in 1923", from A.Kiralfy "The New Civil Code of the R.S.F.S.R. A western view", *International and Comparative Law Quarterly*, Vol. 15, Oct. 1966, p.1116.

"Upon the formation of the USSR in 1923, its constituent republics adopted their Civil Codes very much in conformity with the Russian Civil Code of 1922 (that was based primarily on the 1905 draft Imperial Civil Code)" from R.Dragneva and E.Ferrari, "Contract Law Harmonization and Regional Integration: Can the CIS Learn From the EU?", 31 *Review of Central and East European Law* 1 (2006), fn.5.

"The transition to NEP was consolidated in the 1922 RSFSR Civil Code and a substantial body of economic legislation regulating the legal status of juridical persons and obligations. Although rightly characterized as and era of private entrepreneurship, NEP was in fact a mixed economy in which the State sector coexisted with the private, and civil law with State-oriented economic legislation. P I Stuchka was among the Soviet jurists of the period who supported the theory of 'two-sector law' under which property relations would be regulated by both civil and economic law; civil law was regarded as capitalist law and economic law was regarded as the law of a socialist economy.", from W.Butler, *Russian Law*, 2<sup>nd</sup> ed., Oxford University Press, 2003, p.433.

<sup>78</sup> From J.Logue (ed.), S.Plekhanov and J.Simmons, *Transforming Russian Enterprises: From State Control to Employee Ownership*, Greenwood Press, 1995, p.15.

<sup>79</sup> Paragraph 2 of the Resolution of the All-Russian Central Executive Committee "On Entry into Force of the Civil Code of R.S.F.S.R.", dated 11 November 1922.

<sup>80</sup> Expropriations, looting and robbery during these years can hardly be called "transactions".

Article 1 of the Civil Code 1922 subjected the protection of a civil right to the purpose of the exercise of the right in question; and “[c]ivil rights [were] afforded the protection of law, with the exception of cases, when [such rights] are carried out in contradiction with their socio-economic purpose”.

Article 21 declared that land could not be the subject of “private circulation” (thus reiterating the R.S.F.S.R. Constitution 1918 provisions) and added that the distinction between movables and real property was abolished.

The Civil Code 1922 was relatively tolerant towards private property. It allowed private property to cover non-municipalized buildings, trading enterprises, manufacturing enterprises (if the number of employees thereof was not higher than that prescribed by special laws), tools and means of production, “cash securities”, etc. (Article 54). Article 55 left the door open for concessions to be granted in respect of certain types of property that could otherwise be only state-owned.

The “law of property” part of the Civil Code 1922 set forth the rules on pledges with considerable detail.<sup>81</sup> The pledgee enjoyed a priority right to the proceeds from the sale of the secured assets (Article 85). The right was qualified by recognizing that certain categories of debt have preferential treatment: generally, taxes and wages (Article 101). Secured assets could only be sold at a public auction (Article 104). The Code allowed for assignments, providing, however, that a notice was required in order for the assignment to be valid as against the debtor (Article 124).

The Civil Code 1922 prohibited charging compound interest on loans, unless such loans were made by credit organizations; however, simple interest on loans was allowed (Article 213).<sup>82</sup> Interestingly, the Civil Code 1922 provided for the right of prepayment on loans if certain conditions were met. In particular, loans could be prepaid if the applicable interest rates were higher than 6 percent per annum for loans denominated in golden Rubles, and higher than the interest rate set by the State Bank for its operations for loans denominated in soviet money, respectively (Article 216). Another interesting provision was in Article 219 – a type of a statutory material adverse change clause:<sup>83</sup> a lender could cancel its commitment if

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<sup>81</sup> Articles 85-105 of the Civil Code 1922.

<sup>82</sup> This can be contrasted with the later, Civil Code 1964 that included a general prohibition on charging interest on monetary obligations, with an exception made for credit organizations. See p.34 below.

<sup>83</sup> A material adverse change clause in its most general form allows the lender to cancel its commitment(s) should the (financial) condition of the borrower deteriorate. It is probably safe to assume that the reader is well familiar with this clause, as it has been in the focus of practitioners' attention during the recent financial crisis.

the financial condition of the counterparty significantly deteriorated or if the counterparty was declared insolvent or ceased “*making payments*”.<sup>84</sup>

Suretyship was also covered by the early Soviet law.<sup>85</sup> A contract of suretyship was secondary in nature and the right of subrogation existed. The right of the surety to use against the creditor the defenses that were available to the primary debtor was also provided for.<sup>86</sup> Nevertheless, the Civil Code 1922 included some peculiar rules on statute of limitations for suretyships: a lawsuit must have been started within three months from the expiry of the main obligation and, if the contract of suretyship failed to stipulate its term, it was valid only for a year from the time it was entered into (Article 250). In addition, according to Article 237, a contract of suretyship could have been security only for a “*valid obligation*”. Since the “*primary*” obligation must have been (entered into and be) valid when the suretyship was created, it was impossible to stipulate that suretyship was a “*condition precedent*” to the main obligation.<sup>87</sup>

Provisions of the Civil Code 1922 referred to “*contract of suretyship*”; and rules on “*contract of suretyship*” were placed alongside rules related to other types of contract. The view adopted in the later Russian Civil Codes was different: suretyship became security for obligations and rules on “*contracts of suretyship*” were placed alongside rules on security for obligations.<sup>88</sup> This difference, however, appears to be more technical than substantial: even under the Civil Code 1922 rules, suretyship could only be issued in respect of a valid obligation, and thus, creating an independent and self-sufficient agreement (not dissimilar to that of indemnity) using a “*contract of suretyship*” was impossible.

## **(ii) Civil Code 1964**

By the middle of the twentieth century the Civil Code 1922 was lagging behind the then more sophisticated economy. Thus, in 1964 a new Civil Code of the R.S.F.S.R. was adopted.<sup>89</sup>

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<sup>84</sup> This provision is, of course, primitive and vague. It appears that the “*insolvency*” ground should be covered by the insolvency legislation and the “*stopping of payments*” is too vague and wide, so as to cover, on its literal reading, the stopping of payments by reasons unrelated to (in)solvency or cash flow difficulties.

<sup>85</sup> The Russian term “*poruchitel'stvo*” is most often translated into English as “*suretyship*”. Strictly speaking this is not correct. Suretyship in English law encompasses contracts of guarantee (secondary obligation) and also indemnity (primary obligation). Russian “*poruchitel'stvo*” is secondary in nature and is, therefore, similar to a guarantee. Guarantees are recognized in Russian law, too; however the modern Russian law prescribes that it is only lawful for banks and insurance companies to issue guarantees. See Russian Civil Code, Part I (1994), Chapter 23, §6 “*Bank Guarantee*”. See *Chapter Chapter 2. Security, Bank Guarantee* on p.123 and *Suretyship* on p.127 below.

<sup>86</sup> Articles 237, 239, 245, 246 and 249 of the R.S.F.S.R. Civil Code 1922.

<sup>87</sup> This approach has been retained by the Civil Code 1964, see p.33 below.

<sup>88</sup> See *Suretyship* on p.127 below.

<sup>89</sup> See the Law of the R.S.F.S.R. “*On Approval of the Civil Code of the R.S.F.S.R.*”, dated 11 June 1964, and the Resolution of the Presidium of the Supreme Soviet of the R.S.F.S.R. “*On Order of Entry into Force of the Civil Code of the R.S.F.S.R.*”, dated 12 June 1964.

The Civil Code 1964, as is explained below,<sup>90</sup> became a “socialist” civil code to a greater degree. It is, however, misleading to imply here that the transition to such “greater degree of socialism” in civil law occurred only with the adoption of the Civil Code 1964; Soviet civil law was changing along with the Government’s policy during the period of 1920s-60s. Many changes that had occurred by year 1964 were conveniently brought together in a single document – the Civil Code 1964.

A novelty in the Civil Code 1964 was that the focus in the opening paragraphs of the preamble was put on the transformation of the socialist society (that was declared by the Civil Code 1964 to have existed at that time) into a communist society.

The preamble stated:

*“The objectives of the period are: the creation of material and technical foundations of communism, [...] gradual transformation of the socialist social relationships into communist [social relationships]...”*

*The economy [in the period] of the [...] construction of communism is based on the socialist property on the means of production in the form of state (all-people’s) and collective farm-cooperative property. ...*

*In the construction of communism the commodity-money relationships are fully utilized in accordance with the new essence, which they have in a planned socialist economy, and the following important tools of economic development are applied: economic accountability, money, price, cost, profit, trade, credit, finance. The construction of communism relies on the principle of the material incentive for the citizens, enterprises, collective farms and other economic organizations.”*

As the paragraph above shows, Soviet authorities were comfortable with trying to improve the efficiency of the country’s economy *via* the introduction of profit-based incentives. However, the role of profit-related incentives in the Soviet economy should not be overestimated; any such incentives should be viewed in the context of the directives of the state plan.

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*“In the course of time the 1022 Code manifested itself as quite unsuitable to the new conditions of the resumed “march towards communism.” In most of the important relations of everyday life other enactments and subordinate legislation were used. The Soviet jurists for many years showed a reluctance to commit themselves to a restatement of the principles of civil law”, from A.Kiralfy, “The New Civil Code of the R.S.F.S.R. A Western View”, International and Comparative Law Quarterly, Vol. 15, Oct. 1966, 1116-1134. See also O.Yoffe and Y.Tolstoy, “The New Civil Code of the R.S.F.S.R. A Soviet view”, International and Comparative Law Quarterly, Vol. 15, Oct. 1966, 1090-1115.*

<sup>90</sup> See p.36 below.

In line with the Civil Code 1922, the Civil Code 1964 denied the protection of civil rights in cases where they were “*carried out in contradiction to the purpose of such rights in a socialist society during the construction of communism*” (Article 1).<sup>91</sup>

Article 93 differentiated between two main kinds of property: socialist (which included state (all-people’s) property, property of collective farms, *etc.*), and personal property (a means of satisfaction of personal needs of the citizens). According to Article 94, the state was the sole owner of state property.<sup>92</sup> According to Article 95: “[*]and, natural resources, water, forests, plants, factories, mines, power stations, rail- water- air and automobile transport, banks, means of communication ... were state property. State property can include any other property*”.

Article 33 of the Civil Code 1964 spelt out the limitation on the liability of the state in respect of the state organizations and *vice versa*. The state was not liable in respect of the obligations of a state organization, which was a body corporate, and such an organization bore no liability in respect of the obligations of the state. However, the article also dealt with the situation when an organization did not have sufficient cash and was financed by the state.

Article 105 was dedicated to personal property: citizens could have had the right of personal property in respect of assets designed for the satisfaction of their material and cultural needs. Each citizen could have had in his/her personal property: labor-derived income and savings; dwelling house (or a part of it) and related premises; and items of household and personal consumption and convenience. A citizen’s personal property could not be used to derive non-labor profits. As the reader may recollect, at the time when the Civil Code 1964 was adopted, the Soviet society was declared to be “*socialist*”. In this light, it is interesting to contrast the abovementioned provisions of the Civil Code 1964 with their counterparts in the Civil Code 1922. The Civil Code 1922 used the terms “*private property*” instead of “*personal property*”; and under the Civil Code 1922 regime, certain enterprises (with a limited number of employees) could have been privately owned. Under the Civil Code 1964 no such exceptions were made.<sup>93</sup>

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<sup>91</sup> The reader may note that this clause had been amended in the 1964 Code. The wording of the 1922 Code was more vague. See p.27 above.

<sup>92</sup> State property that was vested with a state organization was in “*operational administration*” of such an organization. Operational administration was an important concept during the Soviet era and it was retained in the modern Russian Civil Code (Article 296).

<sup>93</sup> Article 54 of the Civil Code 1922 and Article 105 of the Civil Code 1964.

The Civil Code 1964 specifically limited the number of houses or flats that a citizen (or a family, as the case could be) could own to one house or flat, respectively; furthermore, the Civil Code 1964 set a limit of living space of 60 square meters<sup>94</sup> *per* citizen (Article 106).<sup>95</sup>

Articles 49 and 50 are worth mentioning in connection with the rules therein that were related to the invalidity of certain transactions. Article 49 invalidated, *inter alia*, transactions that were entered into with an objective contradictory to the interests of a socialist state and society. Article 50 invalidated transactions, which were carried out by a body corporate in contradiction with the objectives set forth in its articles, by-laws or generally by by-laws for organizations of such type.<sup>96</sup>

Article 168 dealt with “*duties*” applicable to the performance of an obligation: each party had to perform its obligations in a manner that was most economical for the socialist economy and to assist the other party in carrying out the other party’s obligations. There was no specific limitation on the scope of the provision; and hence, it also applied to agreements that were private in nature. Though Article 168 appears to be, to a large extent, declarative, it is nevertheless, a useful demonstration of the socialist approach: every obligation, however “quasi-private” was its subject-matter, was to be considered as only a part of the whole economic system, that is the socialist system where the ultimate pinnacle was the State.

Under the Civil Code 1964 rules, charging interest on monetary obligations was generally prohibited, however, with the following exceptions: where credit organizations were involved, or in respect of foreign trade obligations and other cases as prescribed by law (Article 176).

Another novelty in the Civil Code 1964 was the recognition of security for obligations as a separate category in civil law; and a separate chapter was allocated to security in the Civil Code 1964.<sup>97</sup> In the earlier Civil Code 1922, pledges, suretyships and penalties were covered in different locations. Perhaps, the disadvantage introduced into the Civil Code 1964 in this way was that it provided for a closed list of available types of security: penalties, pledges,

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<sup>94</sup> Approximately 645 square feet.

<sup>95</sup> The rule was actually more intricate; however, for the purposes of simplicity, this description is a good approximation.

The restrictions on the quantity and quality of assets that a citizen could own were generally abolished by the 1990 R.S.F.S.R. Law on Property; for more detail see *Law on Property and Law on Enterprises* on p.44 below.

<sup>96</sup> These provisions are similar to the doctrine of *ultra vires* in Common Law. This rule was new to the Civil Code 1964 and was absent from the 1922 Code. The modern Russian Civil Code also includes rules on *ultra vires*; however, the new rules have an additional qualification that requires a certain degree of counterparty’s knowledge as to the transaction being *ultra vires* (Article 173 of the 1994 Civil Code).

<sup>97</sup> Chapter 17 of the Code.

suretyships and, for socialist organizations, guarantees. For individuals “*deposit*” was also available.<sup>98</sup>

Rules on pledges in the Civil Code 1964 could be considered ordinary at first impression. However, as explained below, there were a few interesting details.

The Civil Code 1964 included a carve-out related to state property.<sup>99</sup> According to Article 98, enterprises, buildings, installations, machinery and other property that fell into the category of main<sup>100</sup> means of production of state organizations, could not be subject to pledge and enforcement could not be carried out against such property. Given the prevalence of state property in the R.S.F.S.R. at that time, such a carve-out would severely restrict the use of pledge, perhaps, to use with respect to raw materials, stocks and “accessorial” property. Thus, pledge simply could not have been used for extensive financing transactions.<sup>101</sup>

According to the Civil Code 1964, a pledgee had priority of claim with respect to the proceeds from the sale of secured property; a court judgment<sup>102</sup> was required to establish the claim (Article 200). A more scrupulous analysis shows another significant deficiency in any possible use of pledge. This deficiency originated not in the Civil Code 1964 itself, but in its “sister law” – the Civil Procedural Code 1964 of the R.S.F.S.R.<sup>103</sup> The Civil Procedural Code 1964 set out the priorities of the creditors where the sums collected from the debtor were insufficient to cover all creditors’ claims. In practice the situation where such sums were “insufficient” meant that the debtor was insolvent. The priorities for *unsecured* claims were organized in the following way (in descending order of priority): (i) wages and other debts of social nature; (ii) taxes and other debts to the state of administrative nature; (iii) (financial) indebtedness to state credit organizations; (iv) debts to various state organizations and certain other type of organization; and (v) other debts.<sup>104</sup> If however, proceeds from the property, which had not been secured, were insufficient to cover all unsecured debts then

<sup>98</sup> See *Deposit* on p.133 below.

<sup>99</sup> This carve-out was generally abolished by the R.S.F.S.R. Law on Property 1990, see for more detail *Law on Property and Law on Enterprises* on p.44 below.

<sup>100</sup> Perhaps, a better translation is “long-term”

<sup>101</sup> Since the banks in the U.S.S.R. were state owned, this restriction was not significant. In an environment where the proprietor of both the banks acting as lenders and their borrowers was the State, profits and quality of security were not vital.

<sup>102</sup> The Civil Code 1964 also referred to arbitrazh rulings or arbitral awards when referring to claims on proceeds from secured property.

<sup>103</sup> See the Law of the R.S.F.S.R. “On Approval of Civil Procedure Code of R.S.F.S.R.”, dated 11 June 1964, and Decree of the Presidium of the Supreme Soviet of the R.S.F.S.R. “On the Order of Entry into Force of the Civil and Civil Procedure Codes of the R.S.F.S.R.”, dated 12 June 1964.

Soviet law, not dissimilar to many other systems of law, distinguished between procedural law and substantive law. The Soviet Civil Codes codified substantive civil law, and Civil Procedure Codes codified the procedural law for civil law cases. Essentially, the Civil Procedure Codes governed how proceedings were conducted in courts. For more information, see *Branches of Law* on p.218 below

<sup>104</sup> Articles 418-423 of the Civil Procedural Code 1964.



enforcement could be carried out against *secured property*. In such a case secured debts to state credit organizations were ranked immediately behind the (unsecured) creditors of first priority. Other secured debts were ranked behind (unsecured) creditors of first and second priorities. The Civil Procedural Code 1964 also stipulated that if the secured creditor kept the secured assets, such creditor had to satisfy [other] creditors' claims having priority, in the total amount not to exceed the value of such retained property.<sup>105</sup> Thus, the secured creditor was subordinated to certain claims with a higher ranking priority; however, within the "pool" of secured creditors, each secured creditor had a claim to its respective security in order to satisfy claims. The state of play when creditors look to *their* security may seem quite natural for lawyers in many jurisdictions; however, as it will be shown later, Russian insolvency legislation of the 90-s was drafted so as to provide that secured creditors *shared all* security in proportion to their claims.<sup>106</sup>

The Civil Code 1964 recognized suretyship as a kind of security for obligations (as opposed to a contract, *per* the earlier regime). However, rules on suretyship in the Civil Code 1964 were not changed substantially from those in the Civil Code 1922<sup>107</sup> and suretyship remained "secondary" to, and dependent on the existence of, the main obligation.<sup>108</sup> The Civil Code 1964 required that the "primary" obligation was "valid" when referring to suretyship.<sup>109</sup> Hence, a contract of suretyship could not exist prior to the "primary" obligation having entered into force. In most cases the parties prefer that suretyship is a condition precedent to the main obligation. Clearly, this could not have been achieved under the Civil Code 1964. There was, however, an addition to the Civil Code 1964: Article 210 referred to "*guarantees*" issued by one organization as security for debts of another organization. The Code only

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<sup>105</sup> Article 424 of the Civil Procedural Code 1964.

It may be noted that neither the Civil Code 1964 nor the Civil Procedural Code 1964 regulated the regime of secured claims comprehensively. For example, the Civil Code 1964 was silent on the issue whether the claim of a secured creditor lies to the proceeds of the secured property only and, thus, the secured property should be sold in all cases, or the secured property could be kept by the creditor (in some cases). A list of grounds for the pledge to terminate was set forth in the Civil Code 1964 and such list simply included "transfer of ownership to the pledgee" without any specific detail on the applicable procedures or conditions, thus, apparently, allowing the property to be kept by the creditor, perhaps, at the discretion of the court. The Civil Procedural Code 1964 dealt with the priorities of creditors' claims (arguably, this is substantive law instead of procedural law that the Code was supposed to cover), however also omitting to regulate any procedural aspects of enforcement against secured property. Clearly, such a situation could not be considered satisfactory, should the legislature's intention have been that the institute of pledge be regarded as a respectable tool in raising finance.

<sup>106</sup> Therefore, in the case of two creditors with equal claims, but one having security over an asset worth 10,000,000 Rubles and another – over an asset worth a mere 100 Rubles, each would have received exactly the same dividend on its claim.

See, e.g., *Law on Insolvency 2002, Priorities and Security* on p.186 below.

<sup>107</sup> For description of Civil Code 1922 rules on suretyship, see p.28 above.

<sup>108</sup> Articles 203-208 of the Civil Code 1964.

<sup>109</sup> Article 203 of the Civil Code 1964.

stipulated that some (but not all) provisions on suretyship applied to guarantees; a guarantee, in the Civil Code 1964 meaning, remained a secondary obligation.<sup>110</sup>

Under the rules of the Civil Code 1964, an assignment could have been made if there was no prohibition in law or contract and the assigned obligation was not connected with the identity of the creditor (Article 211). The new rules in the Civil Code 1964 were that: (i) the assignor had to hand over the documents that evidenced the assigned right; (ii) the assignor was liable with respect to the validity of the assigned right (and the law went on to provide that the assignor was not liable for the non-performance by the debtor, unless the assignor issued suretyship in this respect); and (iii) the claims that the debtor had against the assignor could be set off against the assignee if the such claims had matured before the notice of assignment was received by the debtor or if the claims did not have a specific maturity date.<sup>111</sup>

With respect to interest, the Civil Code 1964 had provisions which were somewhat contradictory. On the one hand, it included a general prohibition on interest on monetary and other obligations, unless the transaction involved a credit organization, related to foreign trade, or in other cases provided by law (Article 176); on the other hand, a debtor that defaulted on a monetary obligation was liable to pay default interest of three *percent per annum*, unless law or contract stipulated another default interest rate (default interest rates between socialist organizations were to be set by [other] laws of the U.S.S.R.).<sup>112</sup>

The reader may remember that the R.S.F.S.R. Constitution 1918 declared that banks were nationalized,<sup>113</sup> and the U.S.S.R. Constitutions 1936 and 1977<sup>114</sup> stipulated that banks were under state control. In turn, the rules of the Civil Code 1964 related to banks were drafted so as to reflect the nature of credit in a planned economy. According to Article 393: “*Credit [facilities] are provided to state organizations ... in accordance with approved [state] plans ... by State Bank of the U.S.S.R. and other banks of the U.S.S.R....*”<sup>115</sup>

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<sup>110</sup> This can be contrasted with the Civil Code 1994 meaning. A guarantee under the modern Civil Code takes the form of a “bank guarantee”; it is to a degree independent from the main obligation. See *Bank Guarantee* on p.123 below. Views have been expressed that “guarantees” can be issued by other categories of persons, too: see O.Sadikov (ed.), *Commentaries to Civil Code of Russian Federation (Part I)*, Infra-M, Moscow, 2008, p.863.

<sup>111</sup> Articles 212 and 231 of the Civil Code 1964.

<sup>112</sup> Article 226 of the Civil Code 1964.

<sup>113</sup> See p.14 above.

<sup>114</sup> See pp.18 and 23 above, respectively.

<sup>115</sup> Under the Civil Code 1922 credit facilities and interest were permitted. In the 1930s, however, a reform of credit transactions was carried out and commercial banking was abolished. Banking was concentrated in the hands of State Bank of the U.S.S.R. and special banks, e.g., Bank of Long Term Credit for Production and Electrification, Central Bank for Communal Services and Housing Development and Central Agricultural Bank. By 1959 special banks were generally phased out and their functions transferred either to one of the State Bank of

It is appropriate to illustrate what state planning meant in more detail with an example.<sup>116</sup> In 1965 a reform of the economy was undertaken. One of the major documents of the reform was the Resolution of the Central Committee of the CPSU and Council of Ministers No. 729, dated 4 October 1965. According to this resolution:

*“1. ... five-year plan ... is the main form of state planning of the development of peoples’ economy...*

*Five-year objectives are concretized and refined in annual plans...*

*Five-year and annual plans for enterprises are developed by such enterprises on the basis of control figures set by the higher-standing organization.*

*Supply-side enterprises, in accordance with the control figures, agree in advance with the demand-side enterprises, or distributing and trade organizations, on the quantity, assortment, quality and dates for delivery and form a portfolio of orders”.*

Hence, on the one hand, the state plan directed each enterprise as to what, and how much, it produced. On the other hand, in the same Resolution the Soviet government purported to promote the principles of contract law:

*“10. ... In the interests of consistent exercise of economic accountability between enterprises, and between enterprises and sales, supply, trade ... and other organizations, an economic contract shall [henceforth] be the main document, defining the rights and obligations of the parties to the [production cycle] of all kinds of [goods], including those distributed centrally. In accordance with the above, **as a rule**,<sup>117</sup> the current practice ... of [goods] being [sold] in accordance with orders ... shall cease. ...*

*Material liability of enterprises and organizations for breaches of contract for [sale or supply] shall be increased, so as to compensate, **as a rule**, for damages. ...*

*46. Enterprises that ceased to produce goods, for which there was no customer demand, shall be allowed to pass on the accumulated stock to trade organizations ...; should the trade organizations refuse to accept such stock, such enterprises shall sell such stock to state and cooperative enterprises and organizations.”*

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the U.S.S.R. or Stroibank of the U.S.S.R. (from *History. Bank of Russia*, available at the website of the Central Bank of Russia at <http://www.cbr.ru/today/history/gosbank.asp>).

<sup>116</sup> On how the role of the state plan was eroded in the late history of the Soviet Union, see *Law on Cooperatives* on p.38 below.

<sup>117</sup> “As a rule” in Russian in this context means “often” or “usually” rather than “shall”.

In the same vein, according to Article 97 of the Civil Code 1964, state organizations managed their raw materials, fuel, materials, cash and stock in accordance with their designated purpose and approved plans. Under Article 234, an obligation between socialist organizations should have been terminated or amended by the counterparties if documents of state plan for the peoples' economy, on which such an obligation was based, had been changed by an order that was mandatory for both such counterparties.

The provisions of the Civil Code 1964 and Resolution No. 729 referred to above illustrate how Soviet law had evolved by year 1964 since the time when the Civil Code 1922 was adopted. By year 1964, the law of obligations, which appeared to have been in the 1920s less politically extreme, was explicitly subordinated to the principle of state planning of economy. Even dispensing with the analysis of the statistics on the economic performance of the Soviet Union and R.S.F.S.R. at that time, it is clear that state authorities were preoccupied with trying to amalgamate socialist methods of production (*i.e.*, state ownership of means of production) with "socialist"<sup>118</sup> incentives to increase the effectiveness of the economy. Hence, the awkward combinations of references to "*profit*" in the preamble to the Civil Code 1964, on the one hand, and directions to enter into agreements on the basis of state plans and to sell otherwise unwanted goods to state organizations, on the other hand.

Soviet law appeared to have diluted the meaning of an obligation between socialist organizations to a kind of a procedural arrangement: an agreement between enterprises should have reflected the state plan, and, if the plan had been changed, so should have the agreement between the parties. A Soviet obligation became "flexible" – it flexed to fit the framework of the state plan.<sup>119</sup>

### **1.C. Transitional Period**

In March 1985, Mikhail Gorbachev was elected General Secretary of the Central Committee of the CPSU. Outside Russia and the U.S.S.R., Gorbachev's leadership is primarily associated with "Perestroika" – a series of political and economical reforms that touched upon most spheres of life in the U.S.S.R.<sup>120</sup> Perestroika was introduced with a desire to modernize the

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<sup>118</sup> For example, with retained profits or paid bonuses (for enterprises and workers, respectively). Of course, the reader will note that, admittedly, both mechanisms also function in capitalist economies.

<sup>119</sup> If a civil law obligation between organizations became "flexible" in this sense, then the "obligation" of a state organization to comply with the plan was the counterpart of the "flexible" obligation – *i.e.*, the "inflexible" obligation. Of course, state plan for an organization could have been changed by the higher authorities; however, the obligation *to comply* with the plan (albeit revised) remained.

<sup>120</sup> See, for example, W. Butler (*ed.*), *Perestroika and the Rule of Law*, in *Russian Legal Theory*, Aldershot, Dartmouth, 1996, pp.417-431.

political system and make it more responsive to social and economic needs of the country (ultimately leading to better managerial efficiency in the economy). In turn, another key reform, *glasnost*, involved increased public scrutiny over the state's affairs and, to a degree, the relaxation of the then existing censorship. In 1990, as a result of another round of political reforms, the position of the President of the U.S.S.R. was created; and Mikhail Gorbachev was elected the first President of the U.S.S.R.

Along with the political reforms of the 1980s in the U.S.S.R., tensions grew strong among the constituent republics and the Union authorities. In 1989-91 the three Baltic Republics of the Union (Lithuania, Estonia and Latvia) declared independence. On 12 June 1990 a Declaration on State Sovereignty of the Russian Soviet Federative Republic was adopted; the Declaration was later augmented by the Law of the R.S.F.S.R. "On Safeguarding Economic Sovereignty of R.S.F.S.R.", dated 31 October 1990. Under the law, natural resources and enterprises and organizations located within the territory of the R.S.F.S.R. were, generally, declared to be within the ambit of Russian sovereignty and jurisdiction. In June 1990 Boris Yeltsin was elected the first President of the Russian Federation. On 8<sup>th</sup> December 1991, in Minsk (Belorussia), Belorussian, Russian and Ukrainian representatives<sup>121</sup> signed the Agreement on Establishing of the Commonwealth of Independent States.<sup>122</sup> The Agreement in its preamble referred to the Union Treaty of 1922 and declared that the founding members of the Union (Belorussia, Russia and Ukraine) acknowledged that the Soviet Union as a subject of international law and a geopolitical reality ceased to exist.<sup>123</sup> Thus, the U.S.S.R. was dissolved in late 1991 and the planned economy approach was abandoned.

Inroads into the pervasiveness of the state plan in the economy were made earlier than the described events of 1991. There are three major legislative developments that transformed the shape of the Soviet/Russian economy: (i) the Law of the U.S.S.R. No. 8998-XI On Cooperatives, dated 26 May 1988 (the "**Law on Cooperatives**"); (ii) the Law of the R.S.F.S.R. No. 445-I On Enterprises and Entrepreneurship, dated 25 December 1990 (the "**Law on Enterprises**") and the Law of the R.S.F.S.R. On Property in the R.S.F.S.R., dated 24 December

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Mikhail Gorbachev years in power will be, of course, also remembered outside Russia for the fall of the Berlin wall in 1989.

<sup>121</sup> Including, *inter alios*, Stanislav Shuskevich (at that time, the Chairman of the Supreme Council of Belorussia), Boris Yeltsin (the President of the R.S.F.S.R.) and Leonid Kravchuk (President of Ukraine).

<sup>122</sup> Also known as the "Belavezha Accord", after the locality where the agreement was signed.

<sup>123</sup> The other 11 ex-Soviet Republics, with the exception of Georgia, signed a so-called "Alma-Aty" Protocol to the Agreement on 21 December 1991, where they confirmed the declarations of the Agreement of 8<sup>th</sup> December and joined the CIS.

1990 (the “**Law on Property**”); and (iii) the Foundations of Civil Legislation of the Union of S.S.R. and Republics<sup>124</sup> (the “**Civil Foundations 1991**”).

**(i) Law on Cooperatives**

The Law on Cooperatives was a cornerstone in the development of Soviet economy and legal system. The most important feature of the law was that it allowed cooperatives to *own* means of productions. The law declared that cooperative property (which, as has been mentioned, could have covered means of production) was a type of socialist property. Nevertheless, it can be argued that cooperative property included for-profit elements and thus did not fit well within the doctrine of communism (officially at that time, the U.S.S.R. was still trying to create a communist society). Another important novelty introduced by the Law on Cooperatives was that it allowed the creation of commercial banks (in the form of “*cooperative banks*”).

A cooperative was defined as “*a [voluntary] organization of Soviet citizens ... on membership basis in order to conduct jointly economic and other activities on the basis of property lawfully owned by them [or] rented, ..., [and] self-management and self-financing, as well as the material interest of cooperative members ...*” (Article 5).

The purposes of (re-)introduction of cooperative system in the U.S.S.R. can be discerned from the text of paragraph 5 of Article 1 of the Law on Cooperatives:

*“The cooperative system in the U.S.S.R. gives cooperative members real opportunities and provides a material incentive for them to improve efficient economic management ...*

*The activity of cooperatives, their high labor productivity, and their remuneration system are designed to give an incentive to the development of economic competition and competitiveness in the market for goods, jobs, and services both among cooperatives and between cooperatives on the one hand and state enterprises and organizations on the other hand, and to promote the improvement of the efficiency of economic management in every possible way.”*

It is important to note that the Law on Cooperatives made explicit reference to competition: (i) between state entities and cooperatives; and (ii) among cooperatives. Since cooperative property was not a kind of state property, “competition” between cooperatives arguably meant the creation of a market. This, of course, was a distorted market, where the State

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<sup>124</sup> Adopted by the Resolution of the Supreme Soviet of the U.S.S.R. No. 2212-I “On Entry into Force of Foundations of Civil Legislation of the Union of SSR and Republics”, dated 31 May 1991.

occupied the prevalent position. However, references to competition between cooperatives and state entities meant that the State participates in that market and that the state plan was no longer the only governing force in economic transactions in the U.S.S.R. Indeed, Article 18 of the Law on Cooperatives provided that “[a] cooperative independently plans its production and financial activity...”

Since the state plan no longer was the main governing force for cooperatives (at least), a new tool for organizing of the turnover of goods and supply of services was required. The Law on Cooperatives responded to this requirement by providing that:

*“[t]he observance of contractual commitments and complete consideration for customers' interests are a most important demand on a cooperative's activity and a fundamental criterion by which the quality and efficiency of its work can be assessed. If contractual commitments are not observed the cooperative shall, under the procedure as set forth, be materially liable and compensate damages suffered by its customers. State, cooperatives, and other public enterprises, organizations, and citizens who fail to observe their contractual commitments to cooperatives shall be materially liable in accordance with the respective procedures and compensate damages suffered by the cooperative.”*<sup>125</sup>

The importance of this provision is also clear: the role of contractual obligations in the economy was elevated to new heights. The reader may recollect that under the earlier regime, a change in the state plan entailed an amendment to, or termination of, any civil law obligation that was affected by such a change.<sup>126</sup> The rule on the compensation of damages also was a novelty: previously, if a contract was breached, damages were compensated only “as a rule”.<sup>127</sup>

Erosion of the role of state regulation of economy did not stop there. Under Article 19 of the Law on Cooperatives, “[a] cooperative sells its ... goods, carries out work, and provides services at prices and tariffs set by the cooperative in an agreement with consumers or independently.”

The Law on Cooperatives distinguished between two main types of cooperative: (i) producing cooperatives; and (ii) consumer cooperatives (Article 3). The law set forth the rule that the activities of the producing cooperatives should be based on personal labor of the

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<sup>125</sup> Article 17 of the Law on Cooperatives.

<sup>126</sup> See sub-section on Civil Code 1964 on p.36 above.

<sup>127</sup> See sub-section on Civil Code 1964 on p.35 above.

cooperative's members. This limitation was designed to act as a barrier on the use of "pure" capital in production (and thus, the development of capitalism).<sup>128</sup>

The crucial change introduced by the Law on Cooperatives was that it allowed cooperatives to own means of production (Article 6).<sup>129</sup> This must be contrasted with the U.S.S.R. Constitution 1977, according to which: (i) there existed only state and collective farm property in relation to means of production; and (ii) the State owned the main means of production (*i.e.*, property, plant and equipment).<sup>130</sup> According to the Law on Cooperatives, cooperatives could own buildings, installations, machines, equipment, means of transport, livestock, finished products, goods, cash, and other property in accordance with the cooperative's objectives. Cooperative ownership was declared to be a form of socialist ownership and it was afforded under the Law on Cooperatives legal protection on *par* with state ownership. Perhaps, in order to respond to concerns that property of a cooperative may be confiscated, for example, on the grounds that that the cooperative overstepped the boundaries of the socialist system, the law expressly provided that a cooperative's property may be confiscated only pursuant to a decision of a court or arbitrazh.

Following the logic of the regime where cooperatives could own property, including means of production, and competed with other cooperatives and the State, cooperatives could also be held liable with all their property. Under the same logic, the State was not liable in respect of cooperatives' liabilities and cooperatives were not liable on the debts of the State or, more importantly, debts of cooperatives' members (Article 8). The corporate veil for cooperatives operated in the other "direction", too: members of a cooperative, generally, were not liable for the cooperative's debts (unless otherwise provided by law or the cooperative's articles).

Rules on the setting-up of cooperatives were quite liberal. The creation of a cooperative should have been based on a notification/registration procedure; and no special state

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<sup>128</sup> A cooperative could have owned means of production (Article 7 of the Law on Cooperatives); hence, if members were allowed not to participate personally, *via* their own labor contribution, in the functioning of a cooperative, such members would have been allowed to extract profits from "pure" investments of capital and use of employed labor. Of course, this would have been intolerable in a society that remained "socialist".

There was another barrier put in place so as to prevent "capitalization" of cooperatives. Article 6 of the Law on Cooperatives purported to ensure that the CPSU had influence on the development of cooperatives. The Article provided that "*a cooperative's party organization, as the political nucleus of the collective, operates within the framework of the U.S.S.R. Constitution, promotes the enhancement of the production initiative and social activeness of labor collective members and boosts their political self-awareness*". The Law on Cooperatives also purported to maintain a certain degree of participation of employees in the functioning of a cooperative: "*Socio-economic decisions concerning a cooperative's activity are elaborated and adopted by its administrative organs with the participation of the labor collective and the party, trade union ... and other social organizations...*"

<sup>129</sup> *Cf.*, *e.g.*, with *Law on Individual Labor Activity* on p.53 below.

<sup>130</sup> Articles 10 and 11 of the U.S.S.R. Constitution 1977.



permission was required (Article 11).<sup>131</sup> There was a requirement as to the minimum number of a cooperative's members: there must have been three or more individuals in a cooperative.<sup>132</sup>

Prior to the Law on Cooperatives, Soviet law did not have a regime for a (quasi-)commercial entity; and the cooperative was the first attempt at creating a non-state legal person whose objective was the generation of profit *via* the use of means of production. It appears that the legal regulation of cooperatives was loosely based on that of a limited liability company ("limited liability company" is used here to refer to a generic type of a legal vehicle, rather than to any particular national implementation of such a regime). Nevertheless, there were certain characteristics of cooperatives that were ordinarily pertinent to partnerships (here again, "partnership" is used to refer to a generic type of a legal vehicle, rather than to any particular national implementation). This dichotomy can be supported with the following observation: both cooperatives and their members enjoyed the benefit of the corporate veil<sup>133</sup> – a characteristic common to a limited liability company; however, each member had one vote with respect to the management of the cooperative, irrespective of his/her/its contribution to the capital of the cooperative – a characteristic common to a partnership.<sup>134</sup> Under the Law on Cooperatives, the later provision could not have been contracted out of.<sup>135</sup>

According to the Law on Cooperatives, the powers to govern the affairs of a cooperative were vested with its members. Surprisingly for a western lawyer, a cooperative could also issue "*shares*" (Article 22). The Law on Cooperatives provided that:

*"with the objectives of mobilization of members' or employees' free cash and also free cash of enterprises and organizations and the use of [such cash] as an additional sources of funding for the purposes of expansion ... [a cooperative may issue shares]..."*

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<sup>131</sup> The registration regime was implemented *via* the registration of cooperatives' charters (articles). A charter was to be initially adopted by the founding members of a prospective cooperative. The charter then would have had to be registered with the district or city, as the case may be, executive committee of the Soviets of People's Deputies where the cooperative was located. A cooperative was created in law once its charter had been registered.

<sup>132</sup> There was no restriction on cooperatives being members of other cooperatives. However, the provision in question specifically referred to individuals and, hence, a cooperative could not have been created by other cooperatives only.

<sup>133</sup> Corporate veil for cooperatives was created by Article 8 of the Law on Cooperatives.

<sup>134</sup> The highest body of authority in a cooperative was its general meeting of members; the Law on Cooperatives also permitted the creation of a board – a body that was managing a cooperative's daily affairs (Article 14).

<sup>135</sup> *Cf.*, for example, with the English Partnership Act 1890, s.24, according to which the rule that a difference on the running of partnership can be decided by a majority of partners was subject to an express or implied agreement.

It follows that a cooperative could not issue “*shares*” to individuals who were not members or employees of that cooperative. The law went on to stipulate that “*shares*” were “*supported*” with the entirety of a cooperative’s property and declared that, as a rule, the total price of all issued shares should not exceed gross annual profits of the cooperative (Article 22).

Under the provisions of the Law on Cooperatives, a “*share*” (as this term was used in the act) in fact had more commonalities with another type of security, a bond, rather than a share in traditional understanding: a cooperative had to set fixed face value of shares and the procedure for the payment of annual income on the shares. The “*rate of annual income*” could have been amended in a general meeting of the cooperative’s members with the participation of “*shareholders*”. The Law on Cooperatives was clearly deficient not only in that it used the term “*share*” to refer to an instrument that was largely reminiscent of a bond, but also in that the rules on the procedure to amend the “*rates*” on “*shares*” were completely unworkable from the law.

There are two possible explanations with respect to the deficiencies in the regime for “*shares*” in the Soviet Union: (i) policy prevented the creation of shares *stricto sensu*, since the creation of shares would have meant that proprietary relationships were built on the basis of capital (which contradicted with the foundations of a socialist society), and it was technically difficult to design a comprehensive regime for an (investment) instrument that would maintain socialist values and, at the same time, allow proprietary rights on means of production for individuals and non-state owned organizations; and/or (ii) there was no necessary legal experience in order to design a comprehensive regime either for shares or bonds, since Soviet Law had dispensed, generally, with these financial instruments many decades ago.

The issuance of shares was also regulated by the Resolution of the Council of Ministers of the U.S.S.R. No.1195 “On Issuance of Securities by Enterprises and Organizations”, dated 15 October 1988. Resolution provided for two types of share: (i) employees’ shares (which were distributed to employees); and (ii) enterprises’ (organizations’) shares (distributed to other enterprises and organizations, banks and cooperatives, etc.). Commercial banks could also issue “enterprises’ shares”.

Credit and commercial credit organizations (cooperative banks) received relatively detailed attention in the Law on Cooperatives.

According to Article 23, a (state) bank could extend credit to a newly organized cooperative on favorable terms, such terms to be determined by the respective bank. Credit was to be extended on the basis of contracts that set out mutual rights, obligations and liability of the parties. A cooperative had to pay interest on the loan.<sup>136</sup> At that time banks would have had comparatively little experience in making commercial loans and, therefore, the learning curve for banks had to be painful. On the other side of the spectrum, the newly acquired freedom of banks to lend to non-state entities created acute problems *via* proliferation of self-dealing and conflict of interest.

Another important novelty in the Law on Cooperatives was that it allowed the creation of non-state banks. The non-state banks had to be created by unions of cooperatives and were called "*cooperative banks*". Cooperative banks functioned on the basis of "*economic accountability*", meaning that they were liable on their obligations and that their objective was profit. A cooperative bank was defined as a credit enterprise that supported the development of cooperatives with cash and effected payments on behalf of cooperatives and also "*represented interests of cooperatives in economic and financial authorities*". Moreover, the Law on Cooperatives included provisions related to some other functions of banks. Such other functions were similar to those of broker-dealers, lead managers or paying agents in securities issues: upon agreement with a cooperative, a bank could accept functions related to the sale or return of, and payment of income related to, securities.

According to the Law on Cooperatives, cooperative banks were "*mobilizing*" free cash of a cooperative pursuant to an agreement.<sup>137</sup> Cooperative banks were allowed to attract funds from other enterprises, citizens and could borrow from specialized banks of the U.S.S.R. Unlike other cooperatives (whose charters had to be registered with a prescribed executive committee of the Soviets of People's Deputies), the cooperative banks' charters had to be registered with the State Bank of the U.S.S.R.

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<sup>136</sup> Generally, the Civil Code 1964 also allowed banks to charge interest on their loans; however, interest was prohibited in non-bank loans. For a more detailed description see p.31 above.

<sup>137</sup> The drafting was also unclear. The most likely interpretation was that a cooperative bank and a cooperative had to enter into an agreement that set out the rights of the bank in relation to the cash held by the cooperative at that bank.

**(ii) Law on Property and Law on Enterprises**

The adoption of the Law on Enterprises and Law on Property were other important milestones in the 1990s market reforms in R.S.F.S.R.<sup>138</sup> Together the two laws rang the funeral knell of socialism in the R.S.F.S.R.

The gist of the Law on Property was that it recognized and protected private property (including that in respect of the means of production) in the R.S.F.S.R.

According to Article 6 of the Law on Property, a proprietor owned, used, and disposed of, its property at own discretion.<sup>139</sup> A proprietor could transfer its rights of ownership, use and disposal to another person, could pledge its property or encumber it in other ways,<sup>140</sup> transfer the property into the ownership or management of another person and take all other actions in respect of the property, unless such actions were contrary to law. The property could be used for the purposes of any business activity or any other activity, unless the contrary was provided by law.

Four forms of property were explicitly recognized by the Law on Property: (i) private; (ii) state; (iii) municipal; and (iv) non-governmental organizations'. Creation by the state of any advantages or restrictions on a proprietary right that depended on the form of property was prohibited.

Proprietary rights, under the Law on Property, could relate to: enterprises, assets, land, mining allotments, buildings, equipment, raw materials, cash, securities, and other assets designed for production, consumption, social and any other purpose.

The Law on Property set out the circumstances (the two most important circumstances being employment and entrepreneurship) under which a citizen could acquire property.

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<sup>138</sup> See also the Resolution of the Supreme Soviet of the R.S.F.S.R. No. 446-I "On Order of Entry into Force of Law of the R.S.F.S.R. "On Enterprises and Entrepreneurship"", dated 25 December 1990.

The R.S.F.S.R.'s Law on Enterprises was adopted shortly after the U.S.S.R. Law No. 1529-I "On Enterprises in U.S.S.R.", dated 4 June 1990 (and its enacting Resolution of the Supreme Soviet of U.S.S.R. No. 1530-I "On Order of Entry into Force of Law "On Enterprises in the U.S.S.R.""). Both laws covered, generally, the same subject; however the approach was different. The R.S.F.S.R. Law on Enterprises was more liberal, had less provisions dedicated to social protection, and, as can be expected, significantly toned down (if not excluded altogether) the influence of the authorities of the U.S.S.R. on the economic life in the R.S.F.S.R. The U.S.S.R. Law on Enterprises was to come into force on 1 January 1991. Prior to its entry into force, the enacting Resolution of the R.S.F.S.R. Law on Enterprises provided that the U.S.S.R. Law on Enterprises was "cancelled". Hence, the U.S.S.R. Law on Enterprises never came into force in the R.S.F.S.R. The situation where the republican laws "cancelled" or amended the U.S.S.R. laws was relatively common for the period and is often referred to as "war of laws" (see W.Butler, and M.Gashi-Butler, *Legal Aspects of Doing Business in Russia*, Longman, 1993, p.4)

<sup>139</sup> This can be contrasted with the provision of the Civil Code 1964, which distinguished between two forms of property: (i) state; and (ii) personal. Personal property, for example, could not be used to generate non-Labor profits. See for more detail p.30 above.

<sup>140</sup> Under the Civil Code 1964, state property could not be pledged. See for more detail p.32 above.

However, the list was not closed and any other circumstance, unless contrary to law, was acceptable.<sup>141</sup>

The Law on Property also expressly provided that any asset could be owned by a citizen; the exception to this rule covered types of asset that were specifically designated by law and on the grounds of state and social security or in accordance with international obligations [of the State] only.<sup>142</sup> The quantity and value of property that a citizen acquired pursuant to law or a contract were not limited.<sup>143</sup>

The Law on Property declared that an enterprise that was created as “*proprietor*” and was a body corporate had the right of property in respect of the assets, transferred to such enterprise by way of contributions or deposits by its members, and in respect of assets acquired by such an enterprise as the result of its entrepreneurial activities or on other grounds allowed by law (Article 14).

The Law on Enterprises included a wide definition of entrepreneurial activities and referenced the (main) attribute of such activities – the purpose of generation of profit (Article 1). The language of the Law on Enterprises also allowed foreign nationals and stateless individuals to participate in entrepreneurial activities in the R.S.F.S.R.<sup>144</sup>

The Law on Enterprises followed in the steps of the Law on Property and provided that private, state, municipal and non-governmental enterprises could be created and operated in the R.S.F.S.R. (Article 5).<sup>145</sup>

Under the Law of Enterprises, the following legal entities were types of an enterprise:

- state enterprise;
- municipal enterprise;
- personal (family) private enterprise;
- full partnership;
- mixed partnership;
- partnership with limited liability (closed-type joint stock company);<sup>146</sup> and

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<sup>141</sup> Article 9 of the Law on Property.

<sup>142</sup> Article 10 of the Law on Property.

<sup>143</sup> The reader may recollect that under the earlier legislation, the Civil Code 1964, for example, a citizen could, generally, own only one dwelling house or flat (Article 106), see for more detail p.31 above.

<sup>144</sup> The Law on Cooperatives, unlike the Law on Enterprises, specifically provided that cooperatives were associations of Soviet citizens (Article 5). Hence, foreign nationals were not allowed to be members.

<sup>145</sup> This, too, may be contrasted with the Civil Code 1964, which allowed only two forms of property: state and personal. Generally, enterprises, as the term was used in the Law on Enterprises, could only be owned by the state under the Civil Code 1964.

<sup>146</sup> Under the 1994 Civil Code, new forms of legal entities were provided for. In particular, such new forms included “*open joint stock company*” and “*closed joint stock company*”; the word “*type*” was omitted in both

- open-type joint stock company.

An important task in reforming the soviet planned economy into a free-market economy was the privatization of state enterprises. The Law on Enterprises simply provided that decisions on privatization of state and municipal enterprises and enterprises where state ownership exceeded fifty *percent*, were to be taken with due account of the interests of the employees.

Enterprises were expressly allowed to obtain credit; there was also a provision stipulating that an enterprise could be held liable to the full extent in respect of its credit agreements and (violations of) the payment discipline. An enterprise that was not complying with its payment obligations could have been declared bankrupt by a court in accordance with the laws of the R.S.F.S.R. (Article 24).<sup>147</sup>

Though the Law on Enterprises was ultimately pro-market in its character, it had, probably, one provision that paid its dues to socialism: the chief executive officer of an enterprise with state ownership exceeding fifty *percent*, was to be appointed by the state *and* employees; in all other cases the chief executive officer was appointed by the proprietor(s) or the bodies that the proprietor delegated such power to (Article 31).

Enterprises had to be registered; local Soviets of People's Deputies were charged with registration of all types of enterprise (Article 34).

### ***(iii) Civil Foundations 1991***

According to the Resolution of the Supreme Soviet of the U.S.S.R. No. 2212-I "On Entry into Force of Foundation of Civil Legislation of Union of SSR and Republics", dated 31 May 1991, the Civil Foundations 1991 should have entered into force in the U.S.S.R. on 1 January 1992. As the reader will know, the U.S.S.R. was dissolved in December 1991.<sup>148</sup> Hence, it would appear that the Civil Foundations 1991 never entered into force. Nevertheless, the Resolution of the Supreme Soviet of Russian Federation No.3301-I "On Regulation of Civil Legal Relationships during Economic Reform", dated 14 July 1992, "ratified" the Civil Foundations 1991. The "ratification" was temporary and the Civil Foundations 1991 were to stay in force until a new Russian civil code was enacted; the same approach was adopted with respect to the Civil Code 1964. According to the Resolution, any Russian law adopted after 12 June 1990 had prevalence over the Civil Foundations 1991 and Civil Code 1964.

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cases. However, in English translation of the titles of legal entities provided for by the Law on Enterprises the word "type" is also often omitted. Hence, it is common to find references to "open joint stock companies" and "closed joint stock companies" in respect of entities created under both the regime of the Law on Enterprises and 1994 Civil Code.

<sup>147</sup> Russian law No. 3929-1 "On Insolvency (Bankruptcy) of Enterprises" was adopted on 19 November 1992.

<sup>148</sup> See *Transitional Period* on p.36 above.

According to the Civil Foundations 1991, citizens and bodies corporate exercised their civil rights at their own discretion, including the right to seek protection. The exercise of rights should not violate the rights and legally protected interests of other persons; individuals and bodies corporate should respect moral principles and business ethics (Article 5).<sup>149</sup>

According to Article 6, a person, whose right was violated, could demand full compensation of damages, unless law or agreement stipulated to the contrary. Damages for the purposes of Article 6 included real damages and lost profits.<sup>150</sup>

Article 9 allowed citizens to have ownership rights over assets, engage in entrepreneurial activities and carry out any transactions that were not prohibited by law and “*participate*” in obligations and have other property and non-property rights.

Under the Civil Foundations 1991, a body corporate was liable with all its property.<sup>151</sup> A corporate veil was created for all bodies corporate; thus, a body corporate was not liable for the debts of its proprietors, and proprietors were not liable for the debts of the body corporate. Carve-outs to this rule could be provided for by law or the constitutional documents of a juridical person. The Civil Foundations 1991 provided another general exception to the shielding effect of corporate veil – if bankruptcy (insolvency) of a juridical person was caused by the proprietor’s unlawful actions, the proprietor was liable on the debts of the juridical person, should such juridical person lack sufficient funds to satisfy all its liabilities (Article 15).

An obligation should have been complied with in due manner and in the time stipulated in accordance with the terms of the contract and the requirements of law, or, in the absence of such terms or requirements, in accordance with the usual requirements. Unilateral repudiation of an obligation and unilateral change of the terms of a contract were not allowed, with the exception set forth by law or contract (Article 57).<sup>152</sup>

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<sup>149</sup> This can be contrasted with the Civil Code 1964, according to which civil rights were protected by law, with the exception of cases, when they were exercised in contradiction with the purpose of such rights in a socialist society in the period of construction of communism (Article 4).

<sup>150</sup> Cf. the less developed rules on damages of the Civil Code 1964 and contemporary legislation, see p.35 above.

<sup>151</sup> Cf. the limitations on liability under the Civil Code 1964: according to Article 32, a juridical person was liable on its obligations with its property (a state organization – with assets designated for its use), against which, under the U.S.S.R. law and the Civil Code 1964, enforcement could be carried out. For example, the Civil Code 1964 included a carve-out for all main means of production for state organizations (Article 98).

<sup>152</sup> Cf. the earlier Soviet rules that allowed the obligations to be revised (unilaterally, as the case may be) if a change in the state plan occurs. See for more detail p.36 above.

Rules related to monetary obligations were also revised by the Civil Foundations 1991. First, interest was payable in respect of funds (owned by a person) that were unjustly used<sup>153</sup> by a (another) person. The respective interest rate payable was the bank interest rate existing at the place of the residency of the creditor.<sup>154</sup> In addition, default interest was due on overdue monetary obligations. The applicable interest rate was set at five *percent per annum*.<sup>155</sup> If the overdue monetary obligation was related to entrepreneurial activity or was an obligation of a body corporate, both the statutory default interest and interest in connection with the unjust use of funds were payable (Article 66).

Rules on liability were changed in the Civil Foundations 1991. The general rule was that the debtor was liable for its non-performance if its fault was established, unless the contrary was provided for by law or the contract. Fault could not be established if the debtor could prove that he had exercised all measures within its powers in order to perform the obligation in due manner. However, the rules were different if the obligation was not performed in the course of entrepreneurial activities: the defaulting debtor was liable, unless it could prove that performance was rendered impossible due to force-majeure. The rule on entrepreneurial liability was also subject to other laws and contract (Article 71).<sup>156</sup>

Penalty, pledge, suretyship (guarantee) or advance could be used to secure performance of obligations. This list of types of (quasi-)security was exhaustive (Article 68). In addition, Article 113, dedicated to credit facilities, stipulated that banks could “*accept other undertakings*” as security.<sup>157</sup>

Rules on pledge generally followed the Civil Code 1964 rules; and enforcement of a pledge, unless contrary was provided by law, had to be carried out through courts or arbitrazh courts. However, the restriction on pledge of the main means of production was lifted<sup>158</sup> and it was explicitly provided that any assets, including property rights, could be pledged. As can be expected, under the Civil Foundations 1991, pledge followed the asset (*i.e.*, transfer of

<sup>153</sup> The Russian concept and the term used in the original language are “unjust enrichment”, Article 133 of the Civil Foundations 1990.

<sup>154</sup> With respect to unjust enrichment, the Civil Code 1964 spoke of turning over of the “income” that was received or should have been received during unjust use (Article 473).

<sup>155</sup> The Civil Code 1964 set an interest rate of 3 *percent per annum* (Article 226); however, for socialist organizations default interest rates were set by other normative acts. For example, Instruction of the State Bank of the U.S.S.R. No.2 “On Bank Payments in Peoples’ Economy”, dated 31 May 1979, set a default interest rate of 5 *percent per annum* in respect of payments into the state budget in relation to delays with shipment of pre-paid goods.

<sup>156</sup> Cf. rules of the Civil Code 1964: under Article 222, a person that failed to perform its obligation was liable only when such person was at fault (which included intent or negligence). The absence of fault had to be proved by the person in default.

<sup>157</sup> For the want of precisions and any rules on enforcement/priorities with respect to “obligations” used as security, this provision was of little practical value.

<sup>158</sup> See Article 98 of the Civil Code 1964; the provision is referred to on p.32 above.



ownership did not terminate the pledge); in addition, the law specifically provided that if the right of full economic management or operative control was transferred, pledge remained valid, too.<sup>159</sup>

Under the Civil Foundations 1991, the term “suretyship” was used as a synonym to “guarantee”, which was not the position under the Civil Code 1964.<sup>160</sup> In fact, the tradition of distinguishing suretyship and guarantee appeared to have survived the Civil Foundation’s new definition.<sup>161</sup> A suretyship meant the acceptance of liability to a creditor under an obligation of another person. However, the law stipulated that a surety was liable where the primary debtor had not funds to meet the obligation, unless the contract or law provided for joint and several liability of the surety. It appears that for the purposes of protection of a creditor’s interests, such an approach of the Civil Foundations 1991 was a step back when compared with the Civil Code 1964.<sup>162</sup>

Rules on assignments were not changed by the Civil Foundations 1991. Some restrictions on the type of assigned asset remained (though of minor significance); and the assignor was liable in respect of the validity of the assigned right, but not its performance, unless the assignor issued suretyship in this respect (Article 69).

A body corporate was obligated to deposit its “*free cash*” with banks; in turn, local banks were under an obligation to open bank accounts for bodies corporate or entrepreneurs (Article 109). The Civil Foundations 1991 provided that a bank could use the client’s cash, however, “*guaranteeing*” that cash is available if claims were made against the account and “*guaranteeing*” the right of the client to control and receive (interest) income on such cash.<sup>163</sup>

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<sup>159</sup> On the one hand, this particular provision was important in the anticipation of wide-scale re-organization of state property. On the other hand, the ultimate right of property in relation to the assets under full economic management or operational control lay with the state or a municipality; and, hence, a transfer of assets that were in full economic management or operational control from one entity to another did not automatically result in the change of the right of property. Thus, this provision was, perhaps, either superfluous or deficient.

<sup>160</sup> For more detail see p.33 above.

<sup>161</sup> The Letter of the Supreme Arbitrazh Court No. S-13/OP-167, “On Particular Recommendations, Adopted at Meetings on Court-Arbitrazh Practice”, dated 20 May 1993, referred specifically to “guarantees” and “guarantee letters”. However, both legal instruments were declared to be secondary in nature. Thus, there were no advantages to be gained in practice from the use of “guarantees” instead of suretyships.

<sup>162</sup> Under Article 204 of the Civil Code 1964, the surety and the debtor were jointly and severally liable, unless the contrary was provided by the suretyship contract.

<sup>163</sup> It is intriguing that the law referred to “*guaranteeing*” that cash is available. Generally, banks operate on the basis of a fractional reserve system and one of their main functions is the transformation of maturity (*i.e.*, bank deposits are “on demand” instruments (credit-side on the balance sheet), and bank loans are term instruments, with tenors ranging from anything as short as 1 month bridge loan to two or three decades (debit-side on the balance sheet)). Given that the maturity mismatch and fractional reserves are foundations of the banking business, it is impossible for an ordinary bank to “*guarantee*” that cash is available. Of course, if the client requested a payment instruction within the funds available on the account, and the bank could not implement

The Civil Foundations 1991 distinguished between the regime for bank accounts and bank deposits (Article 111). The law provided that only banks that ensured the safety and timely repayment of deposits *via* insurance, or other means provided by law, could accept deposits from citizens. Safekeeping and timely repayment of deposits in banks that were established by the state and banks with more than 50 *percent* state ownership, were “*guaranteed*” by the state or central bank.<sup>164</sup>

The Civil Foundations 1991 distinguished between loans and credit facilities.<sup>165</sup> Loans were interest-free. Credit facilities unrelated to entrepreneurial activities and made between citizens and were assumed to be interest-free, unless the agreement stipulated to the contrary. On the contrary, credit facilities extended to business persons were presumed to be made with interest. If an agreement was silent on the applicable interest rate, the rate was set to be the average interest rate charged by banks at the creditor’s location. The law provided that a contractual interest rate should be compliant with legislative acts, thus opening the door to state regulation of interest rates (Article 113).

According to Article 114, a credit facility agreement could have provided that a bank or a person engaged in entrepreneurial activities could be under an obligation to extend a credit facility on terms agreed by the parties. This was a positive development in law (keeping in mind the restrictive rules of the Civil Code 1964).<sup>166</sup> If the parties reached an agreement on extending a credit facility in future, the lender could refuse to make the loan if the borrower

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the instruction (for example, due to the lack of liquidity), the bank would be in default, and, perhaps, also insolvent.

As one explanation to the “*guaranteeing*” wording, an argument could be made that in the early 1990s there was no sufficient experience in the regulation of the banking sector. However, the “*guaranteeing*” wording was also kept intact in the Civil Code 1994, Part II (see Article 845), which was adopted in December 1995. By that time, it seems, the relevant experience should have been gained.

It must also be noted that 100% reserve banking is also possible. This is often referred to as “*mutual banking*” and has been discussed as one of the responses to the financial crisis started in 2007. See L.Kotlikoff, *Jimmy Stewart is Dead: Ending the World's Ongoing Financial Plague with Limited Purpose Banking*, John Wiley & Sons, London, 2010. Banks with 100% reserves would have the capacity to repay their clients at any time.

<sup>164</sup> The repayment and value of deposits, however, turned out to be a stumbling rock for the nascent Russian market economy. During the reforms of 1990s many deposits that were made with non-state banks were lost due to either financial fraud or insolvency of the bank holding the deposit. The more significant part of citizens’ deposits was held, however, with Sberbank, a state-owned bank. Russia experienced hyperinflation at that time and interest paid by Sberbank was significantly below inflation; as the result, the deposits lost its value. Of course, the Civil Foundations 1991 did not “*guarantee*” the value of a deposit; however, several years later, in response to the social pressures in relation to the devalued deposits, the Law of the Russian Federation No. 73-FZ “*On Reinstatement and Protection of Saving of Citizens of Russian Federation*”, dated 10 May 1995, was adopted. The law provides for some compensation with respect to the devalued deposits that were made prior to 20 June 1991.

<sup>165</sup> “*Zayem*” (a loan) and “*kredit*” (credit facility) in Russian. It must be admitted that “*loan*” is an imprecise English translation, it is used here for the purposes of brevity. A more precise English equivalent to *zayem*, is, perhaps, “*interest-free borrowing*”.

<sup>166</sup> The Civil Code 1964 (chapter 26) recognized only “*loan*” agreements (Russian “*zayem*”); generally, agreement on a loan was considered to be made when the funds were disbursed. Hence, there could be no agreement to lend in the future.

was declared “unable to pay”; if the borrower failed to comply with its obligations on “securing” the credit; or in other cases provided for by the contract.<sup>167</sup>

The Civil Foundations 1991 introduced in law the distinction between the two basic types of security: a bond and a share. The definition of a bond was wide enough to encompass a variety of financial instruments: a bond was a security that certified its holder’s right to receive the face value of the bond (or another proprietary equivalent) and interest on the face value fixed therein (or other proprietary rights).<sup>168</sup> A share was defined as a security that certified its holder’s right to: (i) receive a share of profits of the company; (ii) participate in the management of the company’s affairs; and (iii) a share of the assets of the company remaining after liquidation.<sup>169</sup> It is interesting to note that the Civil Foundations 1991 allowed both bonds and shares to be registered and bearer instruments. There were also provisions included on the regime for preferential shares. A preferential shareholder, generally: (i) would not participate in the management of a company; (ii) would receive interest on the face value on the shares (and not dividend); (iii) receive preferential treatment in the case of the liquidation of a company.

#### **(iv) Privatization and Market Reforms**

Privatization is, generally, a process whereby assets owned, or services earlier provided, by the state are transferred into private ownership or control. Common reasons for privatization include the raising of funds (or saving expense) and increasing managerial efficiency.

Privatization in the Soviet Union, however, was conducted with different motives and on a much larger scale. The reader may remember that under the U.S.S.R. Constitution 1977<sup>170</sup> and Civil Code 1964<sup>171</sup> the means of production were state property; individuals could have the right of “*personal property*”; and, perhaps, with the exception of the Bank for Foreign Trade (whose “shares” were owned by the state anyway), there were no stock companies in the Soviet Union. Thus, when *Perestroika* started, there were no examples or experience of decentralized non-state ownership of any significant assets in the economy. The following quote is invaluable evidence of the political, social and economical situation in the Soviet

<sup>167</sup> This provision was similar to that of the Civil Code 1922, Article 219 (see p.27 above).

<sup>168</sup> Article 33 of the Civil Foundations 1990.

<sup>169</sup> Article 36 of the Civil Foundations 1990.

Generally, there were two definitions of “shares” at this point in the U.S.S.R./R.S.F.S.R. law. One was provided by Law on Cooperatives, according to which the regime of “shares” was surprisingly similar to a regime that is commonly associated with bonds (see p.42 above for more information). The other relevant provisions could be found in the Law on Enterprises, according to which members/shareholders “owned” the assets of the company.

<sup>170</sup> See *U.S.S.R. Constitution 1977*, p.23 above.

<sup>171</sup> See *Civil Code 1964*, p.30 above.

Union during the late 1980s and early 1990s (and the approach and decisions of the State in response to the crisis):

*“The route to Perestroika, [suffered] and approved by the soviet people, freed the mighty forces of renewal of the society. [Perestroika] pulled the state out from [sleep] and stagnation. Fundamental changes were achieved in international cooperation, disarmament began. Due to political reforms, the processes of democratization and glasnost rapidly develop, citizens’ political rights are widened and the sovereignty of people is strengthened. All this creates conditions for the upheaval of the whole our society, and first of all, the economy.*

*Nevertheless, the heavy burden of the administrative-command system, inconsistency and halfness of the economic reform measures, and that even includes mistakes in the direction of the economy, and disrespect to law brought into being a deep economic crisis in the State.*

*The state of the people’s economy continues to worsen. Production declines, business connections are severed. Separatism grows. The [end-]customer market is devastated. The deficit of the budget and creditworthiness of the State reached critical figures. Antisocial phenomena and crime escalate. Peoples’ life becomes harder, their interest in work declines and belief in the future collapses. Economy is in a critically dangerous state – the old administrative system is ruined, and new free-market work stimuli have not been created yet. Drastic measures based on social consensus are required in order to stabilize the situation and to [ensure] swift advancement on the route to market economy...*

*There is no alternative to the transition to market [economy]. ... The transition to [market economy] is ... driven by the interests of [individuals], and its objective is to create socially-oriented economy, turn all production to the interest of consumers, overcome the deficit ..., ensure the economic freedoms of individuals in practice and set forth the conditions for stimulation of hard work, creativity, initiative and effectiveness.”*

The significance and the value of the above quote (in pointing out the depth of the economic crisis and the need for a “free-market” response) is that its source is a public statement made in 1990 by the Supreme Soviet of the U.S.S.R. – the body of the highest state authority

in the U.S.S.R.<sup>172</sup> In that situation privatization was bound to become one of the major tools of the economic reform.

The procedures used to privatize the Soviet economy changed with time. Different stages of privatization are often distinguished: (i) spontaneous (1987-1991);<sup>173</sup> (ii) large-scale (1992-1994); (iii) cash-driven (1994-1997); (iv) pledge auctions (1995-1996); and (v) selective (2001 and onwards).<sup>174</sup>

It is difficult to produce a systematic description of the early privatization process in the Soviet Union and Russia as privatization at that time was conducted in what appears to be a trial and error method. There are, at least, thirty major legislative acts related to privatization in the Soviet Union and Russia, of which the most important documents will be described below. The chronological approach seems to be the most natural choice in the analysis of otherwise a labyrinthine process.

#### Law on Individual Labor Activity

The Law of the U.S.S.R. “On Individual Labor Activity” (the “**ILA Law**”)<sup>175</sup> was one of the first documents that signified policy shift to more economic freedom for individuals. Under the ILA Law, “*individual labor activities*”<sup>176</sup> was defined to mean activities that were performed otherwise than under a service agreement with the state, a cooperative or public enterprise or citizen, *etc.* The ILA Law allowed a citizen to engage in “*individual labor activities*” in “*crafts*”, consumer services and other types of services, if such services were based exclusively on personal labor of the citizen and members of his/her family (Article 1). Furthermore, the ILA Law used a common soviet clause “*non-labor profits*”, which remained prohibited. A difficulty that had to be solved in the law, was whether property could be used for individual labor activities (the reader may remember the restrictions on personal property in the U.S.S.R. Constitution 1977.<sup>177</sup> This was dealt in the ILA Law in the following way: raw materials, instruments and other assets that were owned by a citizen as personal

<sup>172</sup> The Declaration “On Main Directions for Stabilization of People’s Economy and Transition to Market Economy”, adopted by the Supreme Soviet of the U.S.S.R. on 19 October 1990.

<sup>173</sup> It is suggested that the first step in the privatization process in the Soviet Union was the adoption of Law of the U.S.S.R. No.810-I “On Foundations of Legislation of the U.S.S.R. on Lease”, dated 23 November 1989; see, for example, V.Bartosh, “Legal Foundations for Privatization in Russian Federation during the Period of 12 June 1990 – 12 December 1991”, *Legislation*, No.2, 2000. However, in the Soviet Union privatization was also the process where the institution of private property was reborn; and it was not simply a case of selling state assets into the private hands, and thus it appears to date the market reforms/privatization in the Soviet Union to an earlier period. See also N.Perepelkina, “Privatization as Ground for Acquiring Property Rights, or Do Objectives Justify Means?”, *Civil Law*, No.3, 2008.

<sup>174</sup> E.Moiseeva, “Privatization as Method of Disposal of State and Municipal Property”, *Journal of Russian Law*, No.9, 2006.

<sup>175</sup> See also the enacting Resolution of the Supreme Soviet of the U.S.S.R. No. 6051-XI, dated 19 November 1986.

<sup>176</sup> This expression will be used for the purposes of this sub-section, as that is the language used in the ILA Law.

<sup>177</sup> See *U.S.S.R. Constitution 1977* on p.23 above.

property, assets transferred by a client, assets hired from an enterprise could be used for individual labor activities (Article 4). Arguably this (re-)definition of personal property (as property including raw materials, etc.) was wider than the definition of personal property included in the U.S.S.R. Constitution 1977, according to which personal property was limited to assets designed for personal consumption.

#### Law on State Enterprises

The Law of the U.S.S.R. No. 7284-XI On State Enterprises, dated 30 June 1987 (the “**Law on State Enterprises**”),<sup>178</sup> was intended to promote the commercial side in the functioning of state enterprises and increase the role of an enterprise’s employees in its management.

According to Article 2 of the Law on State Enterprises, an enterprise’s activities were “*constructed*” on the basis of the state plan; at the same time, an enterprise was functioning “*on the principles*” of full economic accounting and self-financing. Profit, or turnover, as the case may be, was declared to be the “*consolidating*” measurement of an enterprise’s success.

An enterprise had to develop its own plans, and in doing so it had to direct itself with the control figures, state orders and long-term economic ratios and standards. However, the respective paragraph also made a reference to customers’ orders (that had to be taken into account). With respect to control figures, the Law on State Enterprises included some further provisions that could be helpful in revealing their role. According to Article 10 of the Law on State Enterprises, control figures “*reflected the requirements of the society for [goods] and minimal levels of the effectiveness of production*”; and control figures should not have been regarded as having the nature of a directive and should not have “*bound*” the employees in the preparation of the enterprise’s plan. Thus, the intention of the legislator was to provide more flexibility to state enterprises in the planning of their affairs. This was complimented by another rule that restricted the type of ratios/data that the control figures could relate to.

Generally, an enterprise developed its plans itself, with various “*higher-standing authorities*” participating in the process; however, major enterprises (that were subject to the supervision at the level of the Soviet Union or a republic) had to agree their plans with their “*higher-standing authority*”.

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<sup>178</sup> See also its enacting Resolution of the Supreme Soviet of the U.S.S.R. No. 7285-XI “On the Order of Entry into Force of the Law of the U.S.S.R. “On State Enterprise””, dated 30 June 1987.

Notwithstanding the relaxations related to the control figures and the process of the adoption of a plan, the Law on State Enterprises provided that an enterprise had to fully comply with “*planning discipline*” and fulfill its plans and contractual obligations (Article 10). Thus, once a plan for the enterprise was put in place, it became a binding document.

The Law on State Enterprises for the first time included an antitrust provision: the “*higher-standing authority*” had to prevent “*monopolistic tendencies of particular enterprises*” (Article 9). The tools that the higher-standing authority had to use to this end were “*measures*” directed against: overstatement of costs and prices; stagnation in the technical development of productions; and artificial limitations on the volume of production. The economic background to this antitrust provision is quite intriguing: on the one hand, it appears that the state intended to address the problems that existed at the time in the Soviet economy; on the other hand, the matters that the provision covered, it seems, were naturally inherent to a planned economy. Under the Law on State Enterprises, prices on goods and services generally remained to be set centrally by the State; however, in certain cases (*e.g.*, for goods produced pursuant to one-off orders or goods produced for the first time) an enterprise could set its own prices (Article 17).

According to Article 4 of the Law on State Enterprises, the enterprise “exercised” the rights of ownership, use and disposal of its assets. The Roman legal tradition distinguished between three rights of ownership: (i) *usus*; (ii) *fructus*; and (iii) *abusus*. Soviet law incorporated the three rights into its definition of the right of a proprietor, though the Russian terms, perhaps, were not quite equivalent to their Latin counterparts.<sup>179</sup> One interpretation of the legal position of the Law on State Enterprises is that since (i) the Civil Code 1964 referred to only three rights of the proprietor, and (ii) all such three rights were exercised by the state enterprise, it follows that, in theory, the State itself was left “bare” and could not have the benefit of what actually was “state” form of property. Another interpretation was that in its “exercise” of rights, a state enterprise actually represented the State.

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<sup>179</sup> Thus, the Civil Code 1964, Article 92, provided that “*a proprietor [had] the rights of ownership, use and disposal of the [respective] assets within the limits prescribed by law*”. It must be noted the modern Civil Code 1994, Article 209, also followed the Roman legal tradition of the split rights of a proprietor into the rights of ownership, use and disposal.

### Foundations of Legislation on Lease

The Law of the U.S.S.R. No.810-I “On Foundations of Legislation of the U.S.S.R. on Lease”, dated 23 November 1989 (the “**Foundations of Legislation on Lease**”)<sup>180</sup> allowed employees to lease whole enterprises (and divisions thereof), and, subsequently, to “*buy out*” the leased property – *i.e.*, to privatize state property<sup>181</sup> However, the law remained a half measure: a leased enterprise was only partially outside the ambit of the state plan and had to observe the prices set by the State.

The terms and conditions, procedure and period for the “buy out” had to be set out in the lease agreement. In order to “buy out” the assets, the lessee had to (pre)pay the total amount of lease payments against the value of the leased assets if the assets were leased for their full serviceable life, or, alternatively, by paying to the lessor the total amount of all lease payments against the total residual value of the assets if the lease had been terminated prior to the expiration of the serviceable life of the assets.

Once the assets were bought out, the lease enterprise, upon a decision of its employees, could have been transformed into a collective enterprise, cooperative, stock company or another type of enterprise that was based on the collective form of property. The proceeds from the “buy out” were to be paid into the respective budget. By virtue of Article 11 of the Foundation of Legislation on Lease, the lessee, acting in accordance with the lease agreement, was free to determine the “*directions*” of its economic activity and dispose of the produced goods and income received.

As the reader will understand, Articles 10 and 11 of the Foundations of Legislation on Lease practically authorized an early form of privatization in the Soviet Union. Though the reference was made to “*collective property*” in the text of the article; the actual result was, perhaps, a peculiar form of restricted “private” property: in its original form the asset (*i.e.*, the state enterprise) was subject to the regime of the state plan; once, and during the period that, the asset was leased, such asset was largely<sup>182</sup> taken out from the ambit of the state plan.

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<sup>180</sup> See the adopting Resolution of the Supreme Soviet of the U.S.S.R. No.811-I “On the Order of Entry into Force of the Foundations of the Legislation of the Union of S.S.R. and Republics on Lease”, dated 23 November 1989.

See also the Resolution of the Council of Ministers of the U.S.S.R. No.280 “On the Order of Transfer of Union Enterprises (Associations) and Their Assets into Leases”, dated 20 March 1990. The Resolution generally permitted transfer of all enterprises and assets into leases, with certain exceptions (*e.g.*, in the defense industry).

<sup>181</sup> The Russian text of the Foundations of Legislation on Lease uses the singular term “*labor collective*” (*trudovoi kollektiv*); however, for the reader’s convenience a more common English term “employees” is used herein.

<sup>182</sup> A leased enterprise, however, was not completely free from the state’s directives. According to Article 18 of the Foundations of Legislation on Lease, a leased enterprise had to accept agreements for the fulfillment of state orders and for sales of goods or services in accordance with the economic “*links*” that had been in place at that



### Resolution on Market Prices

By the end of 1990, the U.S.S.R. authorities had to abandon state regulation of prices. Initially, such regulation was to be abolished for certain goods and services only. According to the Resolution of the Council of Ministers No.1134 “On Transition to Application of Contractual Retail Prices on Certain Types of Consumer Goods”, dated 12 November 1990, prices were deregulated with respect to consumer goods listed in the schedule to the resolution (mainly luxury goods); the deregulation took place in order to *“create the necessary conditions for the transition to market economy and [stimulate] the production of deficit goods ... and for the purposes of advancements in the fight against the shadow economy and speculation”*.

### U.S.S.R. Foundations on Privatization

The U.S.S.R. Law No.2278-I “On Main Foundations of De-statization and Privatization of Enterprises”, dated 1 July 1991 (the **“U.S.S.R. Foundations on Privatization”**),<sup>183</sup> purported, as follows from its title, to set the main rules on privatization in the U.S.S.R.

According to the U.S.S.R. Foundations on Privatization, state enterprises could have been transformed into collective enterprises, stock companies, other enterprises, and into lease enterprises (Article 1). Employees were granted a priority right in respect of free-of-charge transfers of property from state into private ownership (Article 3). The law allowed for quotas to be set in respect of the privatization so as to prevent *“excessive concentration of capital”*.

Foundations on Privatization intended to cover enterprises that were owned by the state and located throughout the U.S.S.R. In fact, only two days later, on 3 July 1991, the Supreme Soviet of the R.S.F.S.R. adopted its own law on privatization.<sup>184</sup> Taking into account the Declaration on State Sovereignty of the R.S.F.S.R. and the Law of the R.S.F.S.R. “On Property on the Territory of the R.S.F.S.R.”,<sup>185</sup> U.S.S.R. Foundations on Privatization did not apply in Russia in practice.

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time, in quantities not exceeding the state order that were accepted in the year when the enterprise was leased out.

<sup>183</sup> See also its enacting Resolution of the Supreme Soviet of the U.S.S.R. No.2279-I “On Entry into Force of the Law of the U.S.S.R. “On Main Foundations of De-statization and Privatization of Enterprises””, dated 1 July 1991.

<sup>184</sup> See *R.S.F.S.R. Law on Privatization* on p.58 below.

<sup>185</sup> Dated 14 July 1990. The law stipulated that assets and “funds” located on the territory of the R.S.F.S.R. were regulated by the laws of the R.S.F.S.R.

### R.S.F.S.R. Law on Privatization

The Law of the R.S.F.S.R. No.1531-I “On Privatization of State and Municipal Enterprises in the R.S.F.S.R.”, dated 3 July 1991 (the “**R.S.F.S.R. Law on Privatization**”),<sup>186</sup> as follows from the title, set forth the basic rules on privatization in Russia (and, unlike its U.S.S.R. sister law,<sup>187</sup> was applied in practice in Russia).<sup>188</sup>

The R.S.F.S.R. Law on Privatization included a generous definition of privatization, according to which almost any imaginable asset could be privatized (*e.g.*, not only enterprises, but also departments, workshops, units, licenses, patents, *etc.*). Nevertheless, the law excluded from its ambit the privatization of dwelling houses and land (Article 1).

Under the law, a crucial role was to be played by state program of privatization.<sup>189</sup> A program had to set forth the objectives and priorities of, and restrictions on, privatization in the R.S.F.S.R.<sup>190</sup>

A privatization program must have included, *inter alia*: (i) the list of items of state property that were designated for privatization; (ii) the requirements to local programs of privatization; and (iii) the determination of preferable procedures for privatization, forms of payment and benefits for the employees.

The R.S.F.S.R. Law on Privatization created two state authorities that were involved in the process of privatization: R.S.F.S.R. State Committee on Management of State Property (the “**GKI**”) (Article 4) and Russian Fund of Federal Property (the “**RFFI**”) (Article 5).

The GKI was appointed the body generally responsible for privatization (it was in charge of the privatization programs and took decisions on privatization of individual entities). The

<sup>186</sup> See also the enacting Resolution of the Supreme Soviet of the R.S.F.S.R. “On the Order of Entry into Force of the Law of R.S.F.S.R. “On Privatization of State and Municipal Enterprises in the R.S.F.S.R.””, dated 3 July 1991.

<sup>187</sup> See *U.S.S.R. Foundations on Privatization* on p.57 above.

<sup>188</sup> Around 150 legislative acts were adopted during 1991-1994 in the Russian Federation. From O.Tschelkov, “Privatization of Enterprises: legislation and Issues in Court and Arbitrazh Practice”, *Economy and Law*, No. 11, 1995.

<sup>189</sup> Thus, there were at least two documents that laid foundations for privatization in any given period: the R.S.F.S.R. Law on Privatization and the privatization programme adopted for that period. This duality was criticized in literature, see, for example, the reference to *travaux preparatoire* to the Law of the Russian Federation “On Privatization of State and Municipal Enterprises” 2001 in V. Vaipan (*ed.*), *Commentary to Federal Law “On Privatization of State and Municipal Assets*”, JustisInform, 2004. However, it seems that a strong argument can be made in favor of having the two-stage approach to privatization. A law on privatization can be used to set forth the rules that are intended to stay in force for a longer period of time; a programme can be used to set rules with a shorter intended application.

<sup>190</sup> See, for example, the “State Programme of Privatization of State and Municipal Enterprises in the Russian Federation for year 1992”, approved by the Resolution of the Supreme Soviet of the Russian Federation No.2980-I, dated 11 June 1992; the Decree of the President of the Russian Federation No. 2284 “On State Program of Privatization of State and Municipal Enterprises in the Russian Federation”, dated 24 December 1994; and the Decree of the President of the Russian Federation No.1535 “On Main Provisions of the State Program of Privatization of State and Municipal Enterprises in the Russian Federation after 1 July 1994”, dated 22 July 1994.

RFFI had the sole authority to act as the seller of state enterprises being privatized and state-owned shares. The RFFI also acted as the “proprietor” in respect of the state enterprises and shares held on behalf of the R.S.F.S.R.

The R.S.F.S.R. Law on Privatization allowed two main forms of payment for privatized assets (Article 11): (i) payment in lawful currency of the R.S.F.S.R.; and (ii) registered privatization deposits.

The regime for registered privatization accounts/deposits was created by the Law of the R.S.F.S.R. “On Registered Privatization Accounts and Deposits in the R.S.F.S.R.”, dated 3 July 1991. The privatization accounts/deposits were “denominated” in virtual “funds” that could have been used only as payment for privatized state property.<sup>191</sup> According to the law, privatization “funds” should have been annually transferred by the state into privatization accounts; and values of such transfers were to be determined by the respective privatization programs.

The idea behind this mechanism was to provide every citizen with a procedure and “funds” that could be used to participate in privatization.<sup>192</sup> Interestingly, there was a three year lock-in period for any investment made with privatization “funds”: during such period investments could not be re-sold or otherwise disposed of.

However, privatization “funds” never took off in practice and, by the Decree of the President of Russian Federation No.2288 “On Measures on Aligning of the Legislation of the Russian Federation with the Constitution of the Russian Federation”, dated 24 December 1993, the law “On Registered Privatization Accounts and Deposits in the R.S.F.S.R.” was annulled.

Originally, the law provided for three methods of privatization (Article 15): (i) sale-purchase *via* a tender<sup>193</sup> or auction<sup>194</sup>; (ii) sale of shares; and (iii) “buy-out” of the leased enterprise.<sup>195</sup>

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<sup>191</sup> In fact, privatization “funds” were evidenced by a kind of a “privatization passbook” that was held by the depositor/account holder. Physically the “privatization passbooks” were identical to passbooks traditionally issued in the Soviet Union by Sberbank for ordinary deposits.

<sup>192</sup> More specifically, most of the commercial assets in the U.S.S.R. were state property and, thus, “ultimately” belong to the people (collectively). If state property was to be dispensed with, it was logical that the beneficiaries, *i.e.*, the citizens, should have received the proceeds from its distribution. Privatization in the R.S.F.S.R. was not conducted on the basis of distribution of all (former) state property in some (equal) fractions to each citizen, but rather by way of providing the opportunity to the citizen to make investment decisions. Hence, the accumulated wealth of the state must have been distributed in some way to the citizens so as to allow them to make their investments.

<sup>193</sup> A tender was initiated when the buyers were required to comply with certain terms and conditions, *e.g.*, to carry out an investment program (Article 20). For a sale *via* tender, a special commission was established in each case. The bidder whose offer was the best match for the terms and conditions of the tender, won the tender. It was the tender commission that had the power to decide whose bid was “best”. Decisions of tender commissions, it appears, were susceptible to “inconsistencies” and were often criticized.

Employees of a state enterprise that was re-organized into a stock company could purchase a certain amount of shares of the stock company at a discount not exceeding thirty *percent*; in addition, employees were entitled to pay in installments over a period up to three years (Article 23).

#### Decree on Privatization Checks

Shortly after the adoption of the R.S.F.S.R. Law on Privatization, the Decree of the President of the Russian Federation No.914 “On Entry into Force of the System of Privatization Checks in the Russian Federation”, dated 14 August 1992 (the “**Decree on Privatization Checks**”) was adopted.

The intention behind the Decree on Privatization Checks was to speed up privatization in Russia. Another important objective was the development of the financial markets in Russia through the use of privatization checks (a privatization check was a bearer security). The Decree on Privatization Checks was a reversal from the approach adopted in the Law of the R.S.F.S.R. “On Registered Privatization Accounts and Deposits in the R.S.F.S.R.”, which opted for the privatization accounts/deposits.<sup>196</sup>

According to the Decree on Privatization Checks, on 1 October 1992 a system of privatization checks (also known in Russia as “*vouchers*”) was introduced. Privatization checks could be used as payment for privatized assets. The face value of a voucher was 10,000 Rubles. Generally, privatization checks were accepted as payment for privatized assets until 31 December 1993.

Privatization checks could be used only in privatization of state, and not municipal, property. There were no restrictions on trade in privatization checks.<sup>197</sup> Once a privatization check was used to make a payment in privatization, such a check was extinguished and taken out of circulation.

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<sup>194</sup> An auction was initiated when there were no specific terms and conditions that the buyer had to comply with (except for the payment of the purchase price, of course). The highest bid won the auction. Auctions were carried out by the (branches of) the RFFI. The R.S.F.S.R. Law on Privatization provided that the initial purchase price could have been lowered, however, by not more than thirty *percent* (Article 21).

<sup>195</sup> Later, it was also possible to pay for privatized assets with “*vouchers*” (privatization cheques).

<sup>196</sup> See p.59 above.

<sup>197</sup> Cf. with the three-year lock-in period provided for the privatization deposits and privatization using benefits; see *R.S.F.S.R. Law on Privatization* p. 59 above.

The Decree on Privatization Checks adopted the simplest possible approach to the distribution of the privatization checks: every citizen of the Russian Federation, who was resident in Russia,<sup>198</sup> was entitled to one privatization check.

Thus, in theory (the practice was far from it), the Decree on Privatization Checks purported to distribute the accumulated wealth of the State<sup>199</sup> in equal shares among the population of Russia.

#### Privatization: results and criticisms

Russian privatization is an extremely controversial topic; from the legal perspective:

*“Privatization in practice was conducted with many breaches of the Constitution of the Russian Federation, ..., [and] laws on privatization... . Many legislative acts ... , regulating [privatization] [were] not aligned into a uniform system and often [contradicted] each other. Laws and state programs of privatization [included] numerous references to secondary legislation, the adoption of which, as a rule [was] delayed.”<sup>200</sup>*

On the other hand, the context in which privatization was conducted must be taken into account. The Russian economy was virtually ruined, the federal budget was depleted and the State could not pay to, or control, the state enterprises. The collapsing production in conjunction with the liberalization of prices caused hyperinflation, unemployment and mass civil protests. In these circumstances, it was simply dangerous for the Government to try to keep control of the enterprises, which turned out to be at that time cost centers, rather than income sources. The Government had to act quickly. And in this respect, privatization was a success:

*“As the result of [the early stages] privatization with the use of privatization checks, some 12,000 stock companies were created [by 1995] and seventy percent of manufacturing capital was privatized.”<sup>201</sup>*

From the social perspective, a privatization of the scale comparable to that in Russia is bound to attract divided opinion and strongest criticisms. The resultant distribution of state wealth (which earlier “belonged” to the people) left a much larger part of the population significantly less well-off than the other, rather insignificant in number, part of the

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<sup>198</sup> There were certain exceptions for citizens who later returned to Russia and for Russian military personnel stationed abroad.

<sup>199</sup> See footnote 192 on p.59 above.

<sup>200</sup> From O.Tschelkov, “Privatization of Enterprises: legislation and Issues in Court and Arbitrazh Practice”, *Economy and Law*, No. 11, 1995.

<sup>201</sup> *Ibid.*

population. This alone will naturally lead to a significantly larger number of condemning opinions voiced as compared to opinions of approval. On the other hand, the legislation adopted at the time was not, it seems, intended to cause such social imbalances. In fact, the Decree on Privatization Checks distributed the means of payment for privatized assets (checks) equally among the population. Furthermore, employees of the respective privatized enterprises generally had the benefits of a discount and installment payment plan.<sup>202</sup> Arguably, however, there was no understanding of the processes in the country at that time (or desire to participate) among the wider population.

From the technical perspective, Russian privatization was a chaotic and hardly controlled process. Often, the fairness of privatization tenders and auctions were questionable. The excesses were bound to cause public censure<sup>203</sup> and lead to barbarous battles for the “crown jewels” of Russia between competing economic groups.

From the legal perspective, the chaotic de-statization resulted in a great degree of uncertainty as to the ownership of privatized assets and a significant number of lawsuits.<sup>204</sup> It appears that the intention behind many of those lawsuits was the desire to alter the distribution of privatized assets rather than to protect lawful rights and interests.

The following example, publicized in the press, may put the legislation on privatization in the context and also demonstrate the difficulties of investing in the then Russia. The case in question relates to an investment made by Illingworth Morris PLC (UK) in JSC Bol’shevichka (Russia). Two opposite views on the case are presented below.

According to a one view,<sup>205</sup> Illingworth Morris PLC (the “**Investor**”) was a business partner of JSC Bol’shevichka (the “**Company**”). Pursuant to an investment tender, the Investor acquired forty-nine *percent* in the charter capital of the Company. The managers of the Company petitioned the Office of the General Prosecutor of the Russian Federation asking to protect the interests of the Company. The managers alleged that the Investor failed to fulfill its obligations to invest in the Company. Following a prosecutor’s inspection, it was revealed that the Moscow Property Fund adopted a program for investment that granted the foreign investor unwarranted benefits. The benefits in question related to a decrease in the value of

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<sup>202</sup> See *R.S.F.S.R. Law on Privatization* on p.58 above.

<sup>203</sup> See, for example, A. Kitz, “Mechanism of Privatization Requires Improvement of Control”, *Civil Law*, No.1, 2006.

<sup>204</sup> See, for example, A.Bobkov, “Mishaps of Privatization”, *Journal of Russian Law*, No.9, 2007 and O.Nikitina, “Privatization of Enterprises. Legislation and Court and Arbitrazh Practice”, *Business-Advocat*, No.10, 1997.

<sup>205</sup> Published by Mr.U.Nasonov (senior prosecutor of department of supervision for compliance with laws and legitimacy of the Office of Prosecutor General of the Russian Federation) “Participation of Foreign Capital in Privatization of State Enterprises”, *Legitimacy*, No.1, 1998.

investments (that the Investor had to make) as against the value that was set at the beginning of the tender. The period for the making of investment was also extended. As soon as the program was approved, the Investor “forgot” about its obligations to invest. Pursuant to a direction of the Office of the General Prosecutor, the Office of the Prosecutor of Moscow started a lawsuit, which resulted in a judgment of the arbitrazh court invalidating the sale-purchase agreement between the Moscow Property Fund and the Investor.

The other view was as follows.<sup>206</sup> Privatization of the shares in the Company was conducted pursuant to an investment tender. According to the tender’s terms, one of the obligations of the purchaser was to acquire trademarks and equipment required to produce high-quality clothing. According to the relevant secondary legislation in force at that time, one of the criteria in determining the winning bid was the value of, and the period for, subsequent investment in the privatized asset. The plan of the privatization of the Company referred to the term for the required investment: three years. The tender notice stipulated that the criterion to determine the winning bid was the value of the required investment. According to the results of the tender, the Investor, known for its trademark “Crombie”, was declared the winner. There was one more participant in the tender, a company that offered investment of lesser value. That company petitioned the arbitrazh court on declaring the results of the tender void. As the result of litigation, including in higher arbitrazh courts, it was decided that though the black letter of the law was not complied with, the spirit of the law was intact, since the Company received the investment that was needed. In addition, the Moscow Property Fund wrote a letter stating that during the two years from the execution of the investment agreement, the Company received more than seven million pounds sterling and that the investment program was at eighty *percent* completion. Three years into the judgment of the arbitrazh courts, the Prosecutor of Moscow, in the interests of the State and the public, started a lawsuit to invalidate the results of the tender, the sale-purchase agreement and the investment agreement. The lawsuit relied on: (i) breach of the term for the investment – five years instead of three years, as *per* the plan of privatization; (ii) and absence of clearance from the State Anti-monopoly Policy Committee. However, it was established during proceedings that both participants of the tender stated that investment would be made during five years. There was no requirement to make investment during the three-year period in the tender notice. The reason for the change from three years (as in the plan) to five years (as in the winning bid) was the request of the Company: the Company required investment in the form of the right to use well-known trademarks.

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<sup>206</sup> Expressed by L.Ryabchenko in “Difficulties of Disputing Privatization”, *Ezh-Jurist*, No.18, 2005.

Thus, it was in the interests of the Company to enjoy such rights for a longer period. Furthermore, the Moscow Property Fund accepted the tender documents, which stated that investment would be carried out over the period of five years. The Investor had no reasons to doubt the authority of the Fund to do so. It was also established that, according to the legislation in force at that time, no clearance from the State Anti-monopoly Policy Committee was required. The proposal of the Investor [to the Fund and court] to re-schedule the investment to be made over a period of three years, instead of the five years, as *per* the investment agreement, was disregarded. However, and notwithstanding all the above circumstances, the arbitrazh courts declared the results of the tender and both agreements invalid.



## Chapter 2. SECURITY LAW

The often quoted definition of security in English law is:

*“Security is created where a person (‘the creditor’) to whom an obligation is owed by another (‘the debtor’) by statute or contract, in addition to the personal promise of the debtor to discharge the obligation, obtains rights exercisable against some property in which the debtor has an interest in order to enforce the discharge of the debtor’s obligation to the creditor.”*<sup>207</sup>

Russian law does not have an abstract definition of security; instead, the Civil Code 1994 (the main source of law of security) explicitly refers to several forms of recognized security: penalty,<sup>208</sup> pledge, lien, suretyship, bank guarantee and deposit.<sup>209</sup> Generally, English law recognizes the following consensual security: pledge, lien, charge and mortgage.<sup>210</sup> As discussed in this chapter, the only “true” consensual security in Russian law is pledge.<sup>211</sup> Unfortunately, until December 2008, when amendments were made to Russian statutes, the only “true” Russian security interest – pledge – was ineffective in protecting creditors’ interests.<sup>212</sup>

Technically, Russian legal terminology operates with the term “*security for the performance of obligations*” (Article 329 of the Civil Code 1994).<sup>213</sup> It is unclear what led the Russian legislator to use the arguably excessive “*performance*” word with reference to security; and

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<sup>207</sup> As submitted by counsel and approved by Browne-Wilkinson V-C in *Re Paramount Airways Ltd* [1990] B.C.C. 130 at 149. The case also discussed statutory definition of security in the Insolvency Act 1986, Section 248(b)(ii), according to which security means “*in relation to England and Wales, any mortgage, charge, lien or other security*”.

Russian law, being continental, does not recognize trusts *per se* (though there is a concept of agreement on “*fiduciary management of property*” – Chapter 53 of the Civil Code 1994). Thus, Quistclose type trusts (*Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 56) cannot operate under Russian law and would be recognized neither as a matter of security, nor insolvency, law.

<sup>208</sup> There is no general rule against penalties in Russian law as in *Dunlop Pneumatic Tyre Co Ltd v Selfridge & Co Ltd* [1915] AC 847 in English law. However, Article 333 of the Civil Code 1994 may offer protection against exorbitant penalties *via* a restriction on unreasonably high interest rates. Russian penalties can be compared to default interest.

<sup>209</sup> In this work “*lien*” refers to Russian *uderzhanie*, and “*deposit*” to *zadatok*. *Uderzhanie* can be also translated as “*retention*” and *zadatok* as “*advance*”.

<sup>210</sup> “*There are only four kinds of consensual security known to English law: (i) pledge; (ii) contractual lien; (iii) equitable charge; and (iv) mortgage*” per Millett L.J at 125 in *Cosslett (Contractors) Ltd, Re* [1997] 4 All E.R. 115.

<sup>211</sup> See *Pledge* on p.71 and *Lien* on p.133 below.

<sup>212</sup> See *Enforcement* on p.106 below.

<sup>213</sup> For example, a piece of earlier Russian legislation, the Law of the Russian Federation No.2872-I On Pledge, dated 29 May 1992, uses the shorter and more comprehensive “*security for obligations*”.

it appears that there is no specific significance attached to it. Thus, the word “*performance*” in the context of security, as a rule, is omitted in this work.

The meaning of the term “security” differs in Russian law from that in English law. If one applied the concepts of English law to Russian security, at least suretyship and bank guarantee would be recognized as *quasi* security;<sup>214</sup> nonetheless, they are viewed as security proper in Russian law. The shortcomings of such an approach of Russian law and the nature of each recognized form of security is discussed in the respective sub-sections of this chapter below.

Russian law allows the parties to agree on forms of security not expressly provided for in the statutes. Article 421 of the Civil Code 1994 declares the parties’ general freedom to enter into any kind of agreement, subject to certain specified exceptions. Furthermore, the Civil Code 1994 expressly provides that “custom” forms of security (that is, forms of security in addition to those expressly referred to in the Civil Code 1994) may be agreed upon by the parties. However, it appears that the opportunity to create other forms of security is not used widely in Russia. Perhaps, there is some unwillingness on the part of Russian courts to accept any legal mechanism that is not expressly validated by a statute.<sup>215</sup> For example, sale and repurchase transactions, also known as “repo” transactions, have been recharacterised by Russian courts as pledges and invalidated.<sup>216</sup>

Generally, security allows lenders to improve recovery rates *via* having the ability to “claim against” an asset, should the borrower fail to repay. The way that a lender establishes the link to the secured asset varies with the form of security and depends on other factors. Some forms of security take possessory form, when the creditor holds (or has control over)

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<sup>214</sup> The term “*quasi* security” is used here broadly, and also refers to English guarantees and indemnities. A more strict use of the term, of course, would imply that it applies to mechanisms that create some form of an “interest” in assets (*e.g.*, repo transactions and retention of title), rather than guarantees and indemnities which are contractual promises.

<sup>215</sup> Sometimes Russian courts did recognize “new” forms of security: the Federal Arbitrazh Court of the North-West region ruled that a “*security deposit ... was a widely recognized form of security*” in its Resolution No.A56-20181/98, dated 15 March 1999. However, there were no specific arguments in the case challenging the validity of this legal mechanism as a form of security.

In another recent case, a lower instance court, the Federal Arbitrazh Court of Moscow region, approved a “preliminary payment” (essentially, a deposit) as a form of security. See the Resolution No.KG-A40/8205-09, dated 22 September 2009.

It is interesting that a prominent Russian jurist, V.Vitryanskii in *Contract Law. General Provisions (book one)*, 3<sup>rd</sup> ed., by M.Braginskii and V.Vitryanskii, Statut, Moscow, 2001, refers to other forms of security, provided for by statute: the subsidiary liability of participants in a full partnership (one of the organizational forms recognized by Russian law); and the right of the creditor, who has performed its part of a transaction, to petition that the transaction will be recognized as valid, despite the absence of the required notary registration, provided that the other party evades such registration, *etc.* Vitryanskii goes on to say that “[a]s to the extra forms of security, which may be provided for by a contract, authors of commentaries usually limit all possible cases to putting up by the debtor of a sum of money into the deposit held by a third party”.

<sup>216</sup> See *Pledge. Repo transactions* on p.97 below.

the secured assets, some require that security is made publicly known by the making of an entry a public register. Ordinarily, under insolvency rules a creditor's claim against the secured asset receives some form of protection from competing with the claims of other creditors.

The ability to claim against the secured asset is not the only route to increase the attractiveness of a deal for a prospective lender. Same result may also be achieved by extending liability on the debtor's obligations to persons other than the (main) debtor. Such arrangements are often referred to as "quasi security". "Quasi security", as a rule, does not receive protection in insolvency from the competing claims of the debtor's, or of such "additionally" liable third persons', creditors and thus is not generally treated as "full" security.<sup>217</sup>

As a rule, it is the lenders who are responsible for designing a security package for a transaction and they also have control over the respective security documents. Of course, it is in the interests of the lenders to receive a most complete and "bullet-proof" security. Lenders also prefer to receive legal opinions on validity and enforceability of security with as little qualifications as possible. On the other hand, borrowers, perhaps having no objections to providing security in principle, prefer to have sufficient freedom in running their businesses. Thus law of security has to provide a regime that is commercially acceptable for lenders, sufficiently certain, and, at the same time, does not intervene unnecessarily with the borrowers' activities. This is of course, is largely an interest balancing exercise.

In public discussions, one can often hear the argument that security benefits exclusively the lenders. However, on closer scrutiny, such an argument turns out to be erroneous. By taking security, lenders improve their recovery rates (or, at least, lenders so believe) thereby decreasing the risk: less risk manifests itself in cheaper credit for the borrowers. Furthermore, banks may be unprepared to lend at all without taking security.<sup>218</sup> If the law of security is not efficient or flexible enough, some categories of business projects may never be carried out, or, from an alternative perspective, borrowers may be strained for funds.

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<sup>217</sup> In practice, transactions may be structured so that the real credit support for a deal is provided by a third party (which may be part of the borrower's group). The lenders' risk assessment will then be based on the credit risk of such third parties and not the borrower (who may have no assets aside from a minimal equity contribution to the capital by shareholders).

As will be shown below, Russian law does not distinguish between security and *quasi* security. Moreover, in certain cases it treats issues of *quantum* of liability as matters of security.

<sup>218</sup> However, this does not imply that all financial transactions are secured: there are large markets where customarily lenders do not take security (or, from the other perspective, borrowers do not offer security).

A crucial issue for lenders in cross-border transactions is the choice of the governing law for security. As a rule, lenders' preference is to insulate the transaction as far as possible from the influence of any laws "local" to the borrower and to use a law, which is sufficiently sophisticated, at least neutral to the interests of the borrower, and, even better, lender-friendly. With respect to any ingressions of Russian law into cross-border financing transactions, the lenders' interests may be illustrated by the following:

*"... banks are trying to limit the application of Russian law and the jurisdiction of Russian courts to unavoidable cases such as, for example, agreements signed between Russian partners or security interests on moveable and immovable assets located in Russia."*<sup>219</sup>

As noted in the preceding paragraph, the reach of Russian law of security is sometimes unavoidable<sup>220</sup> for parties in international financings involving Russian economic interests. It is in this light that this chapter considers some issues related to security granted under Russian law.

Some forms of Russian security are more important than the others and the subdivisions in this chapter reflect this. Arguably, in the cross-border context, the most relevant Russian form of security is pledge, and the analysis in section *Pledge* below<sup>221</sup> includes most amount of detail.

The starting point for the analysis is the question "When does Russian security law apply?" This is answered in *Security, Insolvency and Conflict of Laws* below.

## **2.A. Security, Insolvency and Conflict of Laws**

There are two main routes for Russian law of security to filter itself into a cross-border financing transaction. First, Russian law of security may apply on the ground that a secured asset is located in Russia,<sup>222</sup> second, Russian law may apply on the ground that the security grantor is incorporated in Russia (in a typical setting, this is the result of the application of insolvency rules).

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<sup>219</sup> M.Leimbach, "Specific characteristics of financing operations in Russia", *International Business Law Journal* (I.B.L.J.) 2004, v.5, 623-635.

<sup>220</sup> The way that Russian law of security may "capture" an international financing transaction is described in 2.A *Security, Insolvency and Conflict of Laws* on p.68 below.

<sup>221</sup> P.71 below.

<sup>222</sup> Local borrowers, as a rule, have considerable proportion of their assets subject to local laws, and, as a consequence, local laws matter in any analysis of security over such assets.

It is common practice to give security over local assets under local laws. Though it seems trivial to assert that this should always be the case, the legal analysis may be somewhat more involving. The approach hinges here on the respective conflict of laws rules.

In proceedings in Russian courts, Russian conflicts of laws rules will be applied. Russian conflict of laws rules are codified in Section VI, Part IV of the Civil Code 1994. For example, in line with the recognized norm, Article 1213 provides that an agreement, which relates to real estate located in Russia, must be governed by Russian law. Article 1205 provides that *“the [subject matter] of the right of property and other rights in rem with respect to real and other [property], the exercise of [such rights] and protection are governed by the law of the State, where such [property] is located”*. This rule essentially answers the question “What is the substance of the respective right?” In turn, Article 1206 provides that the creation and cessation of the *“right of property”* and other rights *in rem* are determined in accordance with the law of the State where such property was located at the moment when the relevant action or circumstance occurred. Thus, Article 1206 answers the question “How a right in property is created?”

A complication is introduced by Article 1210, according to which the parties may agree on the law applicable to the rights and obligations arising out of their agreement. The chosen law applies to the creation and cessation of the rights of property and other rights *in rem* related to chattels without *“detriment to third parties”*.

The outcome with respect to security on chattels located in Russia appears to be that the parties may agree that foreign (non-Russian) law applies to their rights and obligations against *each other* and that, where interests of third parties are not involved, rights *in rem* may be created under foreign law. However, the “substance” of a security interest and the way it is created (*e.g.*, formalities) will be subject to Russian law (as *per* Article 1205). For purposes of the law of security, the result is as follows: the parties may enter into an agreement, say, on pledge<sup>223</sup> of movables (located in Russia) governed by foreign law. However, the consequences of such an agreement as related to the pledged assets, including any enforcement against them, remain subject to Russian law.

Furthermore, rights *in rem* that do not “survive” the interests of third parties cannot be referred to as rights *in rem* proper, and so the circumstances where the parties may choose to create such “defective” rights will be limited. Therefore, though Article 1210 ostensibly

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<sup>223</sup> See *Pledge* on p.71 below.

allows a degree of flexibility with respect to assets located in Russia, on closer scrutiny the respective provision does not carry practical significance.

Law of security may operate on a “stand-alone” basis, however, in a more common setting, it operates in conjunction with insolvency law.<sup>224</sup> By way of example, in the former case, the debtor does not pay and the creditor proceeds to enforce against security; in the latter case, the debtor does not pay and is at the same time insolvent, but the creditor’s claims are then prioritized in accordance with insolvency law.<sup>225</sup>

Russian conflict of laws rules with respect to insolvency lack precision.<sup>226</sup> The scope of application of the Russian insolvency statute – the Law on Insolvency 2002 – includes juridical persons that can be declared insolvent “*in accordance with the Civil Code 1994*”.<sup>227</sup> The Civil Code 1994 refers to insolvency in the respective context in Article 65: the approach adopted in the Civil Code 1994 is to provide *generally* that juridical persons *may* be declared insolvent, but then expressly list the types of juridical persons that *cannot* be declared insolvent. Such “outside-of-insolvency” persons are, generally, *quasi-state* entities. For the purposes of this work, it is the definition of a “juridical person”, which is more important: the Law on Insolvency 2002 applies to all juridical persons, with the exception of such “outside-insolvency”, *quasi-state* entities. Article 48 (*Definition of Juridical Person*) of the Civil Code 1994, provides that a juridical person is an organization, which “owns ... separated property and is liable on its obligations with such property, can in its name acquire and exercise property-related and personal ... rights ...” This definition does not specifically refer to *Russian-incorporated* juridical persons, and it could be therefore applied to juridical persons incorporated in other jurisdictions. It is unimaginable that the intention of the legislator was to extend the application of Russian insolvency law to foreign entities generally: perhaps, this respective provision is the result of poor drafting technique. However, some comfort may be provided by the Civil Code 1994: according to its Article 51, a juridical person must be registered in the relevant state register and is deemed to exist only after a respective entry is made. Generally, foreign-incorporated entities do not appear in the mentioned register, meaning that they have not been “created” for the purposes of the Civil Code 1994 (and, thus are not “existing” juridical persons). Since foreign entities do

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<sup>224</sup> See Insolvency Law on p. 135 below.

<sup>225</sup> On Russian insolvency law, see *Insolvency Law*, on p.135 below.

<sup>226</sup> See *Law on Insolvency 2002* on p.160 below.

<sup>227</sup> Item 1 of Article 1 of the Law on Insolvency 2002.

not “exist” for the purposes of Article 51 of the Civil Code 1994, it may be argued that they also do not fall under the regime of the Law on Insolvency 2002.<sup>228</sup>

An intriguing question in Russian law is, which law applies to enforcement against foreign assets secured under foreign law of insolvent Russian debtors? Neither the Civil Code 1994, nor the Law on Insolvency 2002 provides a clear-cut answer. There appears to be some implicit competition between the rules of the Civil Code 1994, which stipulate that the rights *in rem* are governed by the law where the respective asset is located, and the rules of the Law of Insolvency 2002, which set out the priority of the secured creditors’ claims. Under the rules of the Civil Code 1994, a creditor may argue that the “substance” of a security interest (arguably, being of *in rem* nature) is governed by foreign law and any enforcement against foreign secured assets in insolvency will also be governed by foreign law. This may be beneficial for the creditors if the respective foreign jurisdiction creates a favorable regime for their claims (*e.g.*, allows to claim directly against the assets, without any constraints of a public sale or protracted enforcement procedures). On the contrary, the liquidator (trustee) of an insolvent Russian debtor may argue that the Law on Insolvency 2002 does not make any exceptions for assets of the debtor located abroad and that such assets should be subject to the regime of Russian insolvency law. It remains to be seen which argument will prevail.<sup>229</sup>

An attempt to summarize the position of Russian law with respect to secured assets may be made as follows: (i) rights *in rem* and other rights and obligations related to real estate located in Russia are/must be governed by Russian law; (ii) rights *in rem* against moveable assets located in Russia are/must be governed by Russian law; (iii) rights against secured assets located in Russia owned by an insolvent Russian debtor are governed by Russian insolvency law; and (iv) it is unclear what approach Russian law adopts for foreign assets of an insolvent Russian debtor.

## 2.B. Pledge

As was discussed in the introduction to this chapter, the common law view is that security (as opposed to *quasi* security) involves a debtor granting to the creditor some form of a right to “claim” against the secured asset. Under Russian law, the only form of security which

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<sup>228</sup> Nevertheless, this approach is not satisfactory. Article 51 of the Civil Code 1994 in itself leaves questions as to the status of foreign juridical persons – *i.e.*, do they exist at all in Russian law? Part IV of the Civil Code 1994, which sets out the conflict of laws rules, refers to foreign juridical persons (and provides that the status of an entity as a juridical persons is determined by the personal law of such entity), but it does not explicitly provide that such juridical persons (created under foreign law) are also recognized as juridical persons in Russian law.

<sup>229</sup> Generally, Russian insolvency law is purely domestic in its mode of operation. There are no similar rules to, say, English Cross-Border Insolvency Regulations 2006 (SI 2006/1030).

“survives” the insolvency of the debtor (and allows to “claim” against the asset) is *zalog*. Thus, *zalog* (including its derivative forms of security, mortgage and lien), arguably, is the only “true” security interest known to Russian law.<sup>230</sup>

*Zalog* is defined in the Civil Code 1994 as a “way to secure the fulfillment of an obligation by creating a creditor’s security interest in property”. It is customary to translate the Russian term “*zalog*” as “pledge”. *Zalog*, however, includes cases where the respective asset is physically transferred to the creditor (similar to English law pledge) and cases where the asset remains with the debtor (similar to English law charge). Thus, technically, *zalog* is a wider category than English law pledge. However, the convention of referring to *zalog* as “pledge” is followed in this work.

In addition to *zalog*, Russian law operates with a related term: *ipoteka*. *Ipoteka* is treated as a sub-category of pledge, more precisely, a pledge of immovable property.<sup>231</sup> The traditional translation of “*ipoteka*” is “mortgage”. In fact, *ipoteka* is not equivalent to the traditional English mortgage<sup>232</sup> since under Russian law the granting of a mortgage does not transfer the title to the mortgaged asset to the mortgagee. Therefore, *ipoteka* could be viewed as statutory mortgage over real estate without the transfer of title.<sup>233</sup> In this work, the convention of referring to *ipoteka* as “mortgage” is also followed.

Though pledge was known to Soviet legislation,<sup>234</sup> its modern history began with the adoption of the Law on Pledge. It is interesting to note that the Law on Pledge was promulgated only six months after the collapse of the Soviet Union,<sup>235</sup> before the adoption of the Civil Code 1994. Perhaps, this is evidence that the then Russian government placed the development of financial law high on the agenda.

According to the Law on Pledge, pledge is a “method of securing an obligation, when a creditor holding the pledge ... acquires the right to receive satisfaction from the secured property ahead of other creditors” (Article 1). The Law on Pledge provides that a pledge can

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<sup>230</sup> Throughout the history of *zalog* it was questionable whether it is a “true” security interest. In particular, according to earlier Russian legislation, there was no link between the secured obligation and the respective secured asset. This provided grounds for arguments that pledge is a kind of obligation and not a security interest proper. See, e.g., H.Oda, *Russian Commercial Law*, 2<sup>nd</sup> ed., Brill, 2007.

<sup>231</sup> The Civil Code 1994, Article 334, provides that “pledge of land, enterprises, buildings, constructions, flats and other immovable property (mortgage) is regulated by the law on mortgage...” Article 1 of the Federal Law No.102-FZ On Mortgage (Pledge of Immovables), dated 16 July 1998, contains the following wording: “[a]n agreement on pledge of immovable property (a mortgage agreement) ...”

<sup>232</sup> Which was effected by an outright transfer of title. However, according to section 87(1) of the Law of Property Act 1925, a legal mortgage can now be created as a demise of lease for 3,000 years for fee simple or a term one day less than the (then head) lease for a lease.

<sup>233</sup> Cf. English Law of Property Act 1925, s.87 on charge by way of legal mortgage.

<sup>234</sup> For example, Articles 192-202 of the Russian Civil Code 1964 related to pledge.

<sup>235</sup> See *Transitional Period* on p.36 above.



secure “*valid demands*”; however, the law also stipulates that a pledge can secure “*future demands*”.<sup>236</sup> According to the Law on Pledge, pledge is an accessorial obligation (secondary in nature to the secured obligation) and the existence of the pledgee’s rights depends on the existence of the secured obligation (Article 4).

Notwithstanding its early adoption in the crisis-stricken post-Soviet Russia, the Law on Pledge turned to be a document with a long life – it is still in force.<sup>237</sup> However, according to the Federal Law No.52-FZ “On Introduction into Force of Part I of the Civil Code of the Russian Federation”, dated 30 November 1994, legislation pre-dating the Code (including the Law on Pledge) applies to the extent that it does not contradict the Civil Code 1994. Thus, the rules of the Civil Code 1994 “override” the rules of the Law on Pledge.

In the Civil Code 1994, the following definition of pledge is given:

*“Pledge grants a creditor on a secured obligation (the pledgee) the right to receive satisfaction from the value of the pledged property in priority to other creditors of the person who owns that property, with the exceptions as set by law”* (Article 334).

Generally, a pledgor is not free to dispose of the pledged property unless this right is provided for by the agreement or law (Article 346).<sup>238</sup>

The most common exception to Article 334 is the insolvency of the pledgor:<sup>239</sup> pledgees’ claims then have the third order of priority (*i.e.*, there may be higher ranking claims against secured assets); nevertheless, seventy or eighty *percent*, as the case may be,<sup>240</sup> from the proceeds of sale of the pledged property are “ring-fenced” for the respective pledgee.<sup>241</sup>

A crucial amendment was made to Russian law of pledge in December 2008:<sup>242</sup> the Civil Code 1994 now provides that in cases as prescribed by law, the pledgee has the right to

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<sup>236</sup> See *Bank accounts* on p.84 below.

<sup>237</sup> For comparison, the Law on Pledge survived three different statutes on insolvency: see chapter Chapter 3, *Insolvency Law* on p.135 below. At the time of writing, the latest amendment to the Law on Pledge 1992 was made on 30 December 2008.

<sup>238</sup> It is interesting to compare this with the approach in English law to floating and fixed charges (where the ability to dispose of the property without the consent of the pledgee generally defeats a fixed charge): *National Westminster Bank plc v Spectrum Plus Limited & Others* [2005] UKHL 41.

<sup>239</sup> The treatment of security in insolvency is reviewed in *Law on Insolvency 2002, (vii) Priorities and Security* below. Here the discussion focuses on non-insolvency related aspects of security.

<sup>240</sup> Depending on whether the pledge secures a credit agreement or other type of agreement. See p.189 below.

<sup>241</sup> The regime where a direct link is established between the pledged property and the claims of the pledgee in insolvency was (re-)introduced in Russia only recently, by the Federal Law No.296-FZ “On the Making of Amendments to the Federal Law “On Insolvency (Bankruptcy)””, dated 30 December 2008. A similar regime only briefly existed in Russia in 1992-94 (see p.147 below). Regrettably, during 1995-2008, Russian insolvency legislation with respect to security was deficient and treated pledgees quite unfavorably.

<sup>242</sup> The Federal Law No.306-FZ, “On Introducing Amendments into Some Legislative Acts of the Russian Federation in Connection with the Improvement of the Order of Enforcement against Pledged Property”, dated

“receive” (*i.e.*, seize and keep) the pledged property. Prior to the amendment, a pledgee could only organize a public sale of the pledged property and claim against the proceeds. The “old” regime, allegedly, protected the interests of the pledgors against unscrupulous pledgees who were thought to be eager to dispossess the pledgors of their property.<sup>243</sup> The other perceived advantage of a public sale was that it allowed to receive the best available market price for the pledged property. In fact, a public sale may not produce these results.<sup>244</sup> The debtor may be uncooperative, assets may be unique for the debtor’s business, or the auctioneer may lack sufficient incentive to organize the sale in a most efficient way.<sup>245</sup>

The Civil Code 1994 expressly provides that a pledgor may be a person other than the (main) debtor (Article 335).<sup>246</sup> This provision, being simple at first reading, has its own pitfalls. Consider a case where the pledgor indeed was not the debtor and the credit enhancement provided by the pledged property was significant for the creditor. The pledgor is then declared insolvent. Can the creditor accelerate its claims against the main debtor and/or

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30 December 2008. See also the preceding footnote with respect to the “parallel” amendments to Russian insolvency law.

A review of amendments of Russian law of pledge can be found in D.Sosedkin and N.Vygovskaya “Changes in the Russian Law on Pledges”, *Corporate Rescue and Insolvency*, (C.R. & I.) 2009,2(3), pp.111-112.

<sup>243</sup> In practice, there is another possible avenue for the misuse of rights by pledgee/creditor. Assume that the debtor fails to pay and default interest or penalty starts to accrue. The secured creditor may be tempted to wait for the sum to increase until it is approximately equal to the realizable value of security (since, as a rule, loans are over collateralized at the outset). This has been the subject of the Resolutions of the Federal Arbitrazh Court of North-Caucasian region Nos. F08-507/99, dated 7 April 1999, and F08-2003/99, dated 29 October 1999 on case A-53/10964/98-C2-10. In that case, the debtor claimed that the creditor (the Savings Bank of Russian Federation) was abusing its rights contrary to Article 10 of the Civil Code 1994. The debtor wrote to the Bank stating that it was in strained financial conditions and had no means to repay. The debtor asked the Bank to enforce against the pledged property, but no such steps were taken. Default interest continued to accrue and, after a delay, the Bank finally brought a claim against the debtor. The case was subject to two cassation hearings: on the first cassation it was ruled that the lower instance court should consider whether there was an abuse of right by the Bank (the lower instance court confirmed this when re-considering the case) and on second cassation it was ruled that, despite the abuse of rights by the Bank, interest remained payable on the loan. The loan agreement provided for a (high) default interest. The default interest was reduced by the courts, albeit not on the grounds that the creditor abused its rights. In that case, though the courts recognized the possibility for abuse by the pledgee/creditor, this did not have any express consequence in terms of pledgee’s liability. See also Yu.Ryzhkov, R.Makhnenko, V.Mel’nik, “Practice of Considering by Federal Arbitrazh Court of North-Caucasian region of Disputes Connected to the Application of Article 10 of the Civil Code of RF”, *Vestnik of Federal Arbitrazh Court of North-Caucasian region*, No.1, 2002.

*Cf. China and South Sea Bank Ltd v Tan Soon Gin (alias George Tan)* [1990] 1 AC 536, which involved a bank holding security and its claim against a surety (the latter being unhappy about the bank’s inaction with respect to security): the bank was not obliged to do anything and was not under a duty to exercise its power of sale at any time or at all. However, it was also stated that the bank had done nothing injurious to the surety or inconsistent with his rights and had not omitted any act which its duty enjoined it to do.

<sup>244</sup> This is especially so, since there are no elaborate provisions in Russian law on duties arising in such sales (similar to that in *Nash v Eads* (1880) 25 Sol Jo 95, *CA, Re Potters Oil Ltd (No.2)* [1986] 1 All ER 890)

<sup>245</sup> The earlier approach of Russian law, where pledged property could only be sold at a public auction was criticized, see, *e.g.*, V.Skvortzov, “Possibilities to Increase the Securing Function of Pledge through Changes in Rules on Pledges”, *Citizen and Law*, No.1, 2002. It was argued in that paper that business parties are unnecessarily stifled by the requirement to hold a public sale of pledged property.

<sup>246</sup> There is no need to issue a specific guarantee for such a third party pledgor in favor of the creditor; it is not likely that such a third party pledgor would be treated as guarantor for the purposes of Russian law (see *Suretyship* on p.127 below). *Cf. Re Conley* [1938] 2 All ER 127 (no need for a specific guarantee, but the treatment as a surety may result).

claim in pledgor's insolvency? By way of a short historical introduction, what was the position under the Law on Insolvency 1998? In case A14-6591099/129/136,<sup>247</sup> which involved hearing at several instances, a bank, having the benefit of a pledge granted by an insolvent third party petitioned the court in order to enforce security. The court decided that the claims of the bank could not be brought outside the regime of the Law on Insolvency 1998, since its Article 57 provided that all property-related claims are subject to insolvency legislation. The bank then petitioned the liquidation administrator to include its claims in the appropriate, third, order of priority of creditors' claims in the insolvency proceedings. The liquidation administrator refused to do so pursuant to Article 15 of the Law on Insolvency 1998, which granted the right to prove in insolvency only to *creditors* (in interpretation of the administrator – only the *insolvent's* creditors). The bank pursued the claim in courts, but the Federal Arbitrazh Court of the Central region upheld the administrator's decision. Thus, a pledgee's interests were potentially prejudiced by the insolvency of the pledgor (which was not the same person as the debtor). The outcome for the pledgee in that case was that it could claim neither outside insolvency proceedings, nor in insolvency proceedings. Perhaps, this case was an anomaly; indeed, in other cases the courts took the view that the pledgee should claim outside insolvency proceedings.<sup>248</sup> In a recent case No.F04-5032/2009(13103-A27-13), dated 24 September 2009, decided by the Federal Arbitrazh Court of the West-Siberian region, the creditor was allowed to commence its claims against an insolvent pledgee outside insolvency proceedings.<sup>249</sup>

The Law on Insolvency 2002 initially had similar provisions to those of Law on Insolvency 1998 and the courts, following the A14-6591099/129/136 case, decided (now with respect to the Law on Insolvency 2002) that the creditor had to claim outside of insolvency proceedings. However, Article 129 of the Law on Insolvency 2002 relating to the treatment of pledges in insolvency was amended to specifically cover cases where the debtor and pledgor are not the same person and the pledgor becomes insolvent.<sup>250</sup> The amended Article

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<sup>247</sup> The information on the case and the discussion is based on the article by I.Grachev and A.Samsonov "Status of Pledge Creditors", *Ezh-Jurist*, July 2005. Some discussion is also offered in article by N.Kavelina "Legal Status of Pledgees in Relationships of Insolvency", *Laws of Russia: Experience, Analysis, Practice*, No.3, 2007.

<sup>248</sup> See, *e.g.*, the Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.2860/02, dated 17 September 2002, where the lower court decision declining to consider the pledgee's claims outside insolvency proceedings was reversed.

<sup>249</sup> This could seem as a better outcome for the creditor, since there is no need to "stand in the queue" of creditor in insolvency proceedings. However, there seems to be another difficulty. Article 126 of the Law on Insolvency 2002 provides that in liquidation proceedings all enforcement orders (Russian *ispolnitel'nye listy*) are suspended.

<sup>250</sup> The Federal Laws Nos.306-FZ, "On Introducing Amendments into Some Legislative Acts of the Russian Federation in Connection with the Improvement of the Order of Enforcement against Pledged Property", dated 30 December 2008 and 195-FZ "On Introduction of Amendments to Selected Legislative Acts of the Russian Federation", dated 19 July 2009.

129 provides that pledgees on pledges granted by a third party are entitled to prove in any insolvency proceedings of the pledgor equally with any other pledgees.<sup>251</sup>

Returning to Article 335 of the Civil Code 1994, it also provides that the pledgor: (i) for a tangible, must be its owner;<sup>252</sup> (ii) for a right, must be the owner of such right; and (iii) for a lease or other right over property owned by a third person, must obtain the consent of the landlord or such third person unless law or a relevant agreement do not require such a consent for a disposal of the lease or such right. The obvious advice to lenders is to investigate and confirm that the pledgor owns the property or to ensure that the required consent is received before accepting the respective security.

A large proportion of premises in Russian cities are built on land plots leased from state or municipal authorities and the respective lease agreements customarily include a proviso requiring the tenant to seek landlord's consent for pledges of leases.<sup>253</sup> According to Article 63 of the Federal Law No.102-FZ On Mortgage (Pledge of Immovables), dated 16 July 1998 (the "**Law on Mortgage**"), as a rule, mortgage of land plots owned by the State or municipalities is prohibited; and according to Article 69, it is not lawful to mortgage real estate (in this case, meaning, buildings) without the respective underlying land plot.<sup>254</sup>

Articles 63 and 69 of the Law on Mortgage together with the respective lease agreements created a powerful obstacle on using real estate in financial transactions as security. Light on this situation was shed in the Informational Letter of the Presidium of Supreme Arbitrazh Court on the Russian Federation No.90, dated 28 January 2005. In the letter, the Presidium stated that the Land Code of the Russian Federation<sup>255</sup> included a specific rule in item 9 of Article 22 to the extent that state or municipal leases with an overall term over five years could be pledged without the consent of the landlord (*i.e.*, the respective authority) and only notification was required. The Presidium also pointed out that this rule was imperative and could not be altered by an agreement between the landlord and tenant. The court thereby adopted a position favoring the tenants and encouraging the use of real estate as collateral.

<sup>251</sup> The mentioned F04-5032/2009(13103-A27-13) case confirms the new approach of the amended Law on Insolvency 2002. The case also deals with the moment from which the new rules must be applied.

<sup>252</sup> Or a person having the right of operating control – a right of an enterprise based on state or municipal property. Article 113 of the Civil Code 1994.

<sup>253</sup> Item 1.1 of Article 62 of the Law on Mortgage also requires the consent of the landlord to a mortgage of the respective immovable.

<sup>254</sup> A very significant practical problem was the cost of entering into a mortgage agreement. Until 2005, a mortgage agreement had to be notarized and before 23 September 2004 the fee for notarization was as large as 1.5% of the sum of the agreement (which was prohibitive if the real market price of the mortgaged property was stated in the agreement). For a short period of time, from 23 September 2004 to 1 January 2005, the fees for notarization became capped at a reasonable 3,000 Rubles (approximately 100 US Dollars). And finally, from 1 January 2005, mandatory notarization of mortgage agreements was dropped.

<sup>255</sup> No.136-FZ, dated 25 October 2001.

The Civil Code 1994 provides that any property, including tangibles and “*property rights (demands)*” may be pledged (Article 336).<sup>256</sup> There are some exceptions – not all kinds of assets can be pledged: for example the so-called highly personal rights (*e.g.*, rights to alimony payments) are excluded from pledges.

### Registration

An important consideration for any form of security which allows the pledgor to continue to use the pledged property is whether there are sufficient mechanisms to alert the public to the fact that (notwithstanding the continuous use of the property by the pledgor) there is also a pledgee’s claim in respect of such property.

According to Article 336, mortgages (*i.e.*, pledges of immovable property) must be registered with the respective authorities; thus, there is some element of publicity of such security. Should a creditor wish to take a mortgage, being unaware that a prior mortgage already exists, such a pre-existing mortgage will be revealed during registration.

What is the position on moveable property? The Civil Code 1994 allows the pledge to take both possessory and non-possessory forms (Article 338). If pledge takes possessory form it is often clear for a prospective creditor that the property has been pledged earlier and thus cannot be used to support further obligations of the debtor (unless second- or lower-ranking pledge is acceptable). However, granting possessory pledge often makes little commercial sense for the borrower: it cannot use the respective assets in its business. Such assets stop generating additional income, which could be used to repay the loan.<sup>257</sup>

What if the pledge takes the non-possessory form?<sup>258</sup> A brief excursion into legal history may be appropriate at this point. As was mentioned earlier, Russian legislation on pledge was (re)created with the adoption of the Law on Pledge. The law was adopted in transition from

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<sup>256</sup> There are some parallels in Russian law between an assignment and pledge of rights. See, *e.g.*, F.Bogatyrev “On the Nature of Pledge of Property Rights”, *Journal of Russian Law*, No.4, 2005.

<sup>257</sup> There may be routes for the pledgor to continue to use the pledged assets, even if they are transferred into the possession of the pledgee. One of the ways to achieve this result is to lease the assets back to the pledgor. However, even if the continuing use of the assets by the pledgor is achievable, the issue whether pledgee’s “possession” the pledged assets (which in fact are being used by the pledgor) provides sufficient degree of notice to third parties of security.

<sup>258</sup> Cf. English requirements to registration of charges by individuals in section 8 of the Bills of Sale Act 1878 and for companies in sections 860 – 877 892 the Companies Act 2006.

There are no specific rules in Russian law for registration of security created by overseas companies. Mortgages by foreign companies would be subject to the ordinary registration regime; with respect to book of register pledges (see discussion in this sub-section *Registration* below, it is unclear whether this requirement applies to overseas companies). Cf. English section 1052 of the Companies Act 2006 and Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009/1917 as to registration of charges by overseas companies and the earlier “Slavenburg” regime and register (*NV Slavenburg’s Bank v Intercontinental Natural Resources Ltd and others* [1980] 1 All ER 955). The Slavenburg register was not without its difficulties: once an entry was made there was no method of removing it, *e.g.*, on the discharge of the secured obligation.

planned to market economy and during the period of significantly strained financial conditions. The Law on Pledge was drafted with the assistance of foreign experts<sup>259</sup> and regard was given to the systems existing in other jurisdictions. For example, under Article 9 of the U.S. Uniform Commercial Code,<sup>260</sup> the starting point for any security is that it must be perfected by public registration – by the filing of a financing statement; of course, there are exceptions to this general rule.<sup>261</sup> Russian law failed to introduce such a general rule. There is some speculation that the first drafts of the Law on Pledge included a proviso requiring registration of security; however, such provisions were later excluded since the creation of any security register was viewed as too burdensome for the otherwise resource-strained government.

The absence of publicly available information on security granted by a company is a stumbling block for a prospective lender. First, the lender has to have sufficient trust in the borrower's officers with respect to representations related to existing security. Second, even if the borrower's officers acted in good faith in granting security, there is a real threat that at a later date another "pledgee" will allege that it has prior-granted security over the same assets. Though a claim of existence of prior security may be frivolous, it is not a trivial task to rebut such a claim, since there is no public register to which the "real" pledgee could point in support of its claim.

The Law on Pledge obligates the pledgor to maintain a "*book of register of pledges*" (Article 18); this obligation is only imposed on registered entrepreneurs and juridical persons.<sup>262</sup> Entries in such a book must be made no later than ten days from the creation of the pledge and the book must be made available for inspection to any interested person. The law also sets the requirements as to what information an entry in the book must contain. The Law on Pledge stipulates that a pledgor is "*liable for the making of timely and correct entries*". A book of register or pledges, however, has no real teeth if compared with a public register of security interests. In fact, if a pledgee had to turn to enforcing security,<sup>263</sup> it is a sign of the

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<sup>259</sup> Including, *e.g.*, Professor William E. Butler.

<sup>260</sup> In similar respect, in England and Wales, according to the Companies Act 2006 section 860(7)(b) a company must deliver particulars of any charge that if created or evidenced by an instrument which, if executed by an individual, would require registration as a bill of sale. Registration as a bill of sale is required under Bills of Sale (1878) and Bills of Sale (1878) Amendment 1882 Acts. In general, the regime required the registration on non-possessory security granted by companies.

<sup>261</sup> U.S. Uniform Commercial Code, Article 9, Part 3, §9-310(a).

<sup>262</sup> There are no rules at all on when and where the book must be available for inspection. *Cf.* the rules in section 1136(2) of the Companies Act 2006 and the detailed Companies (Company Records) Regulations 2008 (SI 2008/3006) on the availability of a company's records.

<sup>263</sup> And at that time it transpired that there was prior security, not reflected in the book of register of pledges.

pledgor's inability to pay and in such a scenario the key issue for the pledgee is not the liability of the pledgor *per se*, but the ability to have that liability discharged.<sup>264</sup>

Arguably, the regime for the pledges of movables is not satisfactory in Russia. At the time when the Law on Pledge was debated, it was difficult to implement a public register of non-possessory security and the public register approach was replaced with the cheaper pledgor's "*book of pledges*". Perhaps the state now has sufficient resources to implement a centralized register of security and there are no reasons why this should be delayed.

#### Extent of secured obligations

According to Article 337 of the Civil Code 1994, a pledge secures the respective "*demand*" to its full extent at the moment of its discharge, including interest, penalty, damages arising out of delay, expenses of the pledgee related to the upkeep of the pledged property and expenses of enforcement.<sup>265</sup>

#### Content of agreement

Russian law requires that a pledge agreement includes the following information: the "*subject*" of pledge (*i.e.*, identification information for respective assets or rights), the subject-matter, value,<sup>266</sup> and the day for performance of the secured obligation. A pledge agreement must also stipulate with which party the pledged property remains.<sup>267</sup> All pledge agreements must be in writing (Article 339), though there are specific cases where Russian law has more stringent requirements to the form of a pledge agreement, most common example is notarization. In addition, a mortgage agreement must be registered with the respective state authority.<sup>268</sup> The provisions on the contents and form of a pledge agreement are interpreted by Russian courts strictly and the parties are well advised to leave no doubts as to whether all the required information is included into a pledge agreement.

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<sup>264</sup> It is interesting to note that the government of the City of Moscow adopted the Resolution No.788 "On Introduction on the Territory of Moscow of Uniform System of State Registration of Pledge and Uniform Register of Contracts of Pledge", dated 20 September 1994. The Resolution purported to create a system of pledge registration for several types of property, including enterprises, real estate, *etc.* The Resolution was adopted several weeks earlier than the Civil Code 1994 (October 1994).

<sup>265</sup> The Law on Pledge 1992, Article 23, stipulates that penalties and expenses are secured by a pledge *only* if the respective agreement *or law* so provides. Thus, the rules of the Civil Code 1994 with respect to pledge securing penalties and expenses change the default position under the Law on Pledge 1992. See D.Pashov, "Realization of the Right of Pledgee", *Law and Politics*, No.6, 2005.

<sup>266</sup> In fact, the direct translation of the respective wording in the Civil Code 1994 means "size".

<sup>267</sup> There seems to be a contradiction of this rule to another provision in the Civil Code 1994, Article 338, which provides that, unless the pledge agreement stipulates otherwise, the pledged property remains with the pledgee. See I.Stepanova, "Essential Terms of Contract: Problems of Legislation", *Vestnik VAS RF*, No.7, 2007.

<sup>268</sup> Article 29 of the Federal Law No.122-FZ "On State Registration of Rights to Immovable Property and Transactions with it", dated 21 July 1997.

Nevertheless, there is some leeway. The first relaxation of the strict regime relates to the freedom to omit information from a pledge agreement where the parties to the pledge are also the parties to the agreement under which the secured obligation arises. This was recognized in the joint Resolutions of the Plenum of the Supreme Court No.6 and Plenum of the Supreme Arbitrazh Court of the Russian Federation No.8 “On Some Questions, Connected to the Application of Part I of the Civil Code of the Russian Federation”, dated 1 July 1996. According to its item 43:

*“... if any of the conditions mentioned above is absent from the pledge agreement, such an agreement cannot be considered to exist; however, if the pledgor is also the debtor in the main [(arguably, meaning secured)] obligation, conditions on the subject-matter, value and term of the obligation secured by the pledge should be deemed agreed if the pledge agreement refers to the agreement, regulating the main obligation and including the respective terms.”*<sup>269</sup>

The other relaxation available to the parties relates to the case where a pledge agreement is included into a framework agreement and individual loans made are made pursuant to specific “definitive” loan documents entered into on the basis of the framework agreement. This situation was dealt with by the Federal Arbitrazh Court of the Moscow region in the Resolution on case KG-A40/6015-01, dated 25 October 2001.<sup>270</sup> The case related to loans made by the Central Bank of the Russian Federation to OAO “AB “Inkombank””, the latter bank being declared insolvent by that time. The Central Bank and Inkombank entered into a “General Credit Agreement”, which included a clause on pledge of securities for the loans made by the Central Bank. However, the General Credit Agreement only set forth the procedure for the obtaining of loans and not the specific terms or amounts of such loans. The amount of loans and their terms were set out in definitive loan agreements entered into on a case by case basis by the parties. According to the decision of the Arbitrazh Court of the Moscow region, the lower instance court erred in concluding that the pledge clause in the General Credit Agreement had to include all the essential terms of the pledge(s) (as set out above), since it was only a framework (and not a definitive) agreement. Thus, according to case KG-A40/6015-01, some structuring of the loan and pledge documents in accordance with the needs of the parties is possible. However, the case needs to be approached with caution: though the decision apparently upheld the validity of the pledge clause, is also

<sup>269</sup> V.Vitryanskii in “Comments to the Resolution of the Plenum of the Supreme Court and Plenum of Supreme Arbitrazh Court of the Russian Federation No.6/8, dated 1 July 1996”, *Economy and Law*, No.9, 1996, points out to impracticalities which would have occurred in practice, should the courts adopt the contrary approach.

<sup>270</sup> See L.Pulova, “Problems of Pledge Relationships in Arbitrazh Practice”, *Law and Economics*, No.5, 2003.



seemed to imply that the requirements to the contents of a pledge agreement must be satisfied. It is not clear from the text of the judgment whether any other document, except for the General Credit Agreement, allowed the court to conclude that such requirements were satisfied (*e.g.*, in the definitive loan agreements, where specific terms of the pledge could have been set out).<sup>271</sup>

#### Subsequent pledge

The Civil Code 1994 expressly allows for a “*subsequent*” pledge (Article 342). A subsequent pledge is defined as “*one more*” pledge of the pledged property as security for other obligations. The use of the “*one more*” wording in the Civil Code 1994 is unfortunate: on literal interpretation, the provision means that only one subsequent pledge is possible. Article 342 sets the priority of the pledgee’s claims against the pledge as expected: the subsequent pledgee claims after the preceding pledgees’ claims are satisfied.

There was some legal uncertainty with respect to the cessation of pledges where there was also a subsequent pledge: Article 352 used to provide that a pledge ceased if the pledged assets were sold at a public auction. The question that originated here was whether a subsequent pledge ceased if a public sale was held in order to satisfy the claims of the prior pledgee (or, *vice versa*, public sale was held in the interests of a subsequent pledgee)?<sup>272</sup> This situation may occur in practice since it is not a pre-requisite that the obligations secured by the prior and subsequent pledges mature simultaneously.

Recent amendments<sup>273</sup> to Russian statutes appear to have clarified the situation: a prior pledgee is entitled to accelerate its secured rights if the subsequent pledgee enforces against the pledged property. If the prior pledgee chooses not to accelerate, the “*prior*” pledge continues even after enforcement on pledge property. With respect to a subsequent pledge, the solution was provided by the changes to the wording related to the cessation of pledges on public sales: the new version provides that pledge ceases when the public sale is held for the purpose of satisfaction of the claims of the pledgee (item 4 of Article 352). In all likelihood, the reference to the pledgee should be read to mean the *respective* pledgee.

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<sup>271</sup> One must also be mindful of the fact that this decision sided with the interests of the Central Bank of the Russian Federation, which is a *quasi*-state authority.

<sup>272</sup> Analyzing the “old” Article 352, L.Novoselova in “Fate of Pledge of Property Realized during Foreclosure”, prepared for, and available in, *ConsultantPlus*, 2005, came to the conclusion that all pledges ceased on a public sale.

<sup>273</sup> The Federal Law No.306-FZ, “On Introducing Amendments into Some Legislative Acts of the Russian Federation in Connection with the Improvement of the Order of Enforcement against Pledged Property”, dated 30 December 2008.

Thus, enforcement by the prior pledgee does not defeat the pledge of the subsequent pledgee.<sup>274</sup>

The Law on Mortgage has more elaborate rules on cross-acceleration. For mortgages, enforcement on a subsequent mortgage allows the prior mortgagee to accelerate the secured obligations; the prior mortgagee has the right to accelerate and if it chooses not to, the prior mortgage continues to encumber the property. However, though cross-acceleration of the subsequent mortgages is possible, it is not always allowed by the law. Cross-acceleration of the subsequent mortgage is allowed unless for the purposes of the prior mortgage enforcement on only part of the mortgaged property is sufficient (Article 46 of the Law on Mortgage).<sup>275</sup>

Another difficulty related to the priorities among pledgees was resolved by the December 2008 amendment to the Federal Law No.229-FZ “On Enforcement Proceedings”, dated 2 October 2007. Prior to the amendment, the law discriminated between pledges arising out of contract and law: an express provision stipulated that pledges arising out of law were not subject to the general order of priority applicable when the funds obtained during enforcement were insufficient to discharge all claims (however, outside of insolvency proceedings). Since the Law on Enforcement Proceedings omitted to include a similar provision for contract pledgees, the conclusion must have been that such pledgees were not afforded the extra-priority treatment.<sup>276</sup> The amended Law on Enforcement provides that claims of a pledgee are satisfied from the proceeds of the sale of the pledged property outside the generally applicable priorities for (unsecured) claims. There is no distinction now in the language of the law with respect to pledges arising out of contract and law.

Returning to the discussion of prior and subsequent pledges, the Civil Code 1994 provides that a subsequent pledge is allowed if it is not prohibited by the prior contracts of pledge

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<sup>274</sup> This supports the argument on the *in rem* nature of Russian pledge, as opposed to being part of the law of obligations.

<sup>275</sup> Arguably, in practice the reference to enforcement on “part” only of mortgaged property may cause difficulties for subsequent mortgagees. For example, enforcement was effected with respect to the “crown jewel” part of the mortgaged property and there were some proceeds left after the prior mortgagee’s obligations were discharged. Assuming that the part of the property that is remained mortgaged is not sufficient to discharge the subsequent mortgage and also difficult to sell, the subsequent mortgagee’s interests appear to have been adversely affected by enforcement on the prior mortgage, but the subsequent mortgagee had no right to cross-accelerate. The law is silent on the use of remaining proceeds from enforcement on the prior mortgage. It appears that such proceeds will be returned to the mortgagor, and thus “deplete” the pool of security, which would otherwise be available for the subsequent mortgagee.

<sup>276</sup> It seems that this was a drafting mistake, rather than deliberate “downgrading” of the contract pledgees’ claims. The respective hierarchy of priorities provided for by the Law on Enforcement had no provisions, which could shed light on what was the priority of “contract pledgees” as opposed to “law pledgees”. See also “The Concept of Perfection of General Provisions of Russian Law of Obligations”, editorial, *Bulletin of Notary Practice*, No.3, 2009.

and that a pledgor must provide each subsequent pledgee with the details of all prior (contract) pledges.

As mentioned earlier, Russian law does not create any general-purpose public register of pledges; there is only an obligation for the pledgor to maintain a book of register of pledges.<sup>277</sup> The question that may arise is how well does this design works in the prior/subsequent pledges scenario?

Let us first consider what happens if the pledgor indeed purports to enter into subsequent pledges in case when they are prohibited by the prior pledge contract. There are two relevant provisions in the Civil Code 1994: Article 351 provides that a pledgee may accelerate the respective secured obligations if there is a breach of the rules on subsequent pledge in Article 342; and Article 342, as has been mentioned above, provides that subsequent pledge is “*allowed*” if it is not prohibited by prior pledges. There is some conflict between these provisions: is the subsequent pledge in circumstances where it was prohibited void or are the consequences of the breach limited to acceleration by the prior pledgee? There is no express answer to that question in the statute. However, this scenario was subject to judicial consideration in a relatively recent case No.A28-190/2009-3/9 of the Federal Arbitrazh Court of the Volgo-Vyatsk region, dated 3 August 2009.<sup>278</sup> In that case, the subsequent pledgee argued that its (subsequent) pledge was not void and that only Article 351 applies. The court rejected the argument and declared the subsequent pledge void.<sup>279</sup>

The preceding paragraph covered the possible harm to the interests of the subsequent pledgees, should they accept a pledge being unaware of the prohibition on subsequent pledges existing in the prior pledge (indeed, being unaware even of the existence of a prior pledge). An interesting illustration of what may happen in practice in such a situation can be found in cases of the Federal Arbitrazh Court of Moscow region Nos. KG-A40/3248-04, KG-A40/7139-04 and KG-A40/5457-05, dated 12 May 2004, 18 August 2004 and 21 June 2005, respectively.<sup>280</sup> In these cases, what apparently turned to be one and the same, printing equipment was purportedly pledged to several creditors (banks) and also allegedly sold by the pledgor to a third party before any of the pledges were granted. Each pledgee petitioned the court to enforce against the pledged equipment and several mutually exclusive

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<sup>277</sup> See p.78 above.

<sup>278</sup> Discussion of the case is available in S.Karaseva “Review of Practice of Consideration by the region Federal Arbitrazh Courts of Disputes, Connected to the Pledges of Property (Third Quarter of 2009)”, prepared for, and available in, *ConsultantPlus*, 2009.

<sup>279</sup> It must be noted, that this was the decision of “only” region-level Arbitrazh Court, thus it has lesser weight than a decision of, say, the Supreme Arbitrazh Court.

<sup>280</sup> The description of this cases (apparently, without the express reference to the 2005 case), can be found in O.Pleshanova, “Mysteries of Re-pledge”, *Ezh-Jurist*, No.9, 2005.

enforcement orders were granted to different pledgees (this was well possible since the cases were considered at first instance by different judges). Also approximately at that stage, pledgees found out that equipment was missing from the premises where it was agreed to be kept.<sup>281</sup> At higher instance hearings, the court pointed out that there was a prohibition on subsequent pledges and, hence, subsequent pledges were void. However, one of the pledgees (apparently, after the equipment was purportedly sold to a third party) managed to enforce and sell the equipment at a public auction. In the latest of the mentioned Moscow region Arbitrazh Court decisions, the third party sought to claim the equipment from the purchaser at the public sale. However, the court decided that the third party did not prove that the equipment was ever sold to it and that the respective agreement was void. Thus, the purchaser at the public sale was recognized as the new owner of the equipment.

The cases mentioned above may seem to be imprecise as to the factual circumstances and the *ratio* with respect to the outcome. And it is indeed so: there was no verifiable source of information as to whether the equipment was pledged, when, to whom and on which terms. Thus, neither of the parties to the pledges, the purchaser at the public sale nor the courts, could easily evaluate the transactions and form an opinion on what was the then current status of the equipment. Obviously, none of the “soft-touch” requirements of the Civil Code 1994 for the pledgor to inform subsequent pledgees of any prior pledges and to maintain an up-to-date book of register of pledges were of any use in that case. Perhaps, a prudent lender should make the conclusion that the relationship between prior and subsequent pledges and current status of the prospective borrower’s assets (pledged/not pledged) are a source of legal risk and there is no “silver bullet” to reduce such a risk.

### Bank accounts

This sub-section considers whether it is legally possible to grant pledges over cash deposited in bank accounts. The starting point for discussion is whether such a pledge is a pledge of cash or pledge of receivables.<sup>282</sup> The perishable nature of “cash” in a bank account can be vividly observed in a bank’s insolvency, where a depositor could receive only few cents in a dollar (unless the deposit is covered by state insurance) – that is to say that once cash is deposited into an account, it changes its nature.

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<sup>281</sup> In fact, according to the 2005 decision, equipment was immovable property and there were registrations of mortgage with the respective state authority.

<sup>282</sup> For analysis of cash deposited in bank accounts under English law see the famous cases *Re Charge Card Services Limited* [1986] 3 All ER 289 (and the resultant “triple cocktail” for charges over bank accounts), which was overruled by the House of Lords in *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214.

Article 336 of the Civil Code 1994 sets forth the rules on property that can be pledged, and, on first reading, it does not imply that security over cash in bank accounts cannot be granted. Even if deposited cash is viewed as a right to claim against the bank, Article 336 appears to permit pledges over such a right, since it expressly provides that “*property rights*” can be pledged.

However, the position is far from clear. Pledges over bank accounts have been dealt with by Russian courts extensively; and none of the courts’ rulings appear to be conclusive.

The starting point is the Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No. 7965/95, dated 2 July 1996. The court in a mere two pages, concluded that pledge of deposited cash was impossible. The case involved two banks: the lending/pledgee bank and the pledgor bank. The pledgor bank purportedly granted the lending bank a pledge as security for the obligations of a third party borrower. The pledge was granted over cash in a “correspondent account”, that is an account held by one bank with another. The case had been considered by the first instance and the appellate courts with a focus on the powers of the officer of the pledgor bank to execute the disputed pledge agreement, but the analysis provided by the Presidium was directed differently. Instead of looking at corporate powers, the Presidium decided that cash could not be the subject of pledge since the then legislation<sup>283</sup> provided for only one method of enforcement on secured assets – sale at a public auction – and cash could not be sold at a public auction.

It is interesting to note that the complainant in that case was Sberbank of Russia, the largest Russian bank, which is also owned by the State. It is even more interesting that, according to the text of the resolution, Sberbank’s representative put before the Presidium an argument completely different from the court’s *ratio*: that cash in a correspondent account cannot be pledged since it “belongs” to bank’s clients. The Presidium did not address this issue in the resolution at all.<sup>284</sup>

This decision was later re-iterated in the Informational Letter of the Presidium of the Supreme Arbitrazh Court No.26, dated 15 January 1998. Item 3 of the Informational Letter repeated the *ratio* of the 7965/95 case, however, added a slightly different perspective to it: the letter stated that “[b]ased on the nature of “[cash deposited with a bank], such [cash] cannot be used for pledging pursuant to the rules regulating the pledge of chattels”. The

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<sup>283</sup> This has now been changed. See the main text and footnote 291 on p.87 below.

<sup>284</sup> The claim that cash in a correspondent bank account “belongs” to the clients appears to be incorrect. If it were correct, this would have meant that some form of clients’ pass-through right of ownership exists with respect to the monies deposited in bank accounts.

court's reasoning appears to be directed at the fact that cash in a bank account is not a chattel, and, thus, such cash cannot be pledged pursuant to the rules relating to chattels. The interpretation of this statement must be that in case 7965/95 the pledge agreement was purporting to pledge deposited cash as if it were chattel. The Informational Letter No.26 appears to leave the door open for pledges of cash as chose in action (being the right of claim against the bank). To support this view, as was mentioned earlier, Article 336 of the Civil Code 1994 expressly allows pledge of rights.

The issue that remained unanswered by the Informational Letter No.26 was whether the inability to "sell" deposited cash at a public auction during enforcement prevented the use of deposited cash for pledges? Leaving for a moment the respective statutory provisions aside, the approach of the court in the 7965/95 case did not fit well with theory. The reasoning behind the requirement of sale at a public auction is to obtain the best available market price for the pledged asset. Clearly this reasoning does not apply to a pledge of deposited cash, since the respective best market price is a known quantity. Any monies in excess of the secured obligation must simply remain in the pledgor's account. It is, at least, strange that the court adopted a formalistic approach and struck out pledges of deposited cash on what appears to be an artificial ground.

The issue of whether deposited cash can be pledged was discussed further in the letter of the Supreme Arbitrazh Court of the Russian Federation No.SZ-8/up-929, dated 6 September 2001, and in the response of the Association of Russian Banks No. A-01/5-535, dated 17 October 2001. The Supreme Arbitrazh Court requested the Association to set out its position on a number of questions related to pledges of cash. In particular, the court asked: whether pledge of deposited cash was a pledge of chattels or rights; if pledge of deposited cash was a pledge of right, whether full or partial assignment of such a right was possible (or was required for a pledge to take effect); whether there was any difference in the type of account with respect to which pledge of cash may be available; whether pledge of cash was a transaction only available to pledgors that were banks; in what order could payments be made from a pledged account; whether pledge of deposited cash could be granted in favor of the account bank; and how could enforcement be carried out with respect to pledged cash. The questions of the Supreme Arbitrazh Court evidenced at least some readiness to consider points of view other than that expressed by the Presidium in case 7965/95, and,

perhaps, demonstrated a better understanding (by the courts) of the issues that arise in a pledge of deposited cash.<sup>285</sup>

The Association of Russian Banks responded along the following lines: pledge of deposited cash was a pledge of right; it was not necessary that a full assignment of rights on bank accounts could be carried out in order for the pledge to be possible;<sup>286</sup> there was no principle difference among the types of bank account for the purpose of pledge;<sup>287</sup> there was no requirement for the pledgor to be a bank; a pledge should not contradict to the priority of payments from a bank account which would otherwise be applicable;<sup>288</sup> it was possible that deposited cash was pledged to the account bank;<sup>289</sup> and enforcement on pledged cash should be carried by petitioning the court for a transfer of the right to the pledged cash to the pledgee.

In spite of the correspondence (which had no legal force) no steps were taken to clarify in law (or “case law”) the situation with respect to pledges of cash.

The negative view of Russian law on pledge of deposited cash remains; and it is hotly debated by Russian commentators.<sup>290</sup>

The final remark is that a change in legislation since the infamous 7965/95 decision may have had an impact on the reasoning provided in that case. The Law on Pledge was amended<sup>291</sup> to allow the parties to agree on the transfer of the pledged property to the pledgee (or a third party) without holding a public sale. Such an agreement can be concluded

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<sup>285</sup> The questions in the letter are clearly much better founded in theory (and practice) than the 7965/95 case position re impossibility of enforcement.

<sup>286</sup> See *Assignment* on p.113 below.

<sup>287</sup> However, the Association did point out that under the then existing currency control regime, pledge of foreign currency was not always possible.

<sup>288</sup> This question relates to the priority of payments from a bank account set forth by the Civil Code 1994 in Article 855. The article stipulates that transactions are carried on a bank account in their time-wise order, unless there are insufficient funds and then a certain priority of payments applies.

<sup>289</sup> In such a case, as the Association pointed out, the respective security arrangement could not be characterized as pure pledge, but it was still admissible in law as Article 329 of the Civil Code 1994 allowed for types of security not expressly prescribed in statutes.

<sup>290</sup> V.Zaitzev, “Pledge of Money”, *Legislation*, No.5, 2005, reviews commentators’ positions on pledge of cash. S.Pridanov in “Pledge as Form of Securing Obligations of the Borrower Arising out of Contract of Bank Credit”, *Legal Work in Credit Organization*, No.4, 2005, argues that the Presidium of the Supreme Arbitrazh Court in case 7964/95 overstepped its authority effectively prohibiting the pledge of cash on bank accounts without any statutory authority.

A.Lisov in “May Paper Cash be the Subject of Pledge”, *Russian Justitziya*, No.7, 2002, points to circumstances where pledges of money could be not incompatible with the 7965/95 case.

A.Rubanov in “Pledge and Bank Account in Contract Practice”, *Economy and Law* No.9, 1997, argued that drafting a pledge agreement as a pledge of rights arising out of a bank account agreement could overcome the obstacles posed by the 7965/95 case.

<sup>291</sup> The Federal Law No.306-FZ, “On Introducing Amendments into Some Legislative Acts of the Russian Federation in Connection with the Improvement of the Order of Enforcement against Pledged Property”, dated 30 December 2008, added new Article 28.1 (covering the sale/disposal of the pledged property) to the Law on Pledge 1992.

only among entrepreneurs and/or juridical persons. The amendment has importance beyond the pledge of deposited cash on a bank account, but for the latter purpose, it appears that the reasoning of the Presidium given in the 7965/95 no longer applies. If the parties to a pledge agreement stipulate that enforcement will take a form appropriate for deposited cash, this may well solve the key problem of the 7965/95 case.

#### Future obligations

As a rule, a lender requires that security is granted before any loans are made to the (prospective) borrower. If a lender were to lend to a borrower and only later take security, then, during the time between the first disbursement and taking security, the loan would carry higher risk. Though a bank may choose to accept such a higher risk, it would ordinarily require higher interest during any time as the loan(s) are unsecured; of course, this would be contrary to interest of the borrower to receive cheaper funding. The outcome for a lawyer is that clients (a lender or borrower) prefer that security is “operational” as early as possible. Furthermore, from a commercial perspective, a borrower negotiating a loan facility with a lender usually does not have the full knowledge of how large a sum will be required for its business in the future. Therefore, in international financial markets, it is common practice for the lender to agree to lend “up to” a certain sum (and in a specified timeframe). A loan agreement would provide for a mechanism for the making of requests for disbursements from the lender as the borrower may from time to time wish. The first disbursement may be made only some time after the loan agreement is executed, and, indeed, the borrower may request no disbursement at all throughout the whole life of the facility. This, in conjunction with what was mentioned with respect the time when security becomes operational, results in a legal issue: can security be granted for future obligations? A crude analysis of the problem is as follows: until the borrower has actually borrowed, there is no obligation to repay; the exact amount of any such obligation, as it may arise in the future, is not known (only the upper limit is stated in the agreement); but, at the same time, the lender demands that effective security is granted at the outset.

There is no express provision in the Civil Code 1994 related to pledges securing future obligations. However, the Law on Pledge stipulates that “[pledge] may be set with respect to demands, which will arise in the future, if the parties agree on the secured amount of such demands” (Article 4). The interesting part of the provision relates to the drawing of the distinction between the use of “demands” as opposed to “obligations” in the article. Neither the Law on Pledge, nor the Civil Code 1994 includes an express definition for a “demand”. However, there are certain provisions in the Civil Code 1994 that may support the drawing



of distinction between a demand and obligation. For example, Article 314 refers to a demand of the creditor being made on the debtor to perform the debtor's obligations.<sup>292</sup>

Also in this connection, the reader may recollect that Russian law has rather stringent requirements to the contents of a pledge agreement. Such an agreement must include, *inter alia*, information on the secured obligations.<sup>293</sup> As was discussed earlier, it is not always clear how much the borrower will actually borrow when a pledge agreement is entered into. Thus, there is scope for argument that Russian law does not allow to secure future obligations.

Turning to courts' views, indeed, there were some cases where security for future obligations was considered. The Federal Arbitrazh Court of West-Siberian region in case F04/1264-267/A75-99, dated 21 June 1999, where security was granted in respect of "*future credit agreements*" decided that the amount of the secured obligations was unclear and, thus, the pledge agreement did not comply with the requirements of the law as to the contents of a pledge agreement and was void.<sup>294</sup> Clearly, in that case, lenders' interests received a very unfavorable treatment. Of course, the case could not expressly "overrule" the provisions of the statute as to the possibility for providing security for future obligations; however, what the case effectively did was to undermine the possibility to provide such security by requiring that the detail of the future obligations were set out in the pledge agreement.

Another case,<sup>295</sup> that went as high as the Presidium of the Supreme Arbitrazh Court of the Russian Federation, provided some comfort for lenders, at least those lenders that hold a banking license and, thus, may enter into credit agreements under Russian law.<sup>296</sup> In that case, two banks (the lender and borrower banks) entered into a credit agreement, which provided for loans up to a certain sum to be disbursed pursuant to the requests of the borrower. There was also a properly registered mortgage agreement securing the obligations under the credit agreement. The lower instance courts in their analysis of the

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<sup>292</sup> Furthermore, Article 337 of the Civil Code 1994 also refers to pledge as security for a "*demand*" (not obligation). However, Article 337 is dedicated to the "*amount*" of a demand being secured, thus it may be argued that Article 337 only becomes operational when an obligation matures (*e.g.*, debt becomes due and payable) and is so converted into a "*demand*". In contrast to Article 337, Article 334, which includes a definition of pledge, refers to pledge as security for obligations.

<sup>293</sup> See p.79 above.

<sup>294</sup> See E.Suvorov, "Securing by Pledge of Future Demands", *Ezh-Jurist*, No.34, 2006.

<sup>295</sup> See the Resolution of the Supreme Arbitrazh Court of the Russian Federation No.2327/02 on case No.A40-19687/01-57-220, dated 18 June 2002.

<sup>296</sup> A loan agreement and a credit agreement are different kinds of agreement under Russian law. A loan agreement can only come into existence when the loan is *actually made*; under a credit agreement, the lender may *agree* to lend in the *future*. Credit agreements can only be entered into by banks (or other credit organizations) as lenders (Articles 807 and 819 of the Civil Code 1994).

parties' relationships concluded that the credit agreement was not a credit agreement *per se*, but a preliminary agreement on entering into individual credit agreements in the future; in fact the credit agreement itself used the phrase "*preliminary agreement*". The lower court also concluded that neither the Civil Code 1994, nor the Law on Mortgage allowed for a future obligation to be secured by mortgage. Furthermore, the court pointed out that the mortgage agreement, with reference to the requirement to spell out the secured obligations, referred to the credit agreement itself, which only set out the limit for the loans to be made under it. On these arguments, the lower courts declared the pledge agreement void. The Presidium of the Supreme Arbitrazh Court reversed the lower courts' decisions and directed that the case be re-considered. The Presidium pointed out that a credit agreement is a "*consensual*" agreement, meaning that the rights and obligations under such an agreement arise from the date of the agreement (and not when at least one party performs certain actions). Thus, obligations under the credit agreement arose when that agreement was concluded and not when each individual subsequent request for credit was accepted. The Presidium also decided that the limit for lending as repeated in the pledge agreement was sufficient detail for the purpose of identification of the secured obligation and to comply with the requirements of the Civil Code 1994 to the contents of the pledge agreement.<sup>297</sup>

The outcome of the case was that the Presidium adopted a somewhat liberal approach to the conditions that must be set out in a pledge agreement; in particular, the court was sympathetic to the presence of only the general limit for borrowing information in the pledge agreement.<sup>298</sup> From a commercial perspective, this is a logical and welcome outcome,<sup>299</sup> however, the possibility of borrowers raising arguments in cases where only the general lending limit is stipulated cannot be discounted altogether. Yes, there appears to be little chance of such arguments succeeding, but some risk remains. The solution to the problem of securing future obligations lies not with the courts, but with the legislature. Perhaps, the wording in the Law on Pledge with respect to pledges for "*future demands*" should be clarified or a new provision inserted into the Civil Code 1994.

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<sup>297</sup> See also review of that case by L.Kulikova in "Security for Obligations", *Ezh-Jurist*, No.45, 2003.

<sup>298</sup> Basic English law rules on further advances and security (tacking) were laid down in *Devaynes v Noble, Clayton's case* (1816) 1 Mer 529. For English mortgages, see also Land Registration Act 2002, section 49 and Law of Property Act 1925, section 94. The Russian courts' view is close to the English law position.

<sup>299</sup> It must be noted that under previous insolvency regimes for security, the question of the amount of the secured obligation was more acute. The earlier insolvency regimes (see, generally, *Insolvency Law* on p.135 below) provided for sharing of security among *all* secured creditors in insolvency of the debtor in proportion to their claims. Thus, if a pledgee overstated the value of its secured obligation, it would have been entitled to a larger payout in the pledgor's insolvency. The current regime does not allow the sharing of security (or pooling of pledgees' claims) and thus, there is little advantage in overstating the amount of the secured obligation.

The discussion must be continued with respect to mortgages, since the respective legislation includes a specific provision in respect of future obligations. Pursuant to the Law on Mortgage, Article 9, the amount of an obligation (secured by mortgage) may be “*determinable in the future*”, and in such cases, the respective mortgage agreement must include rules for its determination. This provision is beneficial for the lenders in the sense that it apparently allows the obligation to fluctuate. However, it is not clear how wide the interpretation of the “*determinable in the future*” wording can be.<sup>300</sup>

Another provision in the Law on Mortgage, which is clearly useful with respect to future obligations, can be found in Article 11: if an obligation secured by mortgage arose after the respective entry was made in the state immovables register, the rights of the pledgee arise simultaneously with such an obligation. In this manner, the Law on Mortgage impliedly “authorizes” the creation of mortgages in respect of future obligations. An interesting case A40-48398/07-21-357 relates to mortgages for future obligations.<sup>301</sup> The case evolved around a transaction with a complex set of relationships, involving bank guarantees, subrogation claims and mortgage for obligations arising out of one of the guarantees (issued under Russian law). The focal point of the case was the refusal of the state registrar to register the mortgage (which is a mandatory requirement for the mortgage to be valid). The reasons for the refusal were: (i) the obligations purported to be secured by the mortgage were not in existence at that time; and (ii) a guarantee did not constitute an obligation (it was argued that it was only a kind of security, and not a stand-alone obligation). The Federal Arbitrazh Court of Moscow region upheld the lower-court’s decision and ruled that the refusal to register the mortgage was illegal. The claim that a mortgage could not secure future obligations was rejected by reference to Article 11 of the Law on Mortgage and it was also stated that a guarantee can be treated as a stand-alone obligation (since, under Russian law, a bank guarantee is not voided if the obligation “secured” by that guarantee is void – Article 370 of the Civil Code 1994).

### Future assets

We considered pledges purporting to secure future obligations. In addition security for future obligations, commercial interests may often result in the need to acquire assets with

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<sup>300</sup> By way of speculation, one view would be that the law covers only obligations that change depending on circumstances, and not, say, new disbursements under a framework agreement. However, in the light of the decision No.2327/02 case No.A40-19687/01-57-220 discussed above (footnote 295 on p.89 above), this is not likely, at least with respect to the common situation, where the lender is a bank or a credit organization.

<sup>301</sup> See the Resolution of the Federal Arbitrazh Court of the Moscow region No.KG-A40/2072-08, dated 18 June 2008, on case No.A40-48398/07-21-357 and the Decision of the Supreme Arbitrazh Court of the Russian Federation No. 13294/08, dated 17 October, 2008.

the help of borrowed funds. In such cases, the lenders as a rule demand that security is granted over such after-acquired assets. This sub-section covers the position of Russian law for pledges over property that is to be acquired in the future.<sup>302</sup>

Let us first turn to what can be referred to as “automatic statutory pledges” (meaning that such pledges arise by operation of law rather than specific agreement of the parties) over future assets. Among such pledges are pledges that arise under the rules of the Civil Code 1994 and Law on Mortgage.

Under the Civil Code 1994 there are two major cases that relate to pledges of future assets: (i) assets sold on credit; and (ii) pledge of goods in circulation. Pledge of goods in circulation will be considered later in this chapter.<sup>303</sup>

With respect to assets sold on credit, Part II of the Civil Code 1994 (which covers specific types of agreements) protects the interests of the seller: goods sold on credit, once delivered to the purchaser and until fully paid, are regarded as being pledged to the seller (Article 488).

The Law on Mortgage includes more detailed rules with respect to certain immovables acquired with the use of loan financing. If a land plot was acquired with funds borrowed from a bank or other credit organization or with funds borrowed for that purpose from another juridical person, such land plot is regarded as pledged to the lender from the moment when the rights of the purchaser to the plot are registered (Article 64.1 of the Law on Mortgage).<sup>304</sup> The rule on the automatic pledge of purchased land plots is subject to any provisions of law or a contract to the contrary. This provision in the Law on Mortgage must be considered to be very unfortunate: the literal reading of the law suggests that the purchaser can agree with the seller that the land plot is not pledged, even if it is acquired with funds borrowed from a bank. Since the purpose of the provision on automatic pledge is to protect the interests of the lender, it is regrettable that such interests may be overridden without any its participation.

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<sup>302</sup> In English law, security over future assets is generally possible in equity: *Holroyd v Marshall (1862)* 10 HL Cas 191.

<sup>303</sup> See *Pledge of goods in circulation* on p.95 below.

<sup>304</sup> This rule covers land plots specifically. For example, the Federal Arbitrazh Court of Volgo-Vyatsk region in its Resolution on case No.A79-9875/2006, dated 14 November 2007, specifically pointed out that this rule did not cover premises. However, the case itself appears to be flawed, since both the land plot and the building on it were purchased by the borrower. The borrower allegedly paid for the land plot from its own funds; however, the price for the land plot was stated in the sale-purchase contract to be extraordinarily low; and the bulk of the price was attributable to be for the shop. This must have been an artificial device employed by the seller/buyer and it seems that the interests of the lender were unfairly prejudiced by the court’s decision.

Another rule in the Law on Mortgage relates to pledges of land plots, on which a building is acquired, built, or is being built with funds borrowed from a bank or other credit organization or with funds borrowed for *that purpose* from another juridical person. Such a land plot, or the lease of that land plot, is considered to be pledged from the registration of the right of property to such building or from such time as the state registrar receives a notification of the existence of the loan agreement (Article 64.2 of the Law on Mortgage).

At this point it must be noted that neither Article 64.1, nor Article 64.2 specify what proportion of the purchase price (or cost of construction) the borrowed funds must constitute. The literal interpretation of the text of the Law on Mortgage suggests that the borrowed funds must constitute the whole of the purchased price.<sup>305</sup> Such an interpretation is rather prejudicial to the interests of lenders, since it is a common requirement that the borrower uses its own funds to cover a proportion of the purchase price, too. In order to receive protection under the respective provisions, the Law on Mortgage essentially requires that lenders operate on the basis of one hundred *percent* loan-to-value ratio, which is clearly unreasonable and commercially unsound. Thus, to a large extent, Articles 64.1 and 64.2 in practice are “dead” law and do not have much business significance.<sup>306</sup>

To complete the discussion of the Law on Mortgage provisions on pledge of future immovables, it seems that by virtue of item 2 of Article 9 of that law, it is practically impossible to contractually pledge future immovables.<sup>307</sup> Article 9 requires that the pledge agreement expressly refers to the right pursuant to which the pledgor owns the immovable property to be pledged. If the property is not yet owned by the person purporting to grant the mortgage, this requirement cannot be complied with and, hence, mortgages of after acquired real estate pursuant to contract are not allowed.<sup>308</sup>

Let us now turn to a more general discussion of pledges of future property. Article 340 of the Civil Code 1994 stipulates that a pledge agreement may contemplate pledge of corporeal property or property rights, which the pledgor will acquire in the future. The Law on Pledge

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<sup>305</sup> This interpretation was also suggested in E.Vlasov, “Particularities of Mortgages of Land Plots with Buildings, Constructions and Structures”, *Law and Politics*, No.10, 2007.

<sup>306</sup> There is a similar provision with respect to dwellings in the Law on Mortgage: Article 77. Article 77 expressly provides that the automatic pledge arises even if only a proportion of the funds used to purchase the dwelling was provided by the bank.

<sup>307</sup> Cf. English *Holroyd v Marshall* (1862) 10 HL Cas 191. It is not possible to have a legal mortgage on future land, but equitable mortgage is allowed.

<sup>308</sup> Same opinion is expressed in L.Novoselova and B.Gongalo, *Comments to Informational Letter of the Presidium of VAS RF No.26, dated 15 January 1998, “Review of Practice of Consideration of Disputes, connected to Application by Arbitrazh Courts of Rules of Civil Code of the Russian Federation on Pledge”*, available electronically in *Garant* database.

includes a similar provision, with the exception that it refers to corporeal property only and omits to mention property rights (Article 6).

The controversy with respect to general pledges of future assets relates to Article 335 of the Civil Code 1994 that provides that only a proprietor has the right to pledge (its) property. If the property has yet to be acquired by the “pledgor”, he has no right of property over it and thus, apparently, cannot pledge it. Perhaps, the approach to the contradiction in Articles 335 and 340 can be resolved by distinguishing between a pledge agreement and the right of pledge.<sup>309</sup> Whatever the theoretical solution to this problem is, the courts appear to have adopted a certain approach in this respect: the Presidium of Supreme Arbitrazh Court of the Russian Federation in its Informational Letter No.26 “Review of Practice of Consideration of Disputes, Connected to the Application by the Arbitrazh Courts of the Rules of the Civil Code on Pledge”, dated 15 January 1998, stated that the right of pledge pursuant to Article 340 of the Civil Code 1994 arises at the time when the pledgor acquires the right of property to the respective assets.<sup>310</sup>

There is also some doubt as to what approach Russian law adopts with respect to pledges of future rights. In particular, distinction was drawn among: (i) future rights that do not exist by virtue of the non-existence of the respective agreement; (ii) rights that exist, but have not matured yet (e.g., repayment on a term loan); (iii) rights that depend on the performance by the party with that right (e.g., right to demand payment for goods sold may be conditional on such goods having been delivered). One interpretation of the Civil Code 1994 with respect to pledge of future rights is that rights mentioned in (ii) exist and therefore can be pledged as existing rights, without the need to resort to the rule in the Article; and that rights in (i) and (iii) can be pledged pursuant to Article 340.<sup>311</sup> In circumstances, where the pledgor is a trading party and has a pool of receivables the most likely scenario would be to rely on pledge of rights referred to in (ii), i.e., existing rights that do not require any performance by the pledgor; however, in some cases the trading party may still have obligations to deliver the goods or to provide after-sale support to the purchaser (before full

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<sup>309</sup> As suggested in L.Novoselova, “Transactions on Assignment of Future Rights of Demand”, *Khozyaistvo i Pravo*, No.10, 2002.

<sup>310</sup> The Informational Letter refers to a case, where the pledge agreement purported to create pledge over bricks which were to be delivered to the pledgor later. Apparently, by the time that enforcement was attempted, the bricks still had not been delivered to the pledgor, and, thus, the pledge failed (however, the Informational Letter is somewhat vague about the fate of the bricks, since it is doubtful that the pledgee attempted to enforce on bricks that the pledgor had no control of).

It also remains unclear whether security over future acquired assets can be defeated by the intervening insolvency of the pledgor. Under English law, it appears, that such security is not defeated: *Industrials Finance Syndicate, Limited v. Lind (In Re Lind)* [1915] 2 Ch. 345.

<sup>311</sup> P.Malakhov, “Pledge of Future Rights”, *Ezh-Jurist*, No.30, 2005.

payment is received). In such cases, it may be possible to rely on pledge of future rights allowed by Article 340. However, any such pledge must be approached carefully: this is, generally, an untested ground and it is not clear how favorably Russian courts would treat such pledge agreements. Pledge of rights that have not come in existence (*i.e.*, those mentioned in (i)) may be precluded by the stringent requirements of Russian law to the description of the pledges assets of in the agreement. It may be quite difficult to describe rights that do not exist and thus there is a strong chance that an agreement on pledge of such rights would be void.

#### Pledge of goods in circulation

The previous sub-section dealt with pledge of future property, including statutory automatic pledges. Pledge of goods in circulation is another statutory mechanism, which, in a way, allows to extend the operation of pledge to assets that will be acquired by the pledgor in the future. Pledge of goods in circulation allows to secure goods which remain in the possession of the pledgor, who also has the right to change the composition and natural form of the goods (stock, raw materials, *etc.*) provided that their total value does not fall below that stipulated in the pledge agreement (Article 357). The beauty of pledge of goods in circulation is particularly apparent for trade companies, which can use their day-to-day changing trade stock for financing their operations through a relatively certain (in the sense that it is provided for by the statute) mechanism.<sup>312</sup> The pledgor, generally, has the right to dispose of the pledged goods in circulation;<sup>313</sup> and if he does so, the goods cease to be pledged. On the other hand, if goods as specified in a pledge agreement are acquired by the pledgor, such goods become subject to the pledge automatically.

If the pledgor breaches the terms and conditions of the pledge agreement, the pledgee has the right to “suspend” the pledgee’s operations with the assets by way of labeling or stamping the goods until such time that the breaches are rectified. It is interesting to note that the provisions of the Civil Code 1994 on labeling pledged goods in circulation were used by courts as an argument against the pledgee (claimant). The Federal Arbitrazh Court of the

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<sup>312</sup> In English law, a holder of a floating charge over all or substantially all debtor’s assets could appoint an administrative receiver (this was restricted by the Enterprise Act 2002, section 250). There is no equivalent right in Russian law.

<sup>313</sup> One of the issues in English law is re-characterization of a fixed charge as a floating charge: see, *e.g.*, *Ashborder v Green Gas Power Ltd* [2004] EWHC 1517 (Ch) and *National Westminster Bank plc v Spectrum Plus Limited & Others* [2005] UKHL 41. Since Russian pledge of goods in circulation is limited to goods only and has a very peculiar regime, it is doubtful that any (fixed) pledge could be re-characterized as pledge of goods in circulation. Furthermore, even it is so re-characterized, there are few consequences for a creditor under Russian law. Then the (only) important question which could arise in re-characterization under Russian law would be the moment from which the pledge crystallized. The real danger is, however, in that a pledge is much more likely to be struck down, rather than re-characterized if there were any grounds.

Central region in its Resolution on case No.A64-1588/06-9, dated 10 November 2006, stated that the pledged goods were lawfully disposed of by the pledgor, since the pledgee did not exercise its right to label them. Furthermore, the same court in its Resolution on case No.A64-1587/06-8, dated 18 December 2006, pointed out that even though the pledgor was in breach of the terms of the pledge agreement, which apparently prohibited any disposal of the pledged assets in the then existing circumstances, the disposals of such assets were not void, since the provisions of the Civil Code 1994 with respect to the labeling of goods: (i) were mandatory; and (ii) set specific rules with respect to pledges of goods in circulation, which overrode the general rules on invalidity of transactions. The approach of the courts to the labeling of goods protects the interests of an innocent third party, who purchased the goods from the pledgor (who, under the pledge agreement, had no right to sell); however, the interests of the lender are prejudiced: it is quite cumbersome for a lender to set on labeling the goods immediately after any breach of a pledge agreement.<sup>314</sup>

Pledge of goods in circulation is somewhat similar to English law floating charge.<sup>315</sup> However, pledge of goods in circulation is a “narrower” type of security: it can only cover goods (and cannot cover rights, documents, etc.) In addition, a floating charge can crystallize without the need for any labeling or stamping of the pledged goods.<sup>316</sup> As was shown in the

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<sup>314</sup> On the positive side, the Federal Arbitrazh Court of the Moscow region in its Resolution No.KG-A40/4930-04, dated 23 June 2006, on case No.A40-2245/04-9-17 pointed out that it is irrelevant for the purposes of the pledge of goods of circulation where the goods were located (perhaps, unless there is a respective provision in the agreement). This means that the pledgor is free, for example, to transfer the goods from a warehouse to points of sale and pledge would not be defeated by such actions.

<sup>315</sup> For example, a description of a floating charge under English law was given by Lord Halsbury in *Illingworth v Houldsworth* [1904] AC 355 at 357 as follows:

*“In the first place you have that which in a sense I suppose must be an element in the definition of a floating security, that it is something which is to float, not to be put into immediate operation, but such that the company is to be allowed to carry on its business. It contemplates not only that it should carry with it the book debts which were then existing, but it contemplates also the possibility of those book debts being extinguished by payment to the company, and that other book debts should come in and take the place of those that had disappeared. That, my Lords, seems to me to be an essential characteristic of what is properly called a floating security.”*

See also, e.g., *Re Brumark* [2001] UKPC 28 and *National Westminster Bank plc v Spectrum Plus Limited & Others* [2005] UKHL 41.

Russian pledge of goods in circulation does not receive any preferential treatment compared to Russian pledges in insolvency. Cf. a holder of a qualifying floating charge falling under the exceptions introduced by section 250 of the Enterprise Act 2002 (sections 72A-72G of the Insolvency Act 1986), who still can appoint an administrative receiver. Also, both Russian pledges and pledges of goods in circulation are subject to the same priority rules as carve-outs. Cf. current English regime where Insolvency Act 1986, sections 40, 176A, 386 and Schedule 6 create preferential creditors for floating charges *only*.

Russian priority rules for pledges of goods in circulation are same as for pledges in general: see *Subsequent pledge* on p.81 below.

<sup>316</sup> This must be compared with English floating charges, which crystallize (become fixed charges) in specified circumstances under common law:

- a winding up order (*Re Crompton & Co Ltd* [1914] Ch 954);
- appointment of a receiver or administrator, etc. (*Taunton v Sheriff of Warwickshire* [1895] 2 Ch 319); and
- chargor ceases to carry on business (*Re The Real Meat Company Ltd* [1996] BCC 254).



preceding paragraph, Russian courts took the view that labeling is a required action for Russian pledge to “crystallize”.

### Repo transactions

The essence of a sale and repurchase transaction (repo) is that the “borrower” sells assets to the “lender” on the condition that the same assets will be purchased by the “borrower” at a later date. In a simple repo transaction, the “purchase-back” price will exceed the price paid by the “lender” for the assets initially and the difference will represent interest on the loan. The convenience of a repo transaction is that it provides good security for a “lender”, since the title to the “secured” assets is transferred outright and there is no question of priority of lender’s claims against the insolvent debtor: the lender simply keeps the assets.

At first sight, there are no provisions in Russian law that could impede repo transactions; in fact, one might think that all a lawyer needs to implement a repo is the ability to draft two sale-purchase agreements (one of them being conditional on the “borrower” not becoming insolvent). Unfortunately, in practice things turned out to be complicated. In a line of cases, it was decided by the courts that repo transactions were sham transactions, essentially, pledges in disguise. The Presidium of the Supreme Arbitrazh Court of the Russian Federation in case No. 6202/97, dated 6 October 1998, considered a situation where the parties, a bank and borrower, purported to enter into a number of related agreements, including a credit facility agreement and two sale-purchase agreements for shares. The Presidium decided that the parties did not intend to sell the shares and that the sale-purchase agreements in fact concealed the pledge of shares; the Presidium also pointed out that all said agreements must be viewed in their entirety. The facts of the case were that the borrower obtained funds from the bank, but failed to repay; under such circumstances the second, “purchase-back”, agreement was not to be performed. However, the Presidium, in deciding that the sale-purchase agreements were sham transactions, stated that the shares must be returned to the borrower. The Presidium also relied on Article 170 of the Civil Code 1994, according to which a transaction, which concealed another transaction, was void and the rules that were applicable to the concealed transaction must be applied to the parties’ agreement.

There are some strong theoretical issues<sup>317</sup> with the Presidium’s decision: first, the parties are generally free to enter into a contract on terms as they see fit (Article 421 of Civil Code

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Generally, there is nothing to prevent the parties on agreeing on other circumstances where a floating charge crystallizes.

<sup>317</sup> It is interesting to note that a prominent Supreme Arbitrazh Court judge, S.Sarbash in “Some Problems of Security for Performance of Obligations”, *Vestnik VAS RF*, No.7, 2007, noted that it seemed to be most reasonable to recognize “security” nature of a repo transaction.

1994); and second, law expressly provides that the parties may agree on forms of security for obligations other than those expressly provided for in the statute (Article 329).<sup>318</sup> Furthermore, in business practice repo transactions, arguably, were relatively widely used and various official documents, *e.g.*, Central Bank documents, referred to repo transactions.<sup>319</sup>

Even discounting the apparent lack of theoretical grounds for the Presidium's decision, the text of the judgment leaves some questions open. In particular, the Presidium referred to the credit agreement and a disbursement under the said credit agreement; the Presidium also referred to a (different) payment by the bank under the share sale-purchase agreement. The judgment then stated that the funds disbursed under the credit agreement were repaid by the borrower. If these were indeed the facts of the case, it is unclear why the Presidium also stated that the parties agreed in the credit agreement that it was to be secured by repo. If all moneys disbursed under the credit agreement were repaid, how could the share sale-purchase agreement possibly be treated as security for that agreement? Though the Presidium expressly pointed out that the loan under the credit agreement was repaid, there was no mentioning of the fact that the repo transaction itself was another loan. Even if the Presidium was of the opinion that the repo was in fact a pledge, perhaps, the reasoning in its judgment could have been more clear as to the grounds on which the repo had to be re-characterized as pledge and the actual position of the parties (*e.g.*, a statement to the effect that the repo constituted in fact two separate transactions: a loan and a pledge); however, the Presidium failed to do so. The decision of the Presidium on the return of the shares must also be put in the context of the earlier Resolution of the Plenary session of the Presidium of the Supreme Court of the Russian Federation and the Plenary session of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.6/8,<sup>320</sup> according to which "*the legislation [then] in force did not contemplate the possibility to transfer pledged property into the ownership of a pledgee*". At the time of the No. 6202/97 case, the law did not allow the pledgee to enforce directly against the pledged asset and the Presidium might have felt that the repo was a way to structure a financing transaction around that prohibition.<sup>321</sup>

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<sup>318</sup> For a review of arguments against and in favor of repo transactions, see, *e.g.*, E.Ivanova, "REPO Transactions", *International Banking Operations*, No.2, 2006.

<sup>319</sup> See V.Polyakov, "REPO – Place in the System of Institutes of Civil Law", *Legislation and Economy*, No.9, 2004.

<sup>320</sup> "On Some Questions, Related to Application of Part I of Civil Code of Russian Federation", dated 1 July 1996.

<sup>321</sup> Similar arguments were mentioned by the Federal Arbitrazh Court of the Moscow region in its Resolution No.KG-A40/4347-06, dated 29 May 2006, related to a repo of a participation interest in a limited liability company.

In a chain of cases involving a repo sale of land, the courts indeed ruled that the rules on pledge must be applied to the repo transaction (the Resolution of the Arbitrazh Court of Moscow region No.KG-A40/5294-06, dated 23

However, the courts did not seem to always have followed the Presidium's reasoning for repo transactions. For example, the Federal Arbitrazh Court of the North-West region in its Resolution No.A56-6381/04, dated 12 January 2005, relating to, essentially, a repo of shares, declined to declare that the repo was a concealed pledge. The court stated that since the "purchase back" agreement included a term to the effect that the parties will agree on the re-transfer of the shares (as opposed to immediately transferring them back, as the rules on pledge required), the agreement was not purporting to disguise a pledge and was valid.

The courts' approach rendered repo transactions to be a risky business. The more likely outcome for the parties to a repo was the declaration of their agreement(s) void (and, perhaps, the application to their relationships of the rules on pledge); the less likely scenario would be for the courts to uphold the sale-purchase agreement(s) being part of the repo.

However, some eleven years after case 6202/97, Russian law was amended with respect to transactions relating to securities. In November 2009, the Federal Law No.39-FZ "On Securities Market", dated 22 April 1996, was amended to include provisions on repo.<sup>322</sup>

The amendments introduced into the Law on Securities Market a new Article 51.3, dedicated specifically to repo. According to Article 51.3, a repo is a distinct type of agreement.<sup>323</sup> The law treats repo as *one* transaction, including two "*parts*": the first part is the sale of securities to the lender; and the second part is the sale from the lender to the borrower. The provisions of the Civil Code 1994 on sale-purchase apply to repo to the extent that they do not contradict the Law on Securities Market.

Unlike in many other cases in Russian law, there is a good degree of flexibility provided in Article 51.3 with respect to structuring of a repo: the parties may agree that certain types of securities will be transferred and that one of the parties has the right to select which securities will be transferred; not only a set price can be used, but also a method for the determination of the price; though the date for the first part of the transaction must be expressly set, the date for the second part can be also "on demand". The restrictions on repos in Article 51.3 relate to: (i) persons who may enter into repos; and (ii) to securities that

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June 2006, on case No.A40-65945/05-58-526). In the later cases in the chain the dispute related to the correctness of the actions of the state registrar and invalidity of the sale-purchase agreement. However, it is not clear whether the lender could enforce against the land plot, which, as was mentioned by one of the courts, should have been referred to as "being pledged" instead of "sold".

For a discussion of the No.A40-65945/05-58-526 cases, see A.Asriyantz, "Security Sale-purchase: Theory and Practice", *Ezh-Jurist*, No.48, 2006.

<sup>322</sup> Federal Law No.281-FZ "On Introduction of Changes to Parts I and II of the Tax Code of the Russian Federation and Certain Legislative Acts of Russian Federation", dated 25 November 2009.

<sup>323</sup> The legislative technique employed by the legislator would be more common for Part II of the Civil Code 1994. Part II of the Civil Code includes rules on individual types of agreement and one could expect to find the rules on repos, though being more technical than the usual standard adopted in the Civil Code 1994, in its Part II.

may be used for repo. An individual may enter into a repo transaction only if the other party is a professional securities market participant or if such an individual is represented by a broker.<sup>324</sup> The following securities may be used in a repo transaction: securities of a Russian issuer; securities of an investment fund, which has a Russian management company; shares or bonds of a foreign issuer; and foreign depositary receipts for securities of Russian or foreign issuers.

The Law on Securities Market includes fairly detailed provisions allowing the parties to exchange transferred securities for other securities during the term of the repo and to make “adjustment” payments from one party to the other if the price of the transferred securities fluctuates in the market. In addition, Article 51.3 provides for a termination mechanism: essentially, if one of the parties does not perform its obligations, but makes a payment which is sufficient to compensate for the losses of the other party, the obligations under the repo terminate.

Article 51.3 appears to have been drafted taking the practice in the securities market into account, which is clearly a welcome sign of change from the hostile treatment of repos in the 6202/97 case. It remains to be seen how well the new provision of the Law on Securities Market will operate. There is one detail, though, that may not have been taken on by the legislator in introducing of Article 51.3: insolvency law. As the reader may be aware, the European regime for financial collateral also includes protections for financial collateral from the general rules of insolvency legislation on setting of transactions aside.<sup>325</sup> At the time of writing there is no such protection available under Russian insolvency law. Thus, a repo transaction, which according to Russian Law on Securities Market, consists of the two parts (two sale-purchase agreements), may be attacked under Russian insolvency rules. It is also not clear whether the statutory provisions on termination of a repo transaction “convert” the repo relationships into a simple residual monetary claim on insolvency of one of the parties, which is how repos are intended to operate; or whether the parties’ in their agreement can achieve the same result. It is unfortunate that the legislator omitted to deal with the situation expressly and, hence, Russian courts have another chance to arrive at some staggering conclusion as to the nature of repos. And of course, though the Law on

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<sup>324</sup> Thus, two (non-professional) individuals can enter into a repo, if they are each represented by a broker.

<sup>325</sup> Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 On Settlement Finality in Payment and Securities Settlement Systems (as amended) and Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 On Financial Collateral Arrangements (as amended). For the UK, see also Financial Collateral Arrangements (No. 2) Regulations 2003 (SI 2003/3226).

Securities Market authorized the use of the securities' repo, the prohibitive analysis in case 6202/97 may still hold ground with respect to other assets.

#### Pledges of participation interests and shares

Russian law operates with the term "*juridical person*" to refer to several forms of incorporated entities; juridical persons are capable of carrying out rights and obligations on their own behalf (Article 48 of the Civil Code 1994). There are several forms of a juridical person, which are often used as business entities: *obschestvo s ogranichennoy otvetstvennost'yu*, often translated as "limited liability company", and *aktzionernoye obschestvo*, often translated as "joint stock company". With respect to members of limited liability companies and joint stock companies, members own *doli*, often translated as participation interests, and shares, respectively. This sub-section considers some Russian law as it stands in respect of pledges of participation interests and shares.<sup>326</sup>

Let us first consider pledge of participation interests in limited liability companies. By way of introduction, such companies are intended to have limited membership: for example, they cannot be public and participation interests are not freely transferrable. Hence, it is logical to assume that there are also restrictions on pledges of participation interests.

Indeed, the Federal Law No.14-FZ "On Limited Liability Companies", dated 8 December 1998, includes provisions dedicated specifically to pledges of participation interests. There are two initial requirements for a pledge of a participation interest: such a pledge must not be prohibited in the company's constitutional documents; and the consent for the pledge must be given by the participants' general meetings (where the pledgor cannot vote). The pledge agreement must be notarized (otherwise it is void). Recent amendments<sup>327</sup> to the Law on Limited Liability Companies expanded the provisions on pledge of participation interests and significantly improved the level of procedural detail related to such pledges.<sup>328</sup> The new provisions require that a pledge agreement is notarized. Within three days the respective notary must notify: the state companies' registrar on the details of the pledge agreements;

<sup>326</sup> Shares are considered to be securities under Russian law. There are interesting details in Russian law related to pledges of other securities, for example, bills of exchange. See, e.g., L.Novoselova, "Contract on Pledge and other Security Transactions with Bills of Exchange", *Legislation*, No.1, 2, 2002. Also for bills of exchange and securities generally, see Informational Letter of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.67 "Review of Practice of Resolving of Disputes Connected to the Application of Norms on Pledge and Other Security Transactions with Securities", dated 21 January 2002.

<sup>327</sup> The Federal Laws No.312-FZ "On the Introduction of Amendments into Part I of the Civil Code of the Russian Federation and Selected Legislative Acts of the Russian Federation", dated 30 December 2008, and No.205-FZ "On the Introduction of Amendments into Selected Legislative Acts of the Russian Federation", dated 19 July 2009.

<sup>328</sup> For example, A.Evdokimov in "Pledge of Participation Interest in Charter Capital of a Limited Liability Company", *Jurist*, No.6, 2008 stated that pledges of participation interests were not developed in arbitrazh practice apparently due to the brevity of rules of the matter.

and the company on the same. The companies' registrar has a further three days to make a respective entry in the state register. Such an entry may be discharged pursuant to a joint application of the pledgor and pledgee (*e.g.*, if the secured obligation was fully discharged) or pursuant to a court decision.

The new provisions on pledges of participation interests in limited liability companies are, to a large extent, aimed at providing an element of publicity to the respective pledge relationships, which is a very welcome step by the legislator. However, some problems remain unsolved, *e.g.*: the moment from which the pledge becomes effective (registration or date of agreement); voting restrictions if only a part of a participant's share is pledged; pledge of participation interest not fully paid; changes in the charter capital diminishing the value of the pledged participation interest; and out-of-court enforcement.<sup>329</sup> The issue that the discussion will focus here is enforcement against participation interests in general.

The Law on Limited Liability Companies includes a general provision on enforcement on participation interests. According to Article 25, enforcement is possible only if the other property of the debtor is insufficient to pay off the debt(s). The company is also granted the right to pay to the creditor the "actual" value of the participation interest, instead of enforcement. The "actual" value is determined with reference to accounts for the last accounting period before enforcement was attempted. The company has three months to make the decision on the payment of "actual" value and only then enforcement may commence by way of sale at a public auction. Thus, the Law on Liability Companies is, generally, favorable to the company and to its current members.<sup>330</sup> Though the Law on Limited Liability Companies has detailed provisions on the procedures for the creation of a pledge, it completely omits to deal with enforcement of pledges. This is clearly a legislative defect. The first question is whether the general provisions on enforcement against a participation interest also apply to a pledgee (who had already received a go-ahead from the company for the creation of the pledge). Second, must a pledgee satisfy the court that the pledgor has no other assets before proceeding to enforce on the lawfully pledged participation interest? The more reasonable answer is "no"; however there is no way to foresee the courts' position on the issue.

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<sup>329</sup> For a discussion of these issues, see R.Bevezhenko "Novels of Legislation on Pledge of Participation Interests in Limited Liability Companies" in M.Rozhkov (ed.), *Measures of Security and Measures of Liability in Civil Law*, Statute, Moscow, 2010.

<sup>330</sup> Similar rules are included into Article 74 of the Federal Law No.229-FZ "On Enforcement Proceedings", dated 2 October 2007.

The requirement of the Law on Limited Liability Companies to receive the consent of the participants' general meeting also affects the ability of the pledgee to enforce out of court if the pledgor is an individual.<sup>331</sup> According to Article 349 of the Civil Code 1994, if the consent of other person or body was required in order for the pledge to be effective, enforcement cannot take the form of out-of-court proceedings.

Let us now turn to changes in the charter capital of a company and consider how they may affect the rights of the pledgee. Assuming that, say, ten *percent* of participation interests in a company were pledged, what happens if the charter capital is later increased by a ratio of ten? That is, are the interests of the pledgee protected from dilution to one *percent* participation in the company? Ostensibly, the position of Russian courts is that the pledgee receives no protection (at least as a matter of statutory law). In a case where the interests of the pledgee were diluted tenfold (from a pledge of forty-nine to four and nine tenth *percent* participation interest) *via* the acceptance of new members into the limited liability company, the courts refused to provide protection and declare the respective general meeting's decision void.<sup>332</sup> The court focused on the *nominal* value of the participation interest and concluded that it was not affected by the dilution of the company's capital; and, thus, in the opinion of the court, the interests of the pledgee were not harmed. The fact that nominal value of a participation interest had no relevance to its actual value was conveniently overlooked.<sup>333</sup>

The Presidium of the Supreme Arbitrazh Court stated a similar view with respect to additional issuance of shares by a joint stock company. The Presidium concluded that since the pledge agreement provided for a certain number of shares to be pledged, any additional issuance by the company did not give the pledgee the right to claim that a proportionate amount of newly issued shares must be pledged.

For a pledgee the courts' approach means that where the capital of a company was diluted, there are virtually no mechanisms allowing it to protect its security interests.<sup>334</sup>

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<sup>331</sup> The cases where the members of a limited liability company are individuals are not infrequent and, therefore, the restriction may cause a difficulty in practice.

<sup>332</sup> See the Resolution of the Federal Arbitrazh Court of the Ural region No.F09-2824/03-GK, dated 2 October 2003, on case No.A71-293/03, discussed also in R.Bevezenko "Novels of Legislation on Pledge of Participation Interests in Limited Liability Companies" in M.Rozhkova (ed.), *Measures of Security and Measures of Liability in Civil Law*, Statute, Moscow, 2010.

<sup>333</sup> In fact, the bank lent 14,000,000 Rubles secured by a pledge of participation interest with *nominal* value of only 4,284 Rubles. The new members contributed to the charter capital of the company so that it increased to 87,429 Rubles and it was sufficient to render the security practically useless.

<sup>334</sup> The pledgee may be entitled contractually to accelerate. If the debt is governed by Russian law and arises under a credit or loan agreement, Article 813 of the Civil Code 1994 may allow acceleration on the basis that the collateral have deteriorated.

According to the Civil Code 1994, the pledged property may either remain with the pledgor or be transferred to the pledgee (Article 338). Furthermore, according to Article 340, a pledge agreement may provide that property derived from the pledged property and the “fruits” of its use are also pledged. According to Article 346, a pledgor may use the pledged property and keep any profits extracted from that property, unless the contrary is provided for by the agreement or follows from the nature of the pledge. In connection with these provisions, the following two questions must be considered: (i) who has the right to receive dividends (for a joint stock company) or distributed profits (for a limited liability company); and (ii) who has the right to vote with pledged shares/participation interests?

With respect to limited liability companies, the answer on votes may be provided in the rules on the general meetings of members: according to Article 32 of the Law on Limited Liability Companies, each member of the company has the right to vote in proportion to its participation interest, unless that law provides to the contrary. There is no provision in the Law on Limited Liability Companies restricting the right of the pledgor to vote, and, hence, a pledgee cannot receive the right to vote under a pledge agreement.

According to Article 8 of the Law on Limited Liability Companies, a member has the “*right to participate in the distribution of profits*”. Arguably, there are no provisions in the Law on Limited Liability Companies prohibiting pledge of such a right. One must take into account the possible application of case 6202/97, discussed in *Bank accounts*,<sup>335</sup> to pledges of rights to receive profits, since such rights in fact may result in pledges over bank deposits.

The Federal Law No.208-FZ “On Joint Stock Companies”, dated 26 December 1995, differs: shareholders are entitled to vote at general meetings “*with the exception of cases, provided for by federal laws*” (Article 49). Thus, the Civil Code 1994 (being a federal law) may provide for exceptions to the general rule that shareholders vote at a general meeting (and indeed, pursuant to the rules of the Civil Code 1994, the parties may agree on who “*uses*” the shares, *i.e.*, votes them). The issue was further clarified by the then securities regulator *via* secondary legislation, the Resolution of the Federal Commission on the Securities Markets No.13/ps, dated 22 April 2002.<sup>336</sup> According to the resolution, a “pledge order” (a document delivered to the share registrar in order to create the pledge) may stipulate that the pledgor is entitled to receive profits on all or some of pledged securities. Furthermore, in its

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<sup>335</sup> P.84 above.

<sup>336</sup> “On the Peculiarities of Recording in the System of Maintenance of the Register of Pledge of Registered Issuance Securities and the Making of Changes into the System Related to the Transfer of Rights on Pledged Registered Issuance Securities”.



Resolution No.27, dated 2 October 1997,<sup>337</sup> the Commission stated that a “*list of persons entitled to participate in a general meeting*” may include “*other persons as provided for by law*”. This may be interpreted to mean that a pledgee may be such an “*other person*”, if, in accordance with the pledge agreement, he was granted the right to vote the shares.<sup>338</sup>

Shares are often issued in dematerialized form in Russia and there is some evidence that such securities are not treated as chattels under Russian law.<sup>339</sup> Thus, pledges related to dematerialized shares should be structured as pledges of rights comprised in dematerialized securities, rather than pledges of the securities themselves.

Generally, discussion of the nature of dematerialized securities involves complex issues and is beyond the scope of this work. Nevertheless, it must be noted that there are specific rules in the Civil Code 1994 on dematerialized securities. According to Article 149, transactions with such securities may only be carried out by “*addressing*” the person who officially records rights to such securities. In this light, the Presidium of the Supreme Arbitrazh Court of the Russian Federation stated that the right of pledge to dematerialized securities arises not from the moment when the pledge agreement is entered into (common position under Article 340 of the Civil Code 1994 for non-possessory pledges), but from the moment when the pledge was registered; the Presidium also stated that though the pledge must be registered with the securities registrar, such registration is not considered to be state registration and the agreement itself needs not be registered to be effective.<sup>340</sup>

To summarize the discussion in this sub-section: pledges of both participation interests and shares are possible; a pledgee cannot vote on pledged participation interests; voting on pledged shares by the pledgee is possible; arguably, the right to profits on participation interests can be pledged with the interests themselves; and the right to dividends may be pledged with the shares. The provisions of Russian law on pledges of participation interests and shares are not entirely satisfactory and more detailed regulation at the level of law would be welcome (though there were significant improvements in the regime for participation interests recently).

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<sup>337</sup> “On Approval of the Resolution on the Maintenance of the Register of Owners of Registered Securities”.

<sup>338</sup> See M.Gel'tzman, “Pledge One, Pledge Two”, *Ezh-Jurist*, No.26, 2006. M.Gel'tzman's article was written in response to N.Shornikova, who in “Legal Problems of Pledge of Shares”, *Ezh-Jurist*, No.16, 2006, expressed a contrary opinion as to the possibility to transfer the right to vote pledged shares to the pledgee.

<sup>339</sup> In particular, Article 1079 of the Civil Code 1994 provides for “*fiduciary management*” of *rights* arising under immobilized securities, rather than “*fiduciary management*” of such securities *per se*. See S.Pridanov, “Pledge as Form of Securing Obligations of the Borrower Arising out of Contract of Bank Credit”, *Legal Work in Credit Organization*, No.4, 2005.

<sup>340</sup> See the Informational Letter of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.67 “Review of Practice of Resolving of Disputes Connected to the Application of Norms on Pledge and Other Security Transactions with Securities”, dated 21 January 2002.

## Enforcement

This sub-section deals with the question of what happens if a pledgor defaults and the pledgee purports to carry out an enforcement action against the pledged property. To refer to such process, Russian law uses a generic term “*obraschenie vzyskaniya*”, which includes enforcement against pledged assets in various forms, including those where the asset is sold at a public auction or simply kept by the pledgee. In English translations the term “foreclosure” is occasionally used to refer to *obraschenie vzyskaniya*; however, such use is misleading since the Russian term encompasses both foreclosure and power of sale.<sup>341</sup> In this work the term “enforcement” is used to refer to the actions and proceedings taken in order to claim against the pledged property.

Taken at its simplest, a pledgee may wish to claim against the pledged property in two sets of circumstances: the pledgor defaults on payments, but remains solvent; the pledgor defaults and is also insolvent. In the latter case, any enforcement action against the pledged property will be subject to the rules of Russian insolvency law. Russian insolvency is discussed in Chapter 3 *Insolvency Law* below,<sup>342</sup> and this sub-section is concerned with enforcement against a solvent debtor.<sup>343</sup>

Article 348 of the Civil Code 1994 sets out the conditions when a pledgee is entitled to enforce. Even before reviewing the law, it is crucial to note that the respective provisions are imperative, *i.e.*, mandatory, and cannot be contracted out. The consequence for a lender in a cross-border transaction is obvious: though the loan agreement may be governed by foreign law and provide for certain (contractual, as opposed to statutory or case-law based) events of default under that law, enforcement could not be carried out against assets pledged under Russian law unless the requirements of Article 348 are met. Ostensibly, the purpose of the rigid regime of Article 348 is to protect the interests of a debtor from precarious pledgee behavior and shelter the debtor from the overwhelming negotiating power of the lender. However, the protections provided in Article 348 become “ball and

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<sup>341</sup> In fact, until recent amendments to Russian law, the only available enforcement mechanism was power of sale. See *Enforcement* on p.106 below.

<sup>342</sup> For current regime, see *Law on Insolvency 2002* on p.160 below and, more specifically, (vii) *Priorities and Security* therein on p.186 below.

<sup>343</sup> As a rule, lenders are reluctant to take drastic action against a defaulting borrower. There are a few reasons to avoid enforcement. For example, lenders may be forced to act as auctioneers for, or, worse, “run”, the business of the borrower. Furthermore, an operating business is often worth more than just a collection of assets (which is what remains if the borrower is “brought down”). Finally, if one lender takes action, a precipitous rush to the court door by the other lenders may ensue. This will almost inevitably result in the borrower becoming insolvent. In practice, a scenario when the borrower does not have sufficient funds to repay the loan and invites the lenders to enforce against the pledged assets is not very common, but possible. See, *e.g.*, the Resolutions of the Federal Arbitrazh Court of North-Caucasian region Nos. F08-507/99, dated 7 April 1999, and F08-2003/99, dated 29 October 1999, on case A-53/10964/98-C2-10, discussed in footnote 243 on p.74 above.

chains” for healthy finance practice if both parties are sophisticated business entities. Perhaps, the legislators should start taking into account that there is a distinction between high street and institutional lending and that rules fit for one segment of the banking market do not work well in the other(s).

The pledgee may enforce if the debtor fails to perform or improperly performs the secured obligation under circumstances for which the debtor is “*liable*”. The meaning of the word “*liable*” in this context is not entirely clear. Arguably, the provisions of Article 401 of the Civil Code 1994 should be applied here. Article 401 relates to “*liability for breach of obligation*” and sets forth the rule that a person failing to perform an obligation or performing an obligation improperly is liable unless that person proves that proper performance was impossible due to force-majeure (defined to mean extraordinary and unavoidable circumstances under the given conditions).<sup>344</sup> The relevance of this provision is in that it imposes a statutory test for force-majeure which cannot be contracted out. Unfortunately, in the cross-border context this also injects Russian law on force-majeure in any enforcement action against property pledged under Russian law.

Only prescribed “types” of default entitle the pledgee to take enforcement action. First, the timeframe given by the Civil Code 1994 for the performance of a secured obligation is measured in days: enforcement action can be taken if the obligation is not performed on the *day* when it has to be performed. The law or agreement may provide for the right to enforce to arise later; however, only law can stipulate that enforcement action may be taken earlier.

Further restrictions on enforcement relate to the “*severity*” of the debtor’s default. Enforcement is barred if: (i) a default is “*very insignificant*”; and (ii) the “*amount of pledgee’s demands is evidently disproportionate to the value of the pledged property*”. Both (i) and (ii) are presumed (unless proven otherwise) if: (a) the “*sum of the unperformed obligation*” is less than five *percent* of the value assigned to the pledged property; and (b) default in performance is less than three months. The preceding provisions cannot be contracted out, too.

There is one rule on enforcement actions where the legislator did allow the parties to contract out: it relates to secured agreements for periodic payments. The default rule is that “*enforcement action is allowed*” in the case of a “*systematic delay*” in periodic payments. Systematic delay means more than three late payments within a period of twelve months, even if each delay is insignificant.

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<sup>344</sup> Rules of the Civil Code 1994 are more lenient for obligors acting in a non-business context.

The majority of the provisions related to enforcement actions are relatively new in Russian law (introduced in December 2008);<sup>345</sup> and many details remain untested in courts. For example, it is unclear whether four delays in periodic payments entitle the pledgee to enforce notwithstanding the requirements in (i) and (ii) above; or four delays in periodic payments become an additional condition to (i) and (ii) above. The issue may turn out to be important in the scenario where the parties disapply the four delays rule: does then the pledgor receive the protections in (i) and (ii)? If the logic of the legislator was indeed to protect a pledgor from precarious pledgees, it seems that (i) and (ii) should still apply.

There are two types of enforcement proceedings for pledged property: pursuant to a court order; and out-of-court proceedings (items 1 and 2 of Article 349). The parties may agree<sup>346</sup> on out-of-court enforcement proceedings, unless this is prohibited by law.<sup>347</sup> The Civil Code 1994 prohibits out-of-court enforcement in the following cases: in the case of pledgor-individual, if the consent of third person or body (e.g., a governing body of a company) was necessary for the pledge agreement; the pledged property has significant historic, artistic or cultural value for the society; the pledgor cannot be located; when the pledged property is premises owned by individuals; or the pledge (or other) agreement does not provide for an “order”<sup>348</sup> for enforcement against movable property. In addition, for individuals their notarized consent for out-of-court enforcement must be obtained.

The Civil Code 1994 currently provides that if a pledgor does not comply with the agreement on out-of-court enforcement, the pledgee can enforce against the pledged property pursuant to an “*executive inscription*” of a notary.

The rules on executive inscriptions are included into Chapter XVI of the Foundations of Legislation of the Russian Federation on Notaries, No.4462-I, dated 11 February 1993. An executive inscription is an inscription made by the notary on the respective pledge document to the effect that enforcement action against the pledged property must be carried out; and the law prescribes the contents of such an inscription. Before an executive

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<sup>345</sup> The Federal Law No.306-FZ, “On Introducing Amendments into Some Legislative Acts of the Russian Federation in Connection with the Improvement of the Order of Enforcement against Pledged Property”, dated 30 December 2008.

The earlier version of Article 348 simply referred to “*insignificance*” and “*disproportionality*” without explaining the meaning of these terms by way of the presumption in (a) and (b). The provision on the delay in periodic payments is also new.

<sup>346</sup> For an individual, its consent to out-of-court enforcement must be notarized.

<sup>347</sup> The earlier version of Article 349 allowed out-of-court enforcement for immovables only if the parties agree on it *after* the pledgee became entitled to enforce.

<sup>348</sup> The meaning of the use of the word “order” here is not entirely clear. It appears that with respect to moveable property it is not sufficient to provide in the pledge agreement that enforcement shall be carried out-of-court and the parties have to specifically set out the order of enforcement actions.

inscription is made, the notary must be provided with certain documents and then send a notification to the pledgor. Importantly, the notary must be satisfied that enforcement action is “*indisputable*”; if enforcement is not “*indisputable*”, then the pledgee finds itself back in courts. The meaning of “*indisputable*” is not developed further in the law, which is very unfortunate. It seems that a prudent notary should refuse to make an executive inscription if the pledgor advances any one argument against enforcement. It must be remembered here that the starting point for “enforcement” in the Civil Code 1994 is that the pledgor may comply with the pledge agreement voluntarily. The fact that the pledgee has to resort to a notary for an executive inscription in all likelihood simply means that the pledgor failed to comply with the agreement; in these circumstances it is somewhat naïve to assume that the pledgor would not advance any arguments against the inscription being made. Thus, the out-of-court enforcement can only be reasonably used where the pledgor is cooperative with the pledgee.<sup>349</sup>

The rules on out-of-court enforcement for immovable property are set by the Law on Mortgage (Article 55). The Law on Mortgage also provides that out-of-court enforcement must be agreed upon by the parties and requires the notarized consent of the mortgagor in all cases (and not only where the mortgagor is an individual). The Law on Mortgage has its own list of exceptions to the availability of out-of-court enforcement; such a list is generally similar to the list of exceptions provided in the Civil Code 1994. For commercial purposes, the most important exception in the list of the Law on Mortgage relates to certain type of land plots and mortgages of whole enterprises.<sup>350</sup>

The Law on Mortgage differs from the Civil Code 1994 in that it prohibits out-of-court enforcement in cases where that would be, to use the language of the Civil Code 1994, “*disproportionate*”. The following test is adopted by the Law on Mortgage: (i) the “*sum of the unperformed obligation*” is less than five *percent* of the value assigned to the mortgaged property; and (ii) default in performance is less than three months. Both (i) and (ii) are, essentially, the “*insignificance*” and “*disproportionality*” test used in the Civil Code 1994. However, the rules of the Civil Code 1994 only create a presumption and allow the pledgee

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<sup>349</sup> In this context, the use of the word “enforcement” is somewhat misleading, since the pledgor would simply carry out its contractual obligations.

<sup>350</sup> Under the Law on Mortgage, out-of-court enforcement is not available, if: in the case of mortgagor-individual, the consent of a third person or body (e.g., a governing body of a company) was necessary for the mortgage agreement; the mortgage is granted over an enterprise; the mortgaged land plot is designated for agricultural use; if other types of land plot are mortgaged in cases as prescribed by law (essentially, certain state and municipal plots used for construction); the mortgaged property has significant historic, artistic or cultural value for the society; the mortgaged property is in joint ownership and some owners did not give their consent for out-of-court enforcement; the mortgaged property is a dwelling owned by individuals; and the mortgaged property is owned by the state of municipality.

to prove otherwise; the Law on Mortgage creates an outright prohibition. This is not to say that a mortgage may be automatically enforced *via* a court order if default by the debtor is “insignificant” and enforcement would be “disproportionate”: another rule in the Law on Mortgage creates a presumption in favor of the debtor if tests in (i) and (ii) are met. Furthermore, the Law on Mortgage repeats the “four defaults” rule of the Civil Code 1994 for obligations, which are performed by periodic payments. To lenders’ relief this one rule can be contracted out by the parties.

The Law on Pledge gives two options for a pledgee to receive satisfaction from the pledged (moveable) property: by holding a public sale and claiming against the proceeds or by claiming the pledged property *per se* (Article 28.1). The second option is only available for pledge agreements entered into among individual entrepreneurs and juridical persons as security for obligations connected with business activities; claiming against the pledged property directly can be provided for only if out-of-court enforcement proceedings were agreed upon by the parties. In fact, the Law on Pledge allows some flexibility and provides that a pledgee can: (i) a foreclose on the pledged property; or (ii) sell the pledged property to a third person (without holding a public sale) acting as an agent for the pledgor. This provision is important in practice for lenders who do not wish, first, to account for the pledged property on their own balance sheets and then realize such property (which may have various unintended consequences). In any case, any surplus over the value of the secured obligation must be returned to the pledgor.

The rules of the Law on Pledge with respect to the sale of the pledged property to a third person by the pledgee may also be helpful in the light of the limited capacity of a bank lender. For example, in the context of a cross-border financing transaction, a Russian bank may act as a security agent for the lending syndicate and the lenders may initially prefer that the agent has the right to claim the pledged property. This option, in the eyes of the syndicate, may be a quick and relatively reliable way to protect their financial interests. Once the property is transferred to the agent, the syndicate would have the flexibility to dispose of it when, and as, the syndicate sees fit. However, Russian banking legislation may prevent taking such a course of action. According to the Federal Law No.395-I “On Banks and Banking Activities”, dated 2 December 1990, a credit organization is prohibited from carrying out, *inter alia*, trading activities (Article 5). It is not clear whether a Russian bank, when later purporting to realize the value of an asset by selling it, would thereby engage in a trading

activity. Perhaps, such a bank would need to resort to services of another organization;<sup>351</sup> even a better option to ensure that the restriction is not breached would be to act as the agent of the pledgor in any such sale.

To protect the interests of the pledgor, the Law on Pledge requires that the pledged property, if kept by the pledgee or sold to a third party as agent for the pledgor, is realized at a price equal to its market value. The Law on Pledge also provides that the results of the valuation of the pledged property may be appealed by an interested person (this could be the pledgor or debtor). Thus, the Law on Pledge appears to implicitly require the pledgee to carry out a valuation of the pledged property in the aforementioned cases.<sup>352</sup>

It is interesting to note here how the approach to enforcement actions against pledged property changed over time: the long standing position was that Russian “*law [did] not provide for the possibility of transferring the property being the subject of a pledge into the ownership of the pledgee*”.<sup>353</sup> However, the position of the courts as to the transfer of pledged property did not prevent both parties *agreeing* to terminate the secured obligation by transferring the pledged property. There were two mechanisms under the Civil Code 1994 to achieve this: a settlement (Russian *otstupnoye*) and novation agreement. Under a settlement agreement the original obligation of a party is terminated *via* the “*settlement*” (*i.e.*, alternative) performance (Article 409). Under a novation agreement, the parties replace the original obligation by a new obligation (Article 414). Of course, under both types of agreement, the parties could only *agree* to “*terminate*” the original debt by transferring the secured assets or “*replace*” the debt with an obligation to transfer such assets; it was still impossible to provide in an agreement that on debtor’s default the creditor could enforce by claiming ownership of the secured assets. As the reader knows, the current regime generally allows the parties to agree on out-of-court enforcement and on the transfer of the pledged assets to the pledgee (instead of sale at a public auction).

There are additional restrictions on the freedom of the parties to a mortgage agreement: whereas the Civil Code 1994 was silent on the “*order*” of enforcement, apparently allowing

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<sup>351</sup> See the discussion in E.Adushkina, “Legality of Unaided Realization by Credit Organization of Pledged Property”, *Juridical Work in Credit Organization*, No.5, 2006.

<sup>352</sup> In addition, the Law on Pledge, Article 28.1 expressly provides for a number of cases when the valuation of the pledged property before realization is mandatory (*e.g.*, the value of assets according to the pledge agreement is more than 500,000 Rubles).

Valuation would generally add time and expense to the process, but, perhaps, the pledge agreement may provide that the pledgor/debtor incurs the cost of any such valuation.

<sup>353</sup> Paragraph 2 of item 46 of the joint Resolution of the Plenary session of the Presidium of the Supreme Court of the Russian Federation and the Plenary session of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.6/8 “On Some Questions, Related to Application of Part I of Civil Code of Russian Federation”, dated 1 July 1996.

the parties to agree on it, the Law on Mortgage sets forth two approaches, one of which must be adopted by the parties. The first approach is public sale in accordance with the procedure set out in Article 56 of the Law on Mortgage; the second approach is for the pledgee (on its own behalf or for third parties) to acquire the mortgaged property thereby setting off the “*purchase price*” against the secured obligations. The purchase price is taken to be a valuation on the basis of a “*free-market*” price as prescribed by the Russian valuation legislation.<sup>354</sup>

Crucially, the Law on Mortgage provides that the subject of a mortgage cannot be acquired by the pledgee if the mortgage is granted over a land plot. Russian land law is based on the assumption that the land plot “follows” (in the legal sense) any immovables built on it.<sup>355</sup> Thus, if a deal structure contemplates that buildings are mortgaged, the underlying land plot must be also subject to the mortgage. Since the Law on Mortgage prohibits the acquiring by a pledgee of a “*subject of mortgage*”, neither the building, nor the land plot can be acquired by the pledgee. The only scenario where the pledgee could claim directly on the mortgaged immovables is where the pledgor does not own the land plot, and only has a lease for it. Then the wording of the Law on Mortgage does not appear to be triggered, since the land plot itself is not acquired by the pledgee.<sup>356</sup> Of course, this significantly narrows down the scope for the use of direct claims over the mortgaged property in business transactions.<sup>357</sup> It is not easy to find an explanation for such an approach of the legislator.

To conclude the discussion of enforcement procedure for pledged property, the following observations may be made. In recent years the respective legislation was significantly improved and liberalized and, should the debtor default, the secured creditors now have a greater chance of speedy recovery. However, law on enforcement still has some considerable restrictions (especially with respect to mortgages), pitfalls and uncertainties. The thrust of the legislative effort, prior to the amendments, was to protect the interests of the debtor/pledgor; and this was achieved to the detriment of the creditor/pledgee’s interests. From a lender’s perspective, under the “old” regime, enforcement of

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<sup>354</sup> Valuation is regulated pursuant to the Federal Law No.135-FZ “On Valuation Activity in the Russian Federation”, dated 29 July 1998.

<sup>355</sup> The Civil Code 1994, Article 340, and the Law on Mortgage, Article 69: a mortgage of a building is allowed only with the concurrent mortgage of the land plot (or lease) where that building is located. The Civil Code 1994, Article 552: under an agreement of sale of a building or another immovable asset, the purchaser concurrently with the transfer of the right of property on such an immovable, must receive the right for the land plot occupied by that immovable and necessary for its use.

<sup>356</sup> This view is also expressed by A.Konevsky in “Pledge as Effective Instrument in Restructuring of Debt”, *Corporate Lawyer*, No.3, 2009. However, the courts may interpret this provision differently.

<sup>357</sup> This is especially so if the mortgagor operating a factory is not located in a large city (e.g., Moscow). Outside large cities it is customary to own land plots on which premises are situated.



pledges/mortgages was protracted and cumbersome. It appears that this has now been recognized by the legislator and the move towards a more creditor/pledgee friendly regime begun. This is a welcome sign and will hopefully result in a more readily available credit for business borrowers.

## 2.C. Assignment

In layman terms, assignment is a mechanism which allows a party to transfer a part of a contract to a third party.<sup>358</sup> Ordinarily, legal systems provide that only rights can be transferred, as opposed to obligations, since there is a presumption that the identity of the debtor matters to the creditor. Indeed, the creditor has agreed to take the risk of non-performance by the debtor and not of some other person that the creditor may not even have heard about. Assignments *per se* are not security – indeed, how can they be security when a party simply relinquishes its right to another person? However, in practice assignments are used to support obligations. In project finance deals, for example, a very common feature is the assignment of the off-take contracts from the project company. Off-take contracts generate cash and it is clearly beneficial to the lenders to have (some) control over that (and often the only available) source of cash. In a basic scenario, once the loans are repaid, the lenders assign the off-take contracts back to the project company. The operation of such a security assignment is similar to that of repo transaction, with the difference being that instead of back-to-back sale and purchase agreements, there are assignment agreements from, and to, the debtor. In practice the use of assignments is not without its difficulties, as in the majority of contracts both parties carry rights *and* obligations and rights sometimes are predicated on certain obligations. However, this discussion is, generally, outside the scope of this work.

As mentioned in *Security, Insolvency and Conflict of Laws* above,<sup>359</sup> in a cross-border deal, the lenders try to minimize the application of Russian law. However, with respect to assignments the “disapplication” of Russian law may not always be possible. Returning to a project finance deal, a common situation would be where the project company’s (debtor’s)

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<sup>358</sup> English statutory requirements to legal assignments are in section 136(1) of the Law of Property Act 1925:

*“Any absolute assignment by writing under the hand of the assignor (not purporting to be by way of charge only) of any debt or other legal thing in action, of which express notice in writing has been given to the debtor, trustee or other person from whom the assignor would have been entitled to claim such debt or thing in action, is effectual in law...”*

On an assignment being absolute and not conditional, see, *e.g.*, *Re Williams, Williams v Ball* [1917] 1 Ch 1 and on partial assignments (sufficient to pay a sum certain) see *Jones v Humphreys* [1902] 1 KB 10. Thus, under English law partial assignments take the form of an equitable assignment only with the consequences that the assignee cannot sue in its own name and that they are subject to equities. Not giving a notice of assignment may cause difficulties under the priorities rule in *Dearle v Hall* (1823) 3 Russ 1.

<sup>359</sup> P.68.

off-take contracts are entered into with Russian counter-parties, are denominated in Rubles and governed by Russian law. In such circumstances, any dispute is likely to end up in Russian courts (which will apply Russian conflict of laws rules). In theory, it is possible for the parties to apply foreign law to the assignment agreement (as between the “old” and “new” creditors). However, according to Russian conflict of laws rules on assignments, the law of the assigned right determines whether that right can be assigned. The same law determines whether the assigned right was properly discharged (Article 1216 of the Civil Code 1994).

The rules on assignments are included into the Civil Code 1994, Articles 388-90.<sup>360</sup> According to the statutory provisions, an assignment is allowed if it does not “*contradict*” to law, other normative acts or the parties’ agreement.<sup>361</sup> If the creditor’s identity is of “*significant importance*” to the debtor, the assignment is also prohibited.

The law of assignments played a relatively important part in the history modern Russia. After the collapse of the Soviet Union, transition to a free market was declared; however, the economic (and legal) mechanisms necessary for such a transition were absent. Many companies during the transitional years were unable to make cash payments for goods and services. The inability to make cash payments perpetuated itself: if a customer could not pay a producer, that producer also could not pay its suppliers. One solution to this problem was to use complex schemes of multilateral “*netting*” of obligations, which involved assignments.<sup>362</sup> In addition, assignments were a useful tool for a cash-stripped company to receive immediate access to funds if it assigned its receivables to a specialized debt collector (the collector operating on the borderline between legal and illegal economy). It is in this setting that the courts had to adjudicate on the legality of assignments.

The starting point for Russian “*case law*” on assignments is the infamous decisions of the Presidium of the Supreme Arbitrazh Court related to “*continuing relationships*”. One of these decisions is the Resolution of the Presidium of the Supreme Arbitrazh Court No.1617/96, dated 10 September 1996. In that Resolution, the Presidium pointed out that:

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<sup>360</sup> Article 388-90 deal with general rules on assignments, there are other provision that deal with specific aspects, *e.g.*, for securities – Article 146, pledges – Article 355 and Chapter 43 – “Financing on Assignment of a Monetary Demand”.

<sup>361</sup> Thus, it appears that an assignment can be effectively prohibited under Russian law by a parties’ agreement. On English law of assignments, see, *e.g.*, *Don King Productions Inc v Warren and others* [1999] 2 All ER 218 and *Barbados Trust Co v Bank of Zambia* [2007] EWCA Civ 148 (prohibition of assignment may also prohibit a declaration of trust).

<sup>362</sup> Another frequent mechanism was so-called “*barter*”, which, generally, involved an exchange of goods for goods. The basic legal mechanism to achieve this was a “contract of exchange” (Article 567-71 of the Civil Code 1994). See, for example, A.Erdelevskii, “Exchange and Barter”, prepared for, and available in, *ConsultantPlus*, 2001.

*“Rules on assignments cannot be applied to the contract [in question], also because the obligation, the non-performance of which was the basis for the conclusion [of that contract], is of continuing nature.”*

The Resolution No.1617/96 also pointed out to other issues with the assignment. In particular, the assignor, according to the terms of the assignment agreement, received from the assignee a certain proportion of any sums the assignee would collect from the debtor. The Presidium concluded that:

*“Therefore, the [assignor] does not withdraw from the obligation. [It] remains the holder of the right, but only changes the actual source of receiving the debt.”*

This latter analysis of the court appears to be significantly flawed, since there is nothing in the judgment to suggest that the assignor did not withdraw from the obligation as a matter of law. Perhaps, the court simply decided to “second-guess” certain commercial relationships behind the agreements. The Resolution No.1617/96 involved the provision of services by a water company, but similar decisions were reached in the case of other utilities, the most common example being electricity supply.<sup>363</sup>

In the line of the “*continuing relationships*” cases,<sup>364</sup> the Presidium also pointed out that Chapter 24 of the Civil Code 1994, which contains rules on assignments, is headed “*Change of Parties in Obligation*” and, allegedly, the creditor did not “change” under the purported assignment agreement.

The approach of the Presidium with respect to the argument on the necessary change in the parties to an agreement on assignment manifested itself in another line of cases, related to bank account agreements. Here the Presidium decided that the assignment of certain demands related to bank accounts as opposed to the whole set of rights arising out of a bank account agreement was unlawful.<sup>365</sup>

Another clarification of the Presidium’s position came in the Resolution No.6925/98, related to interbank credits.<sup>366</sup>

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<sup>363</sup> See, e.g., the Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.4735/98, dated 17 November 1998.

<sup>364</sup> On similar cases, see, e.g., A.Sarkisov, “Juridical Sense of the Term “Cession” in Modern Russian Legislation (On Materials of Practice of Supreme Arbitrazh Court RF)”, *Arbitrazh and Civil Proceedings*, No.7, 2004.

<sup>365</sup> See, e.g., the Resolutions of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.1136/96, dated 29 October 1996, and No.584/97, dated 27 May 1997.

<sup>366</sup> The Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.6925/98, dated 30 March 1999, on case No.A40-11008/98-83-136.

*“... the subject of an assignment can be the creditor’s right of demand in an obligation provided that [such creditor] has no obligations before the other party in that[assigned] obligation.”*

The analysis of the Presidium in the preceding cases can be criticized (and indeed was): the assigned obligations related to consideration already provided by the assignor and there was no reason why such assignment of receivables should be viewed as inseparable from any future obligations the creditor may have under the agreement. Perhaps, this criticism was acknowledged by the court and in later cases, its view on assignments reversed.

In the Resolution No.4215/00,<sup>367</sup> the Presidium decided that the disputed assignment could be valid since:

*“... the subject of the [assignment] is not the whole body of the bilateral obligations ... (continuing obligations), but a specific supplier’s demand for payment for the supplied gas for a certain payment period”.*<sup>368</sup>

The Presidium also introduced another test for assignments. It stated that:

*“Assignment of a demand, which has arisen in the framework of continuing contractual obligations, is possible if the assigned demand is indisputable, has arisen before its assignment and it not conditioned on reciprocal consideration.”*<sup>369</sup>

The important issues in the latter test adopted by the Presidium are the mentioning of the demand being “*indisputable*” and “*arisen before assignment*” (to be discussed later in this sub-section).

The use by the Presidium of the reference to “*indisputable*” nature of the obligation is very unfortunate. First, Russian law generally does not operate with the term “*indisputable*” with respect to an obligation.<sup>370</sup> Second, an obligation may have been treated by the creditor as “*indisputable*” at the time when it was assigned, since the creditor was not aware of any circumstances allowing the debtor to raise arguments; however, after the assignment, an obligation still could be challenged by the debtor (irrespective of there being any grounds for the dispute). The literal interpretation of the Presidium’s position would mean that no

<sup>367</sup> The Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.4215/00, dated 9 September 2001, on case No.7074/99-16.

<sup>368</sup> The Presidium expressed a similar opinion in its Resolution No.11079/04, dated 14 December 2004, related to continuing relationships of water supply.

<sup>369</sup> A similar approach was adopted in the Resolution of the Presidium No.8955/00, dated 18 December 2001.

<sup>370</sup> The term “*indisputable*” is used with respect to proceedings pursuant to a notary’s executory inscription (Article 90 of the Foundations of Legislation of the Russian Federation on Notaries, No.4462-I, dated 11 February 1993). The term “*indisputable*” was also used (somewhat inappropriately) with respect to the direct debit rights of certain authorities against a debtor’s bank accounts.

obligation can be assigned, since there is always a chance of a future dispute raised by the debtor. Perhaps, the Presidium had “in mind” some other interpretation of the term “indisputable”, since its resolutions suggest that assignments of certain obligations were possible. Thus, the question is how the term “indisputable” should be interpreted: *e.g.*, according to the subjective knowledge of the creditor at the time of assignment, or according to the objective circumstances existing at that time?

The “indisputable” wording was also criticized in literature. In fact, a revision of Article 388 was suggested so as to expressly provide that the debtor may advance arguments against the assignee arising out of any non-performance by the assignor, notwithstanding the fact that such circumstances may emerge after the assignment.<sup>371</sup> This amendment appears to be both reasonable and practical.<sup>372</sup>

However, in a more recent Informational Letter No.120,<sup>373</sup> the Presidium indicated that the “indisputable” test should no longer be applied:

*“The possibility of assignment of a right (demand) is not dependent on whether it is indisputable and whether its realization is predicated on reciprocal performance by the assignor of its obligations towards the debtor.”*

It appears that the Presidium “swung” in a completely opposite direction from its earlier Resolution No.4215/00 and threw out the prior analysis of assignments under Russian law. The “new” approach has been applied in later cases.<sup>374</sup> According to the Informational Letter No.120, it does not matter if the debtor has arguments against the assignor and even is actively pursuing such arguments. It also appears that the Presidium dispensed with the requirement that the assigned obligation has to have matured in the sense that it must not depend on any future performance by the assignor (this point is less certain). However welcome the “new” approach of the Presidium may be, the “older” long-standing cases should not be discounted altogether. The court may well “swing” back and look more favorably on attacks on assignments again.

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<sup>371</sup> *E.g.*, S.Kultyshev in “Assignment of Demands in Court Practice: Position and Perspectives”, *Jurist*, No.6, 2005.

<sup>372</sup> The current position of the Civil Code 1994 is that the debtor can advance arguments against the assignee which the debtor could raise against the assignor, provided that the debtor “had” such arguments at the moment when the notification of assignment was received (Article 386).

<sup>373</sup> Informational Letter of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.120 “Review of Practice of Application by Arbitrazh Courts of Provisions of Chapter 24 of the Civil Code of Russian Federation”, dated 30 January 2007.

<sup>374</sup> *E.g.*, the Resolution of the Supreme Arbitrazh Court of the Russian Federation No.17762/07, dated 27 February 2008 and Decision of the Arbitrazh Court of Moscow on case No.A40—60380/07-100-444 (though the latter was later annulled on the grounds that the plaintiff revoked its lawsuit).

So far the discussion of assignments did not deal with the fact that the parties may wish to assign only a part of an obligation: for example, if a single payment due from a purchaser under a sale-purchase agreement exceeds in value the obligations of the seller to a third party, which the seller wishes to settle *via* assignment. Is such an assignment allowed under Russian law? It appears that under the reasoning of the No.1617/96 (and even No.4215/00) line of cases such an assignment would fail the court's scrutiny. Here again, the Informational Letter No.120 adopted a more favorable approach. In the case referred to in the Informational Letter, a seller indeed assigned only a part of its rights of payment for the goods sold. The lower instance court took the view that the assignment was invalid, since it did not transfer the whole set of the seller's rights under the sale-purchase agreement. However, the cassation instance court pointed out that Article 384 (which provides that the assignee receives the right as it existed on assignment) is dispositive in nature (*i.e.*, is subject to contract) and its operation can be altered by the parties' agreement (in fact, Article 384 expressly refers to the overriding force of the parties' agreement). Hence, the seller was entitled to assign only a part of its rights.<sup>375</sup>

A crucial issue for a security assignment is whether future rights can be transferred to the assignor.<sup>376</sup> If future rights cannot be assigned, the value of assignment as a security tool will be undermined. The transfer of existing rights to the lenders is a "better than nothing" option; however, taking into account the context when a security assignment may be desired (*i.e.*, the on-going sales by the debtor to its customers) it is the future receivables that interest creditors.<sup>377</sup> According to the Resolution No.4215/00, a demand must "*have arisen before assignment*" and one must conclude that assignment of future rights was not possible.<sup>378</sup>

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<sup>375</sup> Some authors apparently sided with the courts on the non-admissibility of assignment without full change in parties, see, *e.g.*, O.Lomidze "Assignment of Right (Cession)", *Russkaya Justitsiya*, No.5, 1998. It must be noted that the analysis in the earlier literature/cases focused not even on a partial assignment of a right, but on assignment of separate and distinctive rights under an agreement (*e.g.*, rights to a specified payment in a series of payments). Some authors correctly pointed to this confusion of different matters, see, *e.g.*, comments in V.Anohin and M.Kerimova "Assignment of Rights on the Basis of Contract", *Khozyaistvo i Pravo*, No.4, 2002.

<sup>376</sup> English law recognizes assignments of future rights: *Tailby v The Official Receiver* (1888) 13 App Cas 523, as confirmed in *National Westminster Bank plc v Spectrum Plus Limited & Others* [2005] UKHL 41 ("*an assignment of future book debts would be effective to vest in the assignee an equitable interest in the future debts at the moment they became owing to the assignor*").

<sup>377</sup> Receivables already due may be valuable if there is a long time lag between the time when such receivables became due and when they are actually paid by the customers. However, if the receivables are due but not payable (the most common situation, as when the purchaser has to pay for delivered goods within a certain period of time), they also have a future-looking element.

<sup>378</sup> A similar view was expressed by O.Sadikov (*ed.* V.Yakovlev) in "Conditions for Assignment of Right of Demand", *Commentary to Court-Arbitrazh Practice*, *Juridical Literature*, Issue 9, 2002.

The Civil Code 1994 includes rules on “*factoring*”, *i.e.*, financing provided in return for an assignment of rights to payments (Chapter 43). In Chapter 43, an “*existing demand*” is defined as one where a monetary claim became due and payable (Article 826); a “*future demand*” is defined as a right to receive monetary funds that will arise in the future. The Civil Code 1994 provides that in an assignment of a future demand, it is deemed transferred to the assignee after it arises. The drafting of the respective provisions does not allow to determine whether a “*future demand*” is a right which has not matured yet (but exists in principle) or whether it is a right that does not exist at all. Thus, rules on factoring seem to suggest that assignment of a demand with some future-related element is possible in theory. However, it is not clear whether a “demand” (used by rules on factoring) equals a “right” (used by rules on assignments); and it is even not clear what Article 826 refers to by using “*future demands*”.<sup>379</sup> Thus, it is uncertain whether rules on “factoring” of future demands also apply to assignment of future rights.

Some commentators adopted a “straightforward” interpretation of Article 384: rights were transferred as they existed at the time of assignment. Therefore, an assignment of future rights was not possible (future rights obviously did not exist at the time of assignment).<sup>380</sup>

However, the Informational Letter No.120 appears to have offered a solution to the assignment of future rights, too:

*“An agreement on assignment the subject of which is a right (demand) not having arisen by the time of the conclusion of that agreement does not contradict to law.”*

The facts of the case discussed in the Letter involve a seller who assigned the rights to receive payment for goods it was going to sell in the future. The lower instance courts relied on Civil Code 1994, Article 382 (which provided that a creditor may assign rights *owned*). Apparently, the courts interpreted this to mean that at the time of assignment, the assignor must *own* the right and it was clearly not the case with a future right. However, the appellate court pointed out that certain provisions of Civil Code 1994 expressly provided for “*dealings*” in future rights (*e.g.*, pledge of future rights and sale-purchase of goods which will be acquired by the seller in the future). The appellate court also stated that provisions of the Civil Code 1994 on sale-purchase generally apply to sale-purchase of rights (Article 454) and that the assignment agreement provided that the right will be transferred *only at the time* it was owned by the assignor. As a result, the appellate court concluded that the assignment in

<sup>379</sup> For a discussion, see V.Vasnev “Assignment of Rights from Obligations, which will Arise in Future”, *Vestnik VAS RF*, No.10, 2006.

<sup>380</sup> M.Braginskii and V.Vitryanskii, *Contract Law, Common Provisions (book one)*, 3<sup>rd</sup> ed., Statut, 2001.

question was essentially a sale-purchase of a future right and that the provisions of Article 382 were not breached. The validity of the assignment was upheld.

In court practice, an attack on an assignment agreement often commenced on the grounds that it was made without consideration. Under Russian law, gifts between commercial organizations are prohibited,<sup>381</sup> and, thus, an assignment in this scenario without apparent consideration could be viewed as a prohibited transaction – a gift. An assignment agreement may not provide for any consideration moving from the assignee, but such consideration is often found in other relationships of the parties. In fact, if an assignment was used as security, there should not be any specific consideration in the assignment agreement itself. The courts appear to have recognized this. For example, the Presidium of the Supreme Arbitrazh Court in its Resolution No.13952/05<sup>382</sup> pointed out that an agreement was presumed to be non-gratuitous, unless the contrary followed from law, contents or the subject matter (Article 423 of the Civil Code); and that there was no rule of law that provided that an assignment is gratuitous. The Presidium also concluded that the subject-matter of the disputed assignment did not allow to consider it gratuitous.

The Presidium returned to the arguments on gratuitous nature of an assignment in Informational Letter No.120. The Letter stated that an assignment agreement, entered into between commercial entities, may be characterized as a gift only if the intention to transfer the right gratuitously was proved. In the case discussed in the Informational Letter, an assignment agreement did not provide for any consideration. The Presidium stated that the absence of the price *per se* in the assignment agreement did not prove that the assignment agreement was gratuitous: the essence of the respective assignment agreement was to transfer the right as settlement for the assignor's obligation to the assignee to repay a loan. Hence, the assignment was not gratuitous.

Let us now turn to another issue that may arise in a bank-borrower relationship: can a bank assign rights arising out of credit agreement to a non-bank entity? According to the Civil Code 1994, only banks can enter into credit agreements.<sup>383</sup> The context is somewhat outside

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<sup>381</sup> Article 575 of the Civil Code 1994.

<sup>382</sup> The Resolution of the Supreme Arbitrazh Court of the Russian Federation No.13952/05, dated 25 April 2006.

<sup>383</sup> Non-banking companies may only enter into loan agreements: Articles 807 and 819 of the Civil Code 1994. The main difference between a loan and credit agreement is that a loan agreement cannot provide for an obligation to lend and it only comes into existence once funds are disbursed; on the contrary, under a credit agreement a bank may accept an obligation to lend in the future.



the scope of a security assignment;<sup>384</sup> nevertheless, it is interesting to note the court's approach. Initially, there were different views expressed on the subject-matter: some authors argued that assignment of rights under a credit agreement is closely connected with a regulated activity and therefore should not be allowed.<sup>385</sup> The courts adopted a different view. According to the analysis of the Federal Arbitrazh Court of the Moscow region,<sup>386</sup> assignment of rights to demand payments under a credit agreement is an assignment of rights arising out of a an obligation to pay money and not to lend. It is the latter activity that requires a bank license, and, therefore, it is not unlawful for a bank to assign its rights arising out of a credit agreement to a non-banking organization. A similar analysis was also applied by regional courts in later cases<sup>387</sup> and set out by the Presidium in the mentioned Informational Letter No.120.<sup>388</sup>

To conclude the discussion of law of assignments in Russia, the following observations may be made. Assignments were treated very unfavorably by the courts initially. The restrictions were so severe that any commercial use of assignment was limited to the cases where only a "naked" right of the assignor to demand payment existed and such right was assigned as a whole. Thankfully, the courts began to soften their view. Arguably, the current position is that it is possible to assign rights in part only, rights, which will arise in the future, and rights in connection with which a dispute may be brought by the debtor.

Provided that future rights may be validly assigned, the parties to a loan agreement may arrange for an assignment of borrower's rights under, say, a sales contract to the lender. Once obligations under a loan agreement are performed, the rights should be assigned back to the borrower. This step may turn out to be a stumbling block for security assignments: in essence, the parties will be effecting two back-to-back sales and purchases of rights.<sup>389</sup> Such

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<sup>384</sup> This is less important as a question of security assignment; however, the ability to assign loans is a significant issue in loan sales. In the cross-border context, however, a loan agreement is not likely to be governed by Russian law, and, therefore, Russian rules on assignments will not be applicable.

<sup>385</sup> For a discussion, see L.Novoselova, "Limitations on Transfer of Creditor's Rights to Other Persons", prepared for, and available in, *ConsultantPlus*, 2002.

<sup>386</sup> The Resolution of the Federal Arbitrazh Court of the Moscow region No.KG-A40/10293-05, dated 27 October 2005.

<sup>387</sup> See, e.g., the Resolution of the Federal Arbitrazh Court of the Ural region No.F09-5986/09-C1, dated 20 August 2009.

<sup>388</sup> A somewhat less intuitive, but also interesting question is whether a borrower can assign its right to disbursement under a credit agreement. There is some discussion in Russian literature – see, e.g., P.Malakhov, "Assignment of a Right of Demand on a Credit Agreement", *Ezh-Jurist*, No.39, 2005 – however, it is not conclusive. Obviously, a bank would argue that the identity of the borrower is of "significant importance", and thus, under the rules of Article 388 of the Civil Code 1994, such an assignment is unlawful. Perhaps, a well-advised bank should not simply rely on Article 388 (which provides that an assignment is allowed, unless it contradicts an agreement) and expressly prohibit assignment without its consent.

<sup>389</sup> Especially, given the view of the Presidium expressed in Informational Letter No.120 on assignment of future right as sale-purchase of future right.

a transaction is similar to a repo transaction, albeit its subject is chose in action, rather than tangible property. As discussed earlier, Russian courts generally disapprove of repo transactions;<sup>390</sup> and though the law was recently changed, the amendments allowing repos relate specifically to transactions in the securities market. Unless the courts widen the “new” approach to repo transactions beyond the scope of the securities market, a repo by assignment of rights may be successfully challenged. The solution, should the parties need to create *quasi*-security by way of assignment may be to structure the sales contracts in such a way that the second assignment is not necessary. This can be achieved, for example, by matching the tenor of the assigned contracts and that of the loan. In any case, quasi-security created in this way will be very fragile and open to challenges.

## 2.D. Other security

The Civil Code 1994, Chapter 23 “*Security for Performance of Obligations*”, expressly recognizes the following forms of security: penalty, pledge, lien, suretyship, bank guarantee and deposit. Pledge was considered earlier and this section is concerned with the remaining forms of security under Russian law.

The Civil Code 1994 refers to each of the elements in the preceding list as “*security*” (Article 329). This may seem alien to lawyers trained in common law. Indeed, how can penalty be “*security*”? Its function and mode of operation are more related to (quantum of) liability, rather than any kind of “*security*”.<sup>391</sup> Thus, the theoretical approach to the conceptualization of security in Russian law is different from that of common law: Russian security is largely within the realm of the law of obligations, rather than being a “*security interest*” or right *in rem*.

Although the Civil Code 1994 allows the parties to agree on “*custom*” forms of security (*i.e.*, those not expressly referred to in the Code),<sup>392</sup> any such “*custom*” security would not receive preferential treatment under the rules of Russian insolvency law. Generally, it is difficult, if not impossible, to imagine a “*custom*” Russian form of security that could defeat rights of third parties. Furthermore, Russian courts are likely to treat with suspicion any “*custom*” security and careful approach must be taken.<sup>393</sup>

<sup>390</sup> See *Repo transactions* on p.97 above.

<sup>391</sup> In the sub-sections below the nature of each form of Russian security (security *per se*, quasi-security or otherwise) is analyzed.

<sup>392</sup> A prominent Russian jurist, V.Vitryanzkii refers to only one custom form of security: deposit paid to a third party. See footnote 215 on p.66 above.

<sup>393</sup> As evidenced by the treatment of repo transactions – see *Repo transactions* on p.97 above.

In the cross-border financing context, the use of any form of Russian security, except for pledge and, to a lesser degree, assignment,<sup>394</sup> is limited. Penalty, suretyship, bank guarantee and deposit only create contractual obligations and do not confer any proper security interest. Russian conflict of laws rules generally do not require that such contractual matters are subject to Russian law. Thus, well advised lenders would opt to govern such contractual relationships by foreign law.<sup>395</sup> The forms of security to be reviewed below are less important than the already reviewed pledge and assignment; thus the following analysis is somewhat less detailed.

The most important of the remaining forms of security are, perhaps, bank guarantee and suretyship. Therefore, contrary to the order of security in Chapter 23 in the Civil Code 1994, the review below starts with bank guarantee and suretyship.

**(i) Bank Guarantee**

Under a bank guarantee, a bank, or a credit or insurance organization undertakes to make an on-demand payment to the beneficiary (Article 368 of the Civil Code 1994). A bank guarantee may only be issued by an entity with a respective license.<sup>396</sup> The definition of a bank guarantee is somewhat misleading in the sense that it does not appear to establish a connection with the secured obligation. Such a link, however, manifests itself, first, in the requirement that a guarantee stipulates which obligation it secures, and, second, in the requirement to the beneficiary making a claim pursuant to a guarantee to state to the guarantor how the respective obligation was breached. It is also interesting to note that the Civil Code 1994 requires that a bank guarantee refers to documents that the beneficiary must provide to the guarantor when making a claim (Article 374).

At the time when Part I of the Civil Code 1994 was adopted, bank guarantee was a novel instrument.<sup>397</sup> Soviet law and pre-Civil Code 1994 Russian law did not contemplate any *quasi* security that was independent of the main obligation. The Civil Code 1922 provided only for suretyship and did not use the term “guarantee” at all.<sup>398</sup> The Civil Code 1964 referred to

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<sup>394</sup> Assignment is technically not a form of security under Russian law. However, it may be used to a similar objective, see *Assignment* on p.113 above.

<sup>395</sup> See *Security, Insolvency and Conflict of Laws* on p.68 above.

<sup>396</sup> O.Sadikov (ed.), *Commentaries to Civil Code of Russian Federation, Part I*, 3<sup>rd</sup> ed., Infra-M, Russia, 2005, p.863, a view was expressed to the effect that non-banks may also issue “guarantees”. The supporting argument is that the Civil Code 1994 leaves the door open for the parties to provide for other forms of security (besides those expressly mentioned in the Code). However, this argument must be approached with utmost caution. Russian courts are not likely to look favorably at a “new” form of security, which apparently purports to avoid the restriction on entities capable of issuing guarantees.

<sup>397</sup> For some history of suretyships and guarantees, see I.Eremycheva and S.Ermakov, “Bank Guarantee as Form of Security for Performance of Obligations: Evolution and Perspectives”, *Law and Economy*, No.10, 2003.

<sup>398</sup> See p.28 above.

both suretyship and guarantee; however, guarantee, similarly to suretyship, was also a secondary obligation.<sup>399</sup> On the contrary, under the Civil Code 1994:

*“[t]he obligation of a guarantor in favor of the beneficiary under a bank guarantee for a bank guarantee under the rules of the Civil Code 1994 does not depend in relationships on the main obligation between them, which is secured by the issuance of that guarantee...”* (Article 370).

The Presidium of the Supreme Arbitrazh Court of the Russian Federation considered bank guarantees in some detail in its Informational Letter No.27.<sup>400</sup>

In particular, in item 5 of the Letter, the Presidium confirmed the independence of a bank guarantee from the (main) secured obligation in the context where the main debtor was late in making payments on a bank loan, but stated to the guarantee’s beneficiary that it, generally, had financial means and would pay shortly. The guarantee, however, did not require the beneficiary to provide to the guarantor any documents evidencing its prior demands on the main debtor. In the circumstances, the Presidium stated that the guarantor was obliged to make the payment to the beneficiary.

The independence of a bank guarantee from the main obligation must be considered further. According to Article 376, a guarantor, which finds out that the main obligation was duly performed, terminated or became invalid, must inform the guarantee’s beneficiary; however, a guarantor remains liable under the guarantee if it receives a subsequent demand of the beneficiary to make the payment. On the face of it, this rule turns a bank guarantee into a separate promise by the guarantor to the beneficiary; however, a guarantee under the general provisions of the Civil Code 1994, is a form of security for the performance of an obligation. Thus, there is an apparent contradiction in Russian rules on guarantees.<sup>401</sup> Russian commentators engaged in extensive discussions on whether a guarantor is still required to make payments if it is a given fact that the main obligation was discharged or is invalid, that is to say, whether a guarantee is truly independent of the main obligation (and some, in spite of Article 376 come to the conclusion that a guarantee is secondary in

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<sup>399</sup> See p.33 above.

<sup>400</sup> The Informational Letter of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.27 “Review of Practice of Adjudicating of Disputes, Connected to the Application of Rules of Civil Code of the Russian Federation on Bank Guarantee”, dated 15 January 1998.

<sup>401</sup> Some authors concluded that “*classifying a guarantee as security has no more grounds as, for example, insurance for the non-payment of funds under a credit agreement*” – E.Pavlodskii, “Security for Performance of Obligations by Suretyship”, *Zakon*, No.5, 1995, quoted *per* V.Golyshev, “Bank Guarantee” Some Questions of Legal Nature”, *Banking Law*, No. 2, 2003.

nature).<sup>402</sup> There is no easy answer to the question whether a guarantee is secondary in nature to the main obligation, especially in the light of another case in the mentioned Informational Letter No.27 (item 4 of the Letter). In the case reviewed by the Presidium, the beneficiary demanded that the guarantor makes a payment of some 20 million Rubles (a substantial sum for a Russian business). The guarantee required the beneficiary to produce to the guarantor documents confirming that the payment had not been made by the main debtor. And the beneficiary did produce a letter from a bank confirming that the debtor had no funds in its bank account to make the payment when it was due. The guarantor, however, made an objection to the claim under the guarantee stating that a third party made the payment to the beneficiary on behalf of the main debtor. The beneficiary then demanded again that the payment was made. According to Article 376, so it seems, the subsequent demand by the beneficiary could not have been ignored by the guarantor. However, the Presidium decided that the beneficiary's claim was an abuse of rights contrary to Article 10 of the Civil Code 1994 and that the guarantor was entitled to refuse to make the payment.<sup>403</sup>

With respect to the validity of a guarantee and its treatment as security, an early case No.8065/95<sup>404</sup> decided by the Presidium of the Supreme Arbitrazh Court of the Russian Federation must be mentioned: a guarantee, which lapsed the day before the last day for the making of payment on the main obligation, was declared void for "*the lack of security function*".<sup>405</sup> Case No.8065/95 adds to counter-arguments in a dispute where a party wishes to rely on Article 376 and the "independence" of a bank guarantee. However, from the theoretical point of view the 8065/95 case is not entirely satisfactory. An obligation secured by a guarantee may exist within a certain timeframe, but, at the same time, have "on demand" nature. Before such an obligation "expires" the creditor may make a valid demand and if that demand is not met by the debtor, it would be logical to claim against a guarantee. In such a scenario, it is not necessary that a guarantee covers the whole period when the

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<sup>402</sup> See, e.g., L.Kuznetzova, "Independence of Bank Guarantee", *Law and Economy*, Nos.5 and 10, 2008 (argues that a guarantee cannot be truly independent).

Cf. M.Braginskii and V.Vitryanskii, *Contract Law. General Provisions (book one)*, 3<sup>rd</sup> ed., Statut, Moscow, 2001 (argues that a guaranty is for almost all purposes independent).

See also L.Novoselova, "Comments to Informational Letter of the Presidium of VAS RF Dated 15 January 1998 No.27 Review of Practice of Adjudicating of Disputes, Connected to the Application of Rules of Civil Code of the Russian Federation on Bank Guarantee" in L.Novoselova and M.Rozhkova (eds.), *Most Topical Questions of Entrepreneurial Activity. Comments to Judicial Practice of VAS RF*, prepared for, and available in *Garant* database, 2009.

<sup>403</sup> A case in the Federal Arbitrazh Court of Moscow region with similar results – the payment under a guarantee was refused given that the main obligation was performed – is discussed in E.Eremycheva and S.Ermakov, "Banking Guarantee as Form of Security for Performance of Obligations: Evolution and Perspectives", *Law and Economy*, No.12, 2003.

<sup>404</sup> The Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.8065/95, dated 25 November 1997.

<sup>405</sup> See L.Nigmatulina, "On Independence of Bank Guarantee", *Juridical World*, No.12, 2005.

main obligation is valid.<sup>406</sup> However, it appears that such “partial” guarantees are not recognized in Russian law.

Another early case decided by the Presidium,<sup>407</sup> involved a guarantee issued by a first bank as security for obligations under another guarantee issued by a second bank. An argument was raised that a guarantee securing another guarantee was void: essentially, it was argued that it (guarantee by the first bank) was security for another security (guarantee by the second bank) and was therefore void. However, the Presidium in that case pointed out that a guarantee was a self-sufficient obligation, which could be in turn secured, including by way of another guarantee.

Though the rules of the Civil Code 1994 do not expressly stipulate that a guarantee must always be issued for a defined term, such a rule is implied by a provision requiring that the beneficiary submits its claim to the guarantor within the period that the guarantee was issued for (Article 374). The Presidium of the Supreme Arbitrazh Court also adopted a pronounced view that a guarantee must include a condition as to the term of its validity.<sup>408</sup>

Finally, according to Article 369, the principal of a guarantee must pay a fee to the guarantor. This rule is mandatory and it generally appears to invalidate a guarantee with no condition as to the payment of fees to the guarantor. However, the Presidium of the Supreme Arbitrazh Court in its Resolution No.5710/96<sup>409</sup> upheld the validity of a guarantee in spite of the absence of any consideration moving to the guarantor. The Presidium stated that the payment of fees to the guarantor is a question internal to the relationships between the guarantor and principal and does not affect the relationships between the guarantor and beneficiary. Nevertheless, relying on guarantees without an express provision for consideration should be treated as an approach with high degree of risk.

Scenarios when a bank guarantee could be used include, for example, trade financing (where a bank guarantee is issued in respect of a letter of credit or an advance payment made by the purchaser). The use of bank guarantee in cross-border financing transactions (where banks act as an international syndicate) would generally remain limited. However, the use of Russian bank guarantees is sometimes required by Russian law. One common scenario is acquisition finance, where a bidder makes a mandatory bid for a Russian joint

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<sup>406</sup> See S.Sarbash, “Some Problems of Security for Performance of Obligations”, *Vestnik VAS RF*, No.7, 2007.

<sup>407</sup> The Resolution of the Supreme Arbitrazh Court of the Russian Federation No.6340/98, dated 17 November 1998.

<sup>408</sup> Item 2 of the Informational Letter No.27.

<sup>409</sup> The Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.5710/96, dated 11 March 1997.

stock company. The statute requires<sup>410</sup> that a bank guarantee is issued in respect of payments for the target's shares and Russian authorities seem to interpret this provision so as to mean that the guarantee must be issued under Russian law.

**(ii) Suretyship**

Russian *poruchitel'stvo* – suretyship – is an undertaking by a third person to be held responsible for an obligation of the (main) debtor (Article 361). Unlike a bank guarantee, where there is a scope for the argument that it is independent from the main obligation,<sup>411</sup> it is generally accepted that Russian suretyship is secondary in nature to the secured obligation.<sup>412</sup> The use of “suretyship” for Russian *poruchitel'stvo* may be somewhat misleading: English suretyship, of course, includes guarantees and indemnities.<sup>413</sup> Since *poruchitel'stvo* can only support an existing obligation, it is similar to the English law guarantee; in turn, a Russian bank guarantee, having (limited) independence from the main obligation, “leans” in the direction of the English law indemnity. Thus, a better translation of *poruchitel'stvo* would be “guarantee”. However, it is more traditional to use “suretyship” in translation and this convention is followed here.

The default rules of the Civil Code 1994 are that a surety is “*responsible before the creditor to the same extent as the debtor, including interest, court expenses and other creditor's damages*”; the parties are free to vary the extent of surety's liability (Article 363).

A surety is entitled to raise against the creditor any objections which the debtor otherwise could, even if the debtor “*abandoned*” such objections or admitted its debt (Article 364).<sup>414</sup> Though this provision protects a surety from insensible behavior of the main debtor, it may create additional difficulties for the secured creditor in forcing it to contest different sets of objections made by two parties (the debtor and surety). However, the law also stipulates that a position to the contrary may follow from the parties' agreement.<sup>415</sup>

<sup>410</sup> Article 84.2 of the Federal Law No.208-FZ, “On Joint Stock Companies”, dated 26 December 1995.

<sup>411</sup> See *Bank Guarantee* on p.123 above.

<sup>412</sup> Article 329 of the Civil Code 1994 stipulates that, unless law provides to the contrary, invalidity of the main obligation imports invalidity into any security for that obligation. Article 370 of the Civil Code 1994 refers to “*independence*” of a bank guarantee (thus, an exception for bank guarantee is created by law). See also discussion on independence of guarantee in *Bank Guarantee* on p.123 above.

<sup>413</sup> Both Russian guarantees and indemnities must be in writing. English guarantees, unless they are financial collateral, are subject to the requirements of section 4 of the Statute of Frauds 1677 (must be done in writing).

<sup>414</sup> See L.Novoselova, “To the Question on Objections in Suretyship Relationships” in M.Rozhkova (ed.), *Measures of Security and Measures of Liability in Civil Law: a Collection of Articles*, Statut, 2010.

<sup>415</sup> A well advised lender should insist on denying the right of surety to advance such additional objections; it is not clear whether the courts would look favorably at such exclusion, however.

The interests of a surety are also protected from changes in the secured obligation:<sup>416</sup> unless the consent of the surety is obtained, a suretyship terminates if the secured obligation changes so as to increase the liability of the surety (Article 367).

A surety, which performed under the suretyship agreement, has the right of subrogation against the main debtor (365).

The Presidium of the Supreme Arbitrazh Court of the Russian Federation dealt with some questions related to suretyships in its Informational Letter No.28.<sup>417</sup> In particular, the Presidium pointed to certain requirements of Russian law to provisions on the determination of a term of time, as must be observed in a suretyship agreement. A term of time under Russian law may be set by a reference to a calendar date, the expiration of a number of years, months, days, *etc.*, or an event which will inevitably occur. Thus, the term of a suretyship agreement could not be set as “*until the [main] obligation is performed*”: such a suretyship agreement would be invalid.

The Civil Code 1994, making a departure from the approach of the Soviet law, provided that suretyship may be issued for future obligations (Article 361). The importance of this provision is clear – a lender would ordinarily insist that security is granted *before* it lends money to the debtor (and non-bank entities cannot *agree* to lend money in the *future* under Russian law).<sup>418</sup> The Informational Letter No.28 confirmed that suretyship for future obligation is possible. The Presidium stated that on the facts of the case, the information in the suretyship agreement was sufficient to identify the secured obligation; the fact that the sum of the main obligation as stated in the suretyship agreement exceeded the actual loan amount was irrelevant.<sup>419</sup>

The use of suretyship in a cross border financing deal is more limited than that of a bank guarantee. Perhaps, a case where a Russian suretyship can be encountered is when a strong Russian surety insists on the use of Russian law for security that it is intending to provide.

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<sup>416</sup> Generally, a surety would not be a party to the agreement between the main debtor and the creditor. In Russian practice, however, the debtor was often a party to the suretyship agreement. The Federal Arbitrazh Court of East-Siberian region in its Resolution on case A19-11125/04-10-F02-6374/05-C2, dated 16 January 2006, concluded that a defective purported execution by the main debtor of the suretyship agreement did not affect the validity of that agreement, since such an execution was merely “*optional*”.

<sup>417</sup> The Informational Letter of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.28 “Review of Practice of Resolving Disputes, Connected to the Application by Arbitrazh Courts of Rules of the Civil Code of the Russian Federation on Suretyship”, dated 20 January 1998.

<sup>418</sup> See also footnote 296 on p.89 above.

<sup>419</sup> For a discussion of suretyship for future obligations, see A.Burkova, “Suretyship for the Future”, *Ezh-Jurist*, No.45, 2006.



**(iii) Penalty**

According to Article 330 of the Civil Code 1994, a penalty<sup>420</sup> is a monetary sum, which a debtor must pay to the creditor in the case of non-performance, or improper performance, of an obligation.

According to the Civil Code 1994, a party entitled to the payment of penalty “*is not obliged to prove ... damages*”. How does then Russian penalty compare to the English law penalty and liquidated damages? The distinction in English law was set in seminal *Clydebank* and *Dunlop* cases and focused on whether a particular contractual provision was a genuine covenanted pre-estimate of damages.<sup>421</sup> Of course, the agreed liquidated damages may prove to be totally unrelated to actual damages of the party entitled to liquidated damages. However, English law, at least in theory, establishes a link between damages and any pre-determined sum payable on breach of obligation; Russian law severs this link at the outset.

The question that begs at this point is: can Russian penalty be a sum which is indeed purported to be *in terrorem* of the debtor? The answer has to be given in several stages.

The starting point is Article 394 of the Civil Code 1994: under its rules, the default position is that damages are compensated to the extent they are not covered by penalty. However, the law or a parties’ agreement may specify cases where only penalty can be claimed (*i.e.*, the right to claim damages is lost); when damages can be claimed to their full extent in addition to the claim for penalty; and when the creditor has the option to claim either penalty or damages. Since both penalty *and* damages can be claimed at the same time, a penalty can, in principle, act *in terrorem* of the debtor under Russian law.<sup>422</sup> A penalty, which can be

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<sup>420</sup> The legislator used three Russian nouns to refer to “penalty” in Article 330: *neustoika*, *shtraf* and *penya*. Reasons for the mentioning of *shtraf* and *penya* are obscure and cause some confusion as to their meaning (*i.e.*, whether they are complete synonyms with *neustoika* or each is different kind of penalty).

<sup>421</sup> *Clydebank Engineering and Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6 and *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79. In *Dunlop* it was stated that:

“1. Though the parties to a contract who use the words “penalty” or “liquidated damages” may *prima facie* be supposed to mean what they say, yet the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages. This doctrine may be said to be found *passim* in nearly every case.

2. The essence of a penalty is a payment of money stipulated as *in terrorem* of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage ...

3. The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided”

(*per* Lord Dunedin at 86).

<sup>422</sup> The Resolution of the Supreme Court of the Russian Federation No.5243/06, dated 19 September 2006, on case No.A40-64205/05-30-394 is an interesting example related to the recognition of foreign arbitral awards and setting them aside on grounds of public policy. In that case, the arbitral award provided that the claimant was entitled to penalty, but not to damages. Lower instance courts decided that penalty could not be claimed in the circumstances where there was no corresponding entitlement to damages; and that the award should be set aside on the grounds of public policy. The Presidium reversed the decisions and stated that in fact Russian law recognized forms of penalty which could be claimed *in addition* to damages. Thus, a claim for penalty only did not contradict Russian law on grounds of public policy.

claimed in addition to damages is often referred to as “*fine penalty*” in Russian literature.<sup>423</sup> In spite of the express provisions in the Civil Code 1994, which allow “*fine penalties*”, the fairness of such penalties was doubted by some Russian commentators.<sup>424</sup>

However, the analysis is not complete by pointing out that “*fine penalties*” are allowed by Article 394: Article 394 protects creditors, but, perhaps, there is some protection for debtors, too? Indeed, protection is offered by Article 333 on decreases of penalties: a penalty can be decreased by the court if it is “*manifestly disproportionate to the consequences of the breach of obligation*”. There are two further clarifications to the rule. First, Article 333 does not prejudice the apportionment of damages according to the blame of the parties (Article 404), and, second, it does not affect the right of a creditor to damages as *per* Article 394. The latter clarification means that a penalty may be decreased only in the part, which exceeds damages (*i.e.*, the part which is a “*fine*” in nature).

The Presidium of the Supreme Arbitrazh Court issued the Informational Letter No.17<sup>425</sup> on the application of Article 333. In the Informational Letter No.17, the Presidium offered some guidance on circumstances, which may be taken into account when deciding on “*manifest disproportionality*” of a penalty:

*“exceedingly high percent [of interest rate] of penalty; significant excess of the sum of penalty over the sum of possible damages caused by the breach of obligation; the length of the breach of obligation, etc.”*

The analysis is now complete and it is interesting to note how the Presidium arrived at a position similar to that in *Clydebank* and *Dunlop* cases: the guidance in the Informational Letter No.17 essentially tells the courts to compare damages and penalty. Such a comparison should be made when the respective sums are known (*i.e.*, is retrospective) and this distinguishes Russian approach to court control over penalties from *Clydebank* and *Dunlop*, which test a *pre-estimate* of damages.

The Informational Letter No.17 also offered guidance on what should be taken into account with respect to the consequences of a breach of an obligation:

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<sup>423</sup> *Shtrafnaya neustoika* in Russian.

<sup>424</sup> On fine penalties, see, *e.g.*, G.Khokhlova, “*Fine Penalty*”, *Zakon*, No.12, 2006.

<sup>425</sup> The Informational Letter of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.17 “*Review of Practice of Application by Arbitrazh Courts of Article 333 of the Civil Code of the Russian Federation*”, dated 14 July 1997.

*“... property and monies not received by the plaintiff, damages suffered (including economic loss), other property or non-property rights, on which the plaintiff is entitled to rely on in accordance with law or contract.”*

The Presidium decided that Article 333 did not allow to decrease a penalty in connection with the creditor’s fault; however, any creditor’s fault could be taken into account when apportionment of *“liability”* was made under Article 404. It is not clear whether the Presidium suggested that the defendant had to argue that its liability *including penalty* had to be decreased under Article 404 (as opposed to Article 333), or whether it was impossible to decrease penalty on the basis of creditor’s fault in principle. The latter interpretation of the Informational Letter No.17 may cause unfair results in practice: a *“fine penalty”* would continue to accrue even if the creditor caused the debtor’s default.<sup>426</sup>

Finally, a debtor has one more line of defense, which may offer help even if the unfavorable interpretation of rules on decreases of penalty in the Informational Letter No.17 applies. According to Article 330, a creditor is not entitled to penalty, if the debtor is not liable<sup>427</sup> for the non-performance, or improper performance, of its obligation. This protection is very narrow: the literal interpretation of the rule means that if the debtor is at least partially liable, penalty will accrue.

A discussion of Russian penalty would be incomplete without mentioning Article 395 of the Civil Code 1994. Article 395 provides that interest is payable on the *“use of others’ monies”*. The law clarifies that the *“use of other’s monies”* includes: unlawful retention, failure to return, *“ungrounded receipt”*, or saving on account of another, of such monies. The interest rate payable is the *“discount bank rate existing where the creditor is located”*. Clarification on the meaning of *“discount bank rate”* was offered by in the joint Resolution of the Presidiums of the Supreme and Supreme Arbitrazh Courts of the Russian Federation No.6/8:<sup>428</sup> *“discount rate”* means the lending rate of the Central Bank of Russia. The Resolution No.6/8 also provided that interest pursuant to Article 395 accrues only on principal (no compounding of interest), unless there is an express provision in law to the contrary. According to Article 395, the court *may* apply *“discount interest rate”* as it existed at the day when lawsuit was commenced or as at the date when the decision was made. The

<sup>426</sup> In the case reviewed by the Presidium with respect to creditor’s fault, this was the exact result.

<sup>427</sup> If an obligation arose in the course of carrying out a business activity, then the liability of the obligor is presumed. Excusing circumstances for non-, or improper, performance may be set forth in the parties agreement; alternatively, the obligor may prove that performance was rendered impossible by force-majeure circumstances (Article 401 of the Civil Code 1994).

<sup>428</sup> The Resolution of the Plenary session of the Presidium of the Supreme Court of the Russian Federation and the Plenary session of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.6/8 *“On Some Questions, Related to Application of Part I of Civil Code of Russian Federation”*, dated 1 July 1996.

Resolution No.6/8 stated that the court should, as a rule, apply the interest rate that was closer to “*discount rates*” that existed during the time when the funds were being used.<sup>429</sup> However, the Resolution No.6/8 and Article 395 on the powers of the court should not be read to mean that the court *must* apply the rate as at the date of the lawsuit or decision: the interest rate that existed when the unpaid debt became due is applicable in the case of a debt that was paid by the debtor, but such a payment was late. As follows from the joint Resolution of the Plenum of the Supreme and Supreme Arbitrazh Courts of the Russian Federation No.13/14,<sup>430</sup> the latter rule is mandatory for the courts (courts do not have the choice), but the parties may agree otherwise.

In the Resolution No.13/14, the courts also stated that the nature of interest payable under Article 395 differs from that of interest payable on loans or credits.<sup>431</sup> This may be used to support the conclusion that interest payable under Article 395 is a form of penalty. However, Russian statutes do not refer to such interest as penalty and there is no uniform opinion among commentators on this point.<sup>432</sup>

In practice, the application of Russian rules on penalties and Article 395 interest in cross-border financing transactions is limited. The Russian conflict of laws rules provide that the governing law of a contract also applies to the consequences of its non-performance, or improper performance (Article 1215). Furthermore, matters related to the payment of interest are governed by the law that applies to the respective obligation (*i.e.*, if the obligation is governed by foreign law, Russian rules do not apply). Thus, if the financing documents are governed by foreign law, neither Russian rules on penalties, nor Article 395 interest rules apply. However, both types of rules will apply to any obligations arising out of documents governed by Russian law. In a typical setting, pledges and mortgages (and, possibly, assignments) related to Russian assets will be governed by Russian law and it is here where Russian rules on penalties and Article 395 interest will apply.

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<sup>429</sup> It is interesting to note that the Resolution No.6/8 also dealt with foreign currencies, for which the Central Bank of Russia did not publish a lending rate. In such a case, the courts should apply average interest rates on short-term bank loans as at the place where the creditor is located.

<sup>430</sup> The Resolution of the Plenum of Supreme Court of the Russian Federation No.13 and Plenum of the Supreme Arbitrazh Court of the Russian Federation No.14 “On Practice of Application of Provisions of the Civil Code of the Russian Federation on Interest on Use of Others’ Funds”, dated 8 October 1998 (as amended on 4 December 2000).

<sup>431</sup> The approach of English law to interest on debts in similar cases is more straightforward (and narrow) – see the Late Payment of Commercial Debts (Interest) Act 1998, under which interest on debt is an implied term of the contracts to which the Act applies.

<sup>432</sup> O.Sadikov (*ed.*), *Commentaries to Civil Code of Russian Federation, Part I*, 3<sup>rd</sup> ed., Infra-M, Russia, 2005, p.891.

**(iv) Deposit**

In Russian law, a deposit is a sum of money, paid by one negotiating party on account of payments due under the agreement from that party to the other party, as “*proof*” of the conclusion of the agreement and as security “*for it*” (Article 380).<sup>433</sup> Article 380 further provides that “*in the case of doubt*” as to whether a payment made by a party on account of an agreement is an advance payment or deposit, such a payment is deemed to be an advance payment (advance payments are not security).

A deposit operates by placing burdens on each party: the payor loses the deposit if it fails to pay the rest; and the payee must repay the sum twice the deposit if it fails to perform (Article 381). A deposit does not bar a claim for damages, and unless otherwise agreed by the parties, deposit count towards the compensation for damages.

A deposit will seldom be a relevant issue in a cross-border financing transaction. In fact, it almost invariably will be an issue internal for the borrower’s relationship with its counterparties. The lenders may wish to have a say on how such relationships are structured, but any agreement on deposit will not affect them directly.

A deposit is considered in Russian law as form of security; in fact, it is somewhat similar to “fine penalty”<sup>434</sup> and advance payment operating together. A deposit does not create any security interest and is in its nature an agreement on the form of payment and *quantum* of liability.<sup>435</sup>

**(v) Lien**

According to Article 359 of the Civil Code 1994, a creditor who holds an “item” (Russian *vesch'*) that must be delivered to the debtor or to the debtor’s order is entitled to retain it (has lien over it) until such time as the debtor performs its obligations to pay for that item or compensates the creditor’s damages connected to that item. Lien can also secure obligations unrelated to the retained item, if both parties in the respective relationship act as business persons. The right of lien is subject to any parties’ agreement to the contrary.

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<sup>433</sup> The drafting of the provision is unfortunate: does “*proof*” mean that it is sufficient to pay a deposit to unconditionally prove that agreement exists? Also, Russian law generally recognizes security for *obligations* and not for *agreements*, as the wording of Article 380 suggests.

<sup>434</sup> See p.130 above.

<sup>435</sup> For more information on deposits, see, *e.g.*, M.Moshkovich “Deposit or non-the-less Advance?”, *Ezh-Jurist*, No.6, 2009 and M.Ermoshkina, “Deposit: Problems and New Possibilities” in M.Rozhkova (ed.), *Measures of Security and Measures of Liability in Civil Law: a Collection of Articles*, Statut, 2010.

Rules on pledge apply in respect of enforcement against property over which a lien exists (Article 360).<sup>436</sup> Thus, lien can be treated a statutory pledge that arises in prescribed circumstances.<sup>437</sup>

Article 359 expressly refers to liens on “items”: under Russian law “items” include movables and immovables (*i.e.*, real estate), cash and securities (Articles 128 and 130 of the Civil Code 1994). Thus, there is a chance that a creditor in a cross-border financing transaction may have lien over, say, debtor’s securities located in Russia. However, Russian conflict of laws rules are of little help in the situation where the main obligation is governed by foreign law and a lien is brought up in the parties’ relationships. It is not clear whether a lien, as a form of statutory “security”, arises if the respective obligation is not governed by Russian law.

Liens may arise in the course of ordinary borrower’s operations. Lenders may have to consider implications of liens when making the decision to lend and should take into account liens when drafting financing documents. Otherwise, liens have little use in cross-border financing transaction and lender should not rely on this form of security. An attempt to enforce a lien may be considered as a remedy of last resort.

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<sup>436</sup> Thus, apparently, a power of sale exists for assets subject to Russian lien. However, there are not details in law whatsoever on when such a right can be exercised. Though generally the power of sale does not appear to exist generally, it may be agreed upon by the parties under English law: *Great Eastern Rly Co v Lord’s Trustee* [1909] AC 109 and *Trident International Ltd v Barlow* [1999] 2 BCLC 506. On unpaid vendor’s lien, see, *e.g.*, *Barclays Bank v Estates & Commercial* [1997] 1 WLR 415 and *Hewett v Court* (1983) 149 CLR 639 on applications to courts for the order of sale.

<sup>437</sup> For more information on liens, see, *e.g.*, M.Soshnikova “On Question of Lien over Property”, *Ezh-Jurist*, No.10, 2008 and A.Leonov, “Legal Problems Connected with Liens over Debtor’s Property”, *Juirst*, No.3, 2009.

## Chapter 3. INSOLVENCY LAW

Insolvency is generally understood to be a situation where a company does not pay off, or is incapable of paying off, its debts. Generally, in a market economy, insolvency's social function is to "cull" inefficiently run companies from those being operating competently and ensure that the inefficient companies cease trading in due course.

It is somewhat paradoxical, and especially so when credit is abundant<sup>438</sup> and when banks are eager to lend and borrowers are glowing with confidence, that a finance lawyer, at an early negotiation stage of, say, a trade finance deal, should be concerned with insolvency law. However, as recent events show, borrowers do, from time to time, find themselves in trouble: not so-long ago "champions" of business, General Motors,<sup>439</sup> LyondellBasell Industries<sup>440</sup> and Lehman Brothers<sup>441</sup> fell victim, amongst others, to the 2007 financial crisis. When a borrower's prospects deteriorate, it often matters (for the creditor's legal adviser) that the interests of the creditor, to the extent possible, are insolvency-proof. It is for this reason that a transactional lawyer may, and often should, point to insolvency law when advising his/her client.

At micro-level, a creditor's ability to recover debt from an insolvent debtor depends, *inter alia*, on the quality and thrust of insolvency law. However, insolvency law is a political issue with macro-level implications and consequences for stakeholders other than just creditors. Thus, if a company is declared insolvent, its employees are likely to lose their jobs, suppliers – their future orders originating from the insolvent company and customers – the support for the products already in use. If a company is sufficiently large, its closure may cause public outcry and, in cases of multinationals, tensions between governments. More generally, a legislature has to take a decision on the degrees of protection of private and public interests (in the majority of cases, this is a trade-off). An added complication is that insolvency law

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<sup>438</sup> Recent events showed that the borrower should equally be concerned with the financial health of the banks participating in a lending syndicate.

<sup>439</sup> "GM to file for Chapter 11 protection", T.Braithwaite, B.Simon, J.Reed, B.Benoit J.MacIntosh, *Financial Times*, 31 May 2009.

<sup>440</sup> Certain U.S. and European entities of the LyondellBasell group filed for Chapter 11 protection. See "Everything that could go wrong did" Andrew A.Jack, *Financial Times*, 8 January 2009 and, for the list of entities, the respective link on <http://www.lyondellbasell.com/News/Chapter11Restructuring/index.htm>, last viewed on 7 November 2009.

<sup>441</sup> "Lehman Brothers Files for Bankruptcy", *Financial Times*, 15 September 2008.

may remain “dormant” during periods of economic growth; however, the significance of a thought-through insolvency regime is often acutely highlighted during recessions.

The starting point for the analysis of any insolvency regime is the determination of the circumstances under which a debtor can be declared insolvent. Generally, there are two main tests that are used to arrive at the decision: (i) balance sheet test; and (ii) cash flow test. Under the balance sheet option, a debtor is considered insolvent when the balance sheet value of its assets is less than its balance sheet liabilities; and under the cash flow option, a debtor is considered insolvent when it does not pay in full its debts, which are due and payable. Each mentioned option is rarely used in “pure” form; and in practice an insolvency test in a given jurisdiction often combines these approaches in one way or another. Other important issues for the legislator to consider include, *inter alia*: persons entitled to file petitions on declaration of insolvency; powers of the insolvency authorities; available insolvency procedures; categories of persons entitled to participate in such procedures;<sup>442</sup> availability of moratorium and claims that it covers; availability of set-off; treatment of security on insolvency; and, finally, the priorities of creditors’ claims.

For the purposes of this work, Russian insolvency legislation can be divided into the following periods: (i) Soviet legislation (1917-1992); (ii) early post-soviet period (1992-1998); (iii) revised regime (1998-2002); and (iv) modern regime (2002 onwards). Soviet insolvency legislation (1917-1992), even if it existed, was not applied in practice to any significant degree; however, each of the later periods started with the adoption of a new comprehensive legislative act dedicated to insolvency.<sup>443</sup> An interesting lesson from the past is related to the wide use of the poorly drafted legislation of the revised regime (1998-2002) as a tool for hostile takeovers.<sup>444</sup>

It is important to note that in the post-Soviet Russia, there was a tendency to provide for varying insolvency regimes; the choice of the applicable regime depended on a number of factors, for example: whether the debtor was an individual or a company;<sup>445</sup> the industry in which the debtor operated (special legislation was adopted for the insolvency of credit institutions<sup>446</sup> and for oil and gas industry);<sup>447</sup> or on the significance of the debtor for the city

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<sup>442</sup> A particular revision of the Russian insolvency legislation, the Federal Law No.6-FZ, “On Insolvency (Bankruptcy)”, dated 8 January 1998, had a major flaw in this respect.

<sup>443</sup> The Law of the Russian Federation No.3929-1 On Insolvency (Bankruptcy) of Enterprises, dated 19 November 1992, the Federal Law No.6-FZ On Insolvency (Bankruptcy), dated 8 January 1998, and the Federal Law No.127-FZ On Insolvency (Bankruptcy), dated 26 October 2002.

<sup>444</sup> See p.153 below.

<sup>445</sup> See, *e.g.*, on difference in tests for insolvency p.150 below.

<sup>446</sup> Federal Law No.40-FZ “On Insolvency (Bankruptcy) of Credit Organizations”, dated 25 February 1999 (as amended). See also English Credit Institutions (Reorganisation and Winding Up) Regulations 2004 (SI 2004/1045).



in which the debtor was located (a separate regime existed for “*core city companies*”).<sup>448</sup> It would have been impossible to cover in this work each such specific regimes, and, hence, only the “ordinary” insolvency regime for a debtor (a commercial body corporate), is discussed below.

### 3.A. Insolvency: 1917-1992

Soviet legislation evolved over time: the direction of its development was closely related to the changes in political wishes of the Government. For example, the Civil Code 1922 was adopted alongside the transition to the New Economic Policy,<sup>449</sup> and, thus, the Code was tolerant towards some elements pertinent to a (controlled) market. Generally, there was no specific insolvency legislation adopted in the period of 1917-1922;<sup>450</sup> however, some insolvency-related rules existed and they were not completely static.

As a matter of policy and practice, in a planned economy, where the State is the predominant economic participant,<sup>451</sup> there is no real necessity for a comprehensive insolvency regime. In fact, insolvency as it could have been applied to enterprises and establishments would have been alien to the spirit and nature of a planned economy. What functions may insolvency fulfill in the environment, where: (i) the managers of enterprises and establishments were appointed/removed by the Government; (ii) prices for goods and services were set forth by the Government; (iii) output of goods and services was governed by the state plan; (iv) agreements (e.g., for goods or services) between enterprises and/or establishments were entered into pursuant to the state plan; and (v) banks were state-owned and made their lending decisions in conformity with the state plan?<sup>452</sup> Where an enterprise or an establishment could not pay, this could have been the result of mismanagement (and the State could then appoint new managers), or the result of poor planning or inappropriate prices. If one of the two latter options was the cause of insolvency, the State could always remedy the situation by providing extra funding or altering the state plan.

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<sup>447</sup> Federal Law No.122-FZ “On Particularities of Insolvency (Bankruptcy) of Subject of Natural Monopolies of Fuel and Energy Complex”, 24 June 1999 (now repealed).

<sup>448</sup> Paragraph 2, Chapter VIII of the Federal Law No.6-FZ “On Insolvency (Bankruptcy)”, dated 8 January 1998.

<sup>449</sup> For New Economic Policy, see p.26 above.

<sup>450</sup> However, pre-Soviet Russian specialized insolvency legislation dates back to mid-eighteenth century: for example, Bankruptcy Charter, dated 15 December 1740, Charter on Bankrupts, dated 19 December 1800 and Charter on Trade Insolvency, dated 23 June 1832 (from L.Tschennikova, “Bankruptcy in Civil Law of Russia: Traditions and Perspectives”, *Russian Justitziya*, No.10, 1998, p.38).

<sup>451</sup> This participation of the State in the economy was, of course, carried out through various enterprises and establishments. However, it was the State that directed the enterprises and establishments and ultimately exercised control over the economy.

<sup>452</sup> For a description of the role of the state plan and the “flexible” nature of Soviet obligations, see p.35 above.

There were very few banks in the Soviet economy;<sup>453</sup> and each bank was in charge of financing of specific enterprises, projects or activities. In such circumstances, if a debtor was insolvent and could not pay its debts, there still could have been no real competition for the debtor's assets between the lenders, simply because there was likely to have been only one lender that had claims against the debtor (and any significant indebtedness on wages was simply not an option in the U.S.S.R.) Even if there were several lenders with claims against the debtor, all such lenders would have had one "shareholder" – the State; and hence, there was little incentive for any one of such "connected" lenders to "pull the blanket" in its direction. Thus, creditors' priorities were not high on the agenda in the Soviet economy.

Nevertheless, Soviet law included some rules related to insolvency. In the early years, when private property on means of production had not yet been completely eliminated, under Article 93 of the R.S.F.S.R. Labor Code 1922,<sup>454</sup> if an employer became insolvent, all payments to employees arising out of collective labor agreements or individual contracts of service were to be made in priority before any other debts. The Civil Code 1922 included provisions related to the liability of partners and partnerships in cases where the partnership or a partner(s) were insolvent.<sup>455</sup> In addition, the Civil Code 1922 imposed a duty of care on the members of the board (*pravleniye*) of a stock company and, in cases where such members breached their duty and the company became insolvent, members were jointly liable to the creditors of the company (Article 356). In addition, the Civil Procedural Code 1923<sup>456</sup> was amended in 1927 and 1929 to include some rules related to insolvency.<sup>457</sup> According to Article 318 of the amended Civil Procedural Code 1923, a debtor that ceased to make payments on debts over a specified sum or a debtor that had had to cease such payments due to the state of its affairs could have been declared insolvent by the court: the declaration was within the authority of courts provided that the debtor was "*incapable of full payment of monetary claims of its creditors*".<sup>458</sup> At the U.S.S.R. level, a similar rule existed in the Regulation on Stock Companies,<sup>459</sup> which also included some unelaborate

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<sup>453</sup> See footnote 115 on p.34 above.

<sup>454</sup> See Resolution of the Central Executive Committee of the R.S.F.S.R. "On Entry into Force of Labor Code of the R.S.F.S.R., edition 1922", dated 9 November 1922.

<sup>455</sup> Articles 294, 305, 308, 310, 315 and 319.

<sup>456</sup> See the Resolution of the All-Russian Central Executive Committee "On Entry into Force of the Civil Procedural Code of the R.S.F.S.R.", dated 10 July 1923.

<sup>457</sup> See Resolutions of the Central Executive Committee and Council of Ministers of the U.S.S.R. "On Insolvency of Private Persons, Individual and Juridical", dated 28 November 1927, and "On Approval of the Regulation on Insolvency of State Enterprises and Mixed Stock Companies and Regulation on Insolvency of Cooperatives", dated 6 February 1929.

<sup>458</sup> S.Karelina, *Mechanism of Legal Regulation of Relationships of Insolvency*, Wolters-Kluwer, 2008.

<sup>459</sup> Approved by the Resolution of Central Executive Committee of U.S.S.R., Council of Ministers of the U.S.S.R., dated 17 August 1927.

provisions related to the liquidation of an insolvent stock company and to the powers of liquidators to suspend payments due from such a company, with the exception of payments to employees and certain other payments of social nature (Article 115).<sup>460</sup>

For the next decades, as the State took further control of the economy, insolvency rules lost any significance.

However, in the more modern period, when the Soviet policy started to swing back in favor of elements of private property in the economy, a reference to insolvency of enterprises was made by the U.S.S.R. legislators in the Law on State Enterprises in the U.S.S.R. 1990.<sup>461</sup> The law simply provided that in liquidation the claims of the state budget and site cleaning-up costs (interesting to note that environmental matters were taken into account even at that time) were satisfied in priority over the other claims (Article 39).<sup>462</sup>

To conclude this sub-section on Soviet insolvency law, it seems becoming to provide the following quote:

*“The basic feature of the insolvency law of the Soviet period was that the creditors did not at all participate in the insolvency procedures. The creditors were not even involved in the appointing of the administrator. In addition, there was gross inequality between private and state enterprises. .... With the cessation of [the New Economic Policy], the rules on insolvency were not applied anymore and they were gradually taken away from the Codes and textbooks pursuant to the “redundant” formula. And for decades in [Russia] there was no insolvency law and, indeed, there could have been none.”<sup>463</sup>*

### **3.B. Law on Insolvency 1992**

Following the absence of any comprehensive insolvency regime during 1917-1992, Russian insolvency law was re-born with the adoption of the Law of the Russian Federation No.3929-1 On Insolvency (Bankruptcy) of Enterprises, dated 19 November 1992 (the “**Law on**

<sup>460</sup> In addition to the mentioned laws, at the R.S.F.S.R. level, the Regulation on Stock Companies, approved by the Resolution of the Council of Ministers of the R.S.F.S.R. No.601, dated 25 December 1990, stipulated that in cases where *mala fides* actions of directors or members of the board led to the insolvency of the company, such directors and members could be liable in damages pursuant to a decision of the court (Article 10).

<sup>461</sup> See the Resolution of the Supreme Soviet of the U.S.S.R. No. 1530-1 “On the Order of Entry into Force of the Law of the U.S.S.R. “On Enterprises in the U.S.S.R.””, dated 4 June 1990. Not to be confused with the Law of the U.S.S.R. “On State Enterprises”, dated 30 June 1987 (see *Law on State Enterprises* on p.54 above).

<sup>462</sup> The Law On State Enterprises in the U.S.S.R. 1990 never entered into force in Russia. In the war of laws (of the U.S.S.R. and its constituent republics – see footnote 138 on p.44 above), the Russian authorities repealed the U.S.S.R. law by the Resolution of the Supreme Soviet of the R.S.F.S.R. No.446-1 “On the Order of Entry into Force of the Law of the R.S.F.S.R. “On Enterprises and Entrepreneurial Activities””, dated 25 December 1990.

<sup>463</sup> M.Tel’ukina, “The Nature and Some Problems of the Insolvency Law”, *Zakonodatel’s tvo*, 2000, No.4.

**Insolvency 1992**).<sup>464</sup> Generally, the Law on Insolvency 1992 covered all “enterprises” without exceptions from its scope being made on the basis of the size of the company or the type of its business.<sup>465</sup>

Of course, the adoption of the law was necessary in the context of the collapse of the Soviet Union, the abandonment of control over prices and declaration of the principles of free market in the economy. And, being the first attempt to regulate a practically unfamiliar area, the Law on Insolvency 1992 must not be judged too strictly.

**(i) Insolvency Test**

The Law on Insolvency 1992 adopted a modified balance sheet insolvency test: insolvency was defined as the inability to satisfy creditors’ claims in respect of payments for goods and/or services, inability to make mandatory payments into the state budget and payments into state funds arising *in connection* with the fact that the obligations of the debtor *exceeded* its assets, or, alternatively, *in connection* with the unsatisfactory structure of the debtor’s balance sheet (Article 1).

The balance sheet test as it is set out in the preceding paragraph was supplemented with a reference to “*external indication*” of insolvency; such “*external indication*” was defined as cessation of current payments, generally, for a consecutive period of three months. There were two routes to the declaration of insolvency of a debtor; and such a declaration could be made by: (i) an arbitrazh court; and (ii) the debtor when a voluntary liquidation procedure was initiated.

The reader will immediately note that one leg of the balance sheet insolvency test provided for by the Law on Insolvency 1992 was vague: specifically, what was considered to be an “*unsatisfactory*” structure of a balance sheet? The other leg of the test referred to the liabilities of the debtor exceeding its assets. There were difficulties with this, too: (i) the test compared *all* liabilities with *all* assets, and thus there was no recognition in the law itself of the fact that what mattered more in practice was current liabilities and current assets; and (ii) the insolvency test could be easily circumvented if the asset-side of the balance sheet was artificially inflated, *e.g.*, with receivables due from an empty shell company. It was quite common in the 1990s to create shell companies with fictitious addresses and “frontman”

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<sup>464</sup> See Resolution of the Supreme Soviet of the Russian Federation No.3930-1 “On Order of Entry into Force of Law of Russian Federation “On Insolvency (Bankruptcy) of Enterprises”.

<sup>465</sup> For example, with respect to a bank, the Law on Insolvency 1992 simply provided that a bank can be declared insolvent only after its license had been revoked by the Central Bank of the Russian Federation (Article 11).

directors. Such a company was controlled by the interested party while it was still useful and could be (later) abandoned at any time.

Russian authorities soon recognized that the “unsatisfactory” balance sheet test was indeed unsatisfactory. On 22 December 1993, the President of the Russian Federation adopted the Decree No.2264 “On Measures on Realization of Legislative Acts on Insolvency (Bankruptcy)”: the decree generally set forth the authority of various governmental bodies with respect to insolvency proceedings; however, it also ordered the Government to adopt the test(s) for “*unsatisfactory*” balance sheets. Six months later, the Government adopted the Resolution No.498 “On Some Measures on Realization of Legislation on Insolvency (Bankruptcy) of Enterprises”, dated 20 May 1994, which, *inter alia*, set forth the required details for the insolvency test. The mentioned resolution relied on three ratios: (i) current; (ii) own funds; and (iii) return to solvency.<sup>466</sup> Thus, the resolution purported to address both concerns identified earlier: it focused on the current ratio (as opposed to all assets and all liabilities) and provided straightforward formulae which allowed determining whether the debtor was insolvent.<sup>467</sup>

According to Article 2 of the Law on Insolvency 1992, the debtor, its creditor(s) and a prosecutor were entitled to petition the court for the opening of insolvency proceedings.<sup>468</sup> All insolvency cases were in the jurisdiction of arbitrazh courts<sup>469</sup> (Article 3). According to Article 6, a creditor with outstanding claims, which were not paid by the debtor within three months from the day when such claims had arisen, was entitled to send to the debtor a notice requiring (the debtor) to “*comply with its obligations*” (*i.e.*, to pay) within a week. After the notice period expired, the creditor could petition the court for insolvency of the debtor.<sup>470</sup>

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<sup>466</sup> Return to insolvency ratio meant, basically, the change in the current ratio from the start to end of the accounting reporting period.

<sup>467</sup> This approach had its disadvantages, too. Since the resolution set forth a “numerical” approach based on the data of a balance sheet, rather than allowing for an element of judgment and analysis, it could be viewed as too rigid.

<sup>468</sup> The mentioned Resolution No.498 provided that the Federal Department on Administration of Insolvencies (Bankruptcies) is, generally, the competent authority to petition the courts. However, the Russian tax authorities also were competent to petition the courts (as creditors): see Informational Letter of the Supreme Arbitrazh Court No.S1-7/OP-237, dated 25 April 1995 and Letter of the State Tax Service No.NP-6-11/104 On Procedure for Petitioning Arbitrazh Courts on Liquidation of Enterprises, dated 16 February 1996.

Generally, each creditor could petition the court on the insolvency proceedings, independently of any other creditor. Previous unsuccessful petitions did not preclude new petitions by other creditors. See Resolution of the Presidium of the Supreme Arbitrazh Court No.3863/98, dated 20 April 1999.

<sup>469</sup> Arbitrazh courts were the more “commercial” and, perhaps, professional, courts in Russia. See also footnote 62 on p.23 above.

<sup>470</sup> Cf. statutory demand for £750 in English law, under Section 123 (*Definition of inability to pay debts*) of the Insolvency Act 1986:

“(1) A company is deemed unable to pay its debts—

A creditor's petition could be revoked before the court started proceedings; therefore, petitioning for insolvency could be used by creditors as a bargaining tool in negotiations with a non-compliant debtor. According to Article 10 of the Law on Insolvency 1992, the following persons, *inter alios*, were entitled to participate in insolvency proceedings: the debtor, the debtor's owner, the debtor's banks, (known to the court) creditors and a representative of the debtor's employees.<sup>471</sup>

## **(ii) Insolvency Procedures**

The Law on Insolvency 1992 introduced the following insolvency procedures into Russian legislation: (i) external administration; (ii) "rehabilitation"<sup>472</sup> (both (i) and (ii) were classified as "reorganizational" procedures); (iii) involuntary liquidation; (iv) voluntary liquidation<sup>473</sup> (both (iii) and (iv) were classified as "liquidation" procedures); and (v) "settlement".<sup>474</sup> Perhaps, both external organization and rehabilitation can be described as debtor "rescue" procedures.

### External administration

In external administration a moratorium was available to the debtor. The definition of the moratorium was rather simple and also could not be considered satisfactory: "during external administration a moratorium applies to the claims of the creditors"; there were no provisions in the Law on Insolvency 1992 to clarify the scope of the moratorium.

Apparently, there were no exclusions from the moratorium on the face of the provision;<sup>475</sup> however the courts subsequently adopted the position that a moratorium did not cover claims related to wages and some other claims of social nature.<sup>476</sup>

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*(a) if a creditor (by assignment or otherwise) to whom the company is indebted in a sum exceeding £750 then due has served on the company, by leaving it at the company's registered office, a written demand (in the prescribed form) requiring the company to pay the sum so due and the company has for 3 weeks thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor, or demand for 750 pounds sterling is provided for by section 123(a)(1) of the Insolvency Act 1986.*

<sup>471</sup> This provision was drafted significantly better than its counterpart in the successor to the Law on Insolvency 1992, the Federal Law No.6-FZ On Insolvency (Bankruptcy), dated 8 January 1998. See the discussion of observation on p.153 below and the immediately preceding text related to the provisions applicable in observation under the Rule of the Law No.6-FZ On Insolvency (Bankruptcy) (1998).

<sup>472</sup> *Sanatziya* in Russian.

<sup>473</sup> Voluntary liquidation was initiated by a company's management and its regime was, generally, similar to that of (involuntary) liquidation (*konkursnoye proizvodstvo* – see *Liquidation proceedings* on p.145 below) and will not be considered here in any detail.

<sup>474</sup> *Mirovoe soglasenie* in Russian.

<sup>475</sup> "The Law ... does not provide for a partial moratorium..." – see Informational Letter of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No. 20 "Review of Practice of Application by Arbitrazh Courts of Legislation on Insolvency (Bankruptcy)", dated 7 August 1997, item 12.

<sup>476</sup> Cf. O.Nikitina, "This Terrible Word: Bankruptcy", *Business-Advocat*, 1997, No.9 and the Resolution of the Presidium of the Supreme Arbitrazh Court No.2513/97, dated 9 September 1997.

The other deficiency was that the Law on Insolvency 1992 was silent on the question of default interest and penalties.<sup>477</sup> Penalties continued to accrue throughout the length of the moratorium and it was difficult, if not impossible, for a debtor to emerge from external administration being able to pay the accrued penalties which then became payable.<sup>478</sup> The moratorium did not apply to claims, which arose during external administration (as opposed to claims that became “live” before the onset of external administration).<sup>479</sup>

All, the debtor, its proprietor and a creditor could petition the court for external administration. The Law on Insolvency 1992 presumed that external administration should be introduced where “*a real possibility to restore the ability to make payments by the debtor ... existed so as the functioning of the debtor continued via the sale of a part of the debtor’s assets or other ... means*”. The length of external administration was limited to eighteen months.

The debtor’s affairs during external administration were managed by an “*external administrator*”. An external administrator had powers equal to those of the chief executive officer,<sup>480</sup> and was specifically granted the powers with respect to the debtor’s assets.<sup>481</sup> An external administrator was appointed by the court, though the creditors and the debtor could offer their candidates.

### Rehabilitation

As has been mentioned earlier, the second “reorganization” procedure provided for by the Law on Insolvency 1992 was “rehabilitation”. Rehabilitation was intended to be a procedure that would have allowed an interested person(s) to “save” the debtor on the brink of bankruptcy. The law assumed that there were “*persons*” interested in the rehabilitation of the debtor; among such persons, the proprietor of the debtor, creditors and employees

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<sup>477</sup> This was rectified by the successor law to the Law on Insolvency 1992, see V.Vitryanskii, “New [Developments] in Legislation on Insolvency (Bankruptcy)”, *Economy and Law*, 1998, No.3.

There is no general rule against penalties in Russian law similar to *Dunlop Pneumatic Tyre Co Ltd v Selfridge & Co Ltd* [1915] AC 847 in English law; though some protection is allowed against exorbitant penalties (Article 333 of the Civil Code 1994).

<sup>478</sup> See the Letter of Supreme Arbitrazh Court of the Russian Federation No. S1-7/OP-237, dated 25 April 1995. The same approach applied to penalties related to tax payments, which could be quite significant. See the Letter of the Tax Service of the Russian Federation No. N 10-3-04/23, dated 12 January 1998.

<sup>479</sup> See the Letter of the Supreme Arbitrazh Court, No.OP-13/4, dated 15 May 1995 and Informational Letter of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No. 20 “Review of Practice of Application by Arbitrazh Courts of Legislation on Insolvency (Bankruptcy)”, dated 7 August 1997, item 20.

<sup>480</sup> Actually, the powers of an administrator were wider than those of a director: limitations (for example, in the company’s charter) on director’s powers did not apply to administrators. See the Informational Letter of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No. 20 “Review of Practice of Application by Arbitrazh Courts of Legislation on Insolvency (Bankruptcy)”, dated 7 August 1997.

<sup>481</sup> During external administration, the external administrator should have prepared a plan, which had to win the approval of the meeting of creditors and the court (Article 12, items 8 and 11).

enjoyed “*priority*” (however, the law omitted to specify what was the priority among those with “*priority*”). In certain cases, the court had to conduct a tender among persons wishing to participate in rehabilitation. Within seven days from the court’s decision designating the persons participating in rehabilitation, such persons had to hold a meeting to “*reach an agreement*”. In this agreement the parties had to accept an obligation to satisfy the claims of all creditors “*on schedule agreed with the creditors*”; and the persons accepting the liability under the agreement, essentially, became jointly liable with the debtor on the accepted obligations. Furthermore, forty *percent* of the total of the creditors’ claims had to be satisfied within twelve months from the onset of rehabilitation.<sup>482</sup> The creditors’ claims in a rehabilitation must have been satisfied in the same order as they would have been prioritized on insolvency. There was no moratorium available, and, in addition, there were no provisions in the law on payments of cents in a dollar (or, rather, kopeks in a Ruble) only. In fact, the courts adopted the position that the extension of the term for payment of debt or acceptance of kopeks in a Ruble “*did not constitute the means of rehabilitation and were the subject of a settlement agreement*”.<sup>483</sup>

#### Settlement

A settlement could have been reached at any stage of insolvency (Article 40), thus potentially allowing the debtor to also exit intact from the liquidation proceedings stage.<sup>484</sup>

A settlement agreement had to be approved by the creditors with the claims of fourth and below, each, orders of priority and by the court (Article 41); and the agreement was binding for the fourth and below orders of priority only. Creditors who did not agree to enter into the settlement agreement received a degree of protection *via* a provision that stipulated that their interests could not be prejudiced when compared to other creditors of the same order of priority.

Article 42 of the Law on Insolvency 1992 was drafted rather rigidly and provided that within two weeks from the approval of the settlement agreement by an arbitrazh court, the creditors must have “*received satisfaction for their claims of thirty-five percent of the debt*”. Generally, the drafting of Article 42 was not entirely clear, since it referred to the “*satisfaction of claims*” and “*debt*” but not to the *payment of debt*.

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<sup>482</sup> This blanket rule was not satisfactory, of course. If, for example, the shareholders could satisfy 40 *percent* of creditors’ claims within a year, there was, perhaps, no need for a rehabilitation at all.

<sup>483</sup> See Informational Letter of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No. 20 “Review of Practice of Application by Arbitrazh Courts of Legislation on Insolvency (Bankruptcy)”, dated 7 August 1997, item 23.

<sup>484</sup> See *Liquidation proceedings* on p.145 below.



### Liquidation proceedings

The Law on Insolvency 1992 used a special term to refer to the procedure that applied to an insolvent debtor: “*konkursnoye proizvodstvo*” in Russian. The first word, “*konkursnoye*”, may be translated into English as “tender” or “competition”; and “*proizodstvo*” simply means “proceedings”. The use of term “competition” has its roots in the history of the Russian legal tradition and is also used in modern Russian insolvency legislation.<sup>485</sup> However, the direct English translation “competition proceedings” may prove to be so misleading as to require, in the opinion of the author, the use of a more familiar translation “liquidation proceedings” instead; and this translation will be used throughout this work.<sup>486</sup>

The Law on Insolvency 1992 defined liquidation proceedings as a “*procedure directed at mandatory or voluntary liquidation of an insolvent enterprise, as the result of which [procedure] [the assets of the insolvent] were distributed to its creditors*” (Article 1). Once the court found that a debtor was insolvent, such court should “*decide on mandatory liquidation*” (i.e., rule that the debtor must be liquidated) and open insolvency proceedings. The court had a duty to notify certain persons on the opening of insolvency proceedings; characteristically, however, shareholders were not among such persons (Article 16).<sup>487</sup>

Once liquidation proceedings commenced, and unless the consent of the creditors’ committee was obtained, any transfer or other disposition of the insolvent’s assets was prohibited; and the satisfaction of claims against the insolvent was also prohibited. All claims were to be dealt within the framework of the liquidation proceedings (Article 18). As can be expected, the Law on Insolvency 1992 made an exception for some payments. Such excepted payments were “*current payments connected with the continuation of the functioning of the enterprise-debtor*” (Article 30).<sup>488</sup> As a consequence of the provisions of

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<sup>485</sup> For example, a leading Russian (pre-Soviet) jurist Gabriel Shershenivich in his *Konkursnoye Pravo (Insolvency Law in English)*, 2<sup>nd</sup> ed., Kazan’, typography of the Emperor’s University, 1898, p.1 (available through Russian legal database Garant) referred to “competition law” in its then “contemporary” meaning as “*a body of juridical rules which solved the composition of claims against assets that were insufficient for the full satisfaction [of such claims]*”. Generally, the use of the term “competition” in this context of insolvency signifies that there is a competition among creditors for the satisfaction of their claims.

<sup>486</sup> Thus, “insolvency proceedings”, as used here, refers here to proceedings in court initiated pursuant to an insolvency petition in general; and “liquidation proceedings”, as used here, refers to a specific stage in insolvency proceedings.

<sup>487</sup> And yet, shareholders are directly affected by the declaration of insolvency and cannot in all cases rely on the debtor passing on the respective notice.

<sup>488</sup> Tax-related payments, if the obligation to pay arose during one of the stages of the insolvency proceedings, were considered to be current payments. See the Resolution of the Presidium of the Supreme Arbitrazh Court No. 3521/97, dated 13 January 1998.

the Law on Insolvency 1992, the Russian courts also adopted the position that set-off in insolvency was impossible.<sup>489</sup>

Crucially, the Law on Insolvency 1992 made another exception for the payments to secured creditors: secured creditors' claims were elevated above (most) other creditors' claims and were not affected by the "lock-up" for payments during liquidation proceedings.

Article 20 of the Law on Insolvency 1992 set forth the list of the participants in liquidation proceedings: the administrator, creditors' committee, the debtor, employees and other interested persons. The position adopted by the law on the persons having the ability to participate in liquidation proceedings is important – the courts have to consider the interests of such persons in the proceedings. They are, generally, afforded the right to file petitions with the court or to appeal the court's (interim) decisions.<sup>490</sup> The Law on Insolvency 1992 omitted to refer to shareholders/members in the list; as a consequence, shareholders/members could only argue before the court that they were "*interested persons*". The outcome of the argument would depend on the view of the court on a case by case basis and this could not be considered a satisfactory solution; ultimately, the shareholders/members are in a position of the quasi-creditors of the debtor albeit with the "deepest" subordination.<sup>491</sup>

In liquidation proceedings a "*liquidation administrator*" was in charge of the affairs of the debtor; the chief executive officer of the debtor was "*removed*" on the opening of liquidation proceedings and its rights and obligations were transferred to the liquidation administrator (Article 24). The liquidation administrator had the rights to dispose<sup>492</sup> of the debtor's property, "*carried out the functions of the management of the debtor enterprise*" and called the creditors' meeting (Article 21). The liquidation administrator had to sell the assets of the debtor to the highest bidder (Article 34).<sup>493</sup>

The reader may recollect that the Law on Insolvency 1992 adopted a (modified) balance sheet insolvency test; and a debtor could manipulate its balance sheet so as to avoid a

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<sup>489</sup> See the Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.6110/98, dated 23 February 1999. The same position was re-adopted with respect to the Law on Insolvency 1998. See footnote 513 on p.152 below.

<sup>490</sup> By way of preliminary comment, the Law on Insolvency 1998 did not afford the necessary degree of protection to the interests of the company's shareholders/members during "observation" proceedings and this was one of the major flaws in the law that allowed to use it for the unintended purposes – as a takeover tool.

<sup>491</sup> Since equitable claims are, generally, satisfied on residual basis, after the claims of all creditors are satisfied.

<sup>492</sup> In Roman law, the rights of the proprietor include "*usus*", "*fructus*" and "*abusus*". Russian law employs a similar concept and the rights of a proprietor include the rights to: own, use and dispose of the property.

<sup>493</sup> This was also the procedure for secured assets.

positive result under the test.<sup>494</sup> There were many companies that could not pay their debts and were “insolvent” for any practical purposes but continued to operate, since they could circumvent *via* accounting manipulations the (positive result under the) test for insolvency. In addition, the creditors were reluctant to petition the courts on liquidation of companies that had little or no assets, since that would lead to the creditor’s out-of-pocket expenses without any foreseeable dividend coming from the debtor (creditors had to pay for liquidation proceedings). Thus, the Law on Insolvency 1992 did not “clean up” the economy (and the companies’ register) from companies that could not pay their creditors: such companies either continued to operate because the insolvency test, as applied, never yielded a positive outcome, or were never struck off from the register because there was no one willing to initiate the insolvency proceedings.

The position adopted by the Law on Insolvency 1992 in dealing with secured assets was rather unsophisticated: the secured assets were not included into the assets of the debtor that were subject to the insolvency proceedings (Article 26). Furthermore, “*debt*” claims having the benefit of security were satisfied “*outside the priorities of [liquidation proceedings]*” (Article 29). Thus, arguably, the original wording of the Law on Insolvency 1992 afforded a reasonable degree of protection to the secured creditors. Unfortunately, the secured creditors needed not rejoice at this provision of the law. The Civil Code 1994<sup>495</sup> has also dealt with insolvency and its rules changed the secured creditors’ position. According to Article 65 of the Civil Code 1994, a law on insolvency (bankruptcy) set forth the tests for insolvency and the procedures for the liquidation of insolvent companies; however, the priorities for the satisfaction of the creditors’ claims, according to the Civil Code 1994, were set forth in its Article 64. As the reader may anticipate, Article 64 of the Civil Code 1994 was not so gracious to the secured creditors. The secured creditors were put into the third order of priority, after the claims of the company’s employees for wages and certain other social claims. The surprises of the Civil Code 1994 were not exhausted at this point; and it also stipulated that, unless otherwise was provided by law, the claims of the creditors in each order of priority were satisfied *pro rata*. The Law on Insolvency 1992 had no express provision to the contrary (though initially it could have been interpreted in a contrary way), and hence the claims of all secured creditors were aggregated and then satisfied proportionately. As a consequence, it did not matter whether a secured creditor had security over the (valuable) premises of the debtor or, say, an office typewriter of negligible

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<sup>494</sup> See p.140 above.

<sup>495</sup> The Civil Code 1994, Part I, entered into force on 1 January 1995, see Federal Law No.52-FZ “On Entry into Force of Part I of the Civil Code of the Russian Federation”, dated 30 November 1994.

value; all secured claims were satisfied *pro rata* and the dividend ratio on each individual secured claim would have been exactly the same irrespective of the (value of the) secured assets. The reader may appreciate the significance of the position where any subsequent (secured) creditor simply by having the benefit of *any* security enjoyed the same rights as a creditor who had an earlier security over assets with *substantial value*. Clearly, this was unsatisfactory and made the taking of any security for a lender practically pointless.<sup>496</sup>

The original priorities under the Law on Insolvency 1992 included seven levels of subordination and were, generally, as follows: (i) claims arising out of personal injuries or death; (ii) salary-related claims and claims by authors under intellectual property agreements; (iii) claims of the (state) budget; (iv) claims of “*insolvency creditors*”; (v) claims of employees who had contributions into the assets of the enterprise; (vi) claims of other proprietors (of the debtor); and (vii) all other claims (Article 30). As was mentioned earlier, the Law on Insolvency 1992 also referred to extra- (or super-) priority claims: claims of the administrator and claims related to the “*current*” operations of the debtor, which, generally, were not subject to the restrictive *pro rata* regime of the insolvency proceedings; the courts recognized that the regime of such extra-priority claims continued to apply after the adoption of the Civil Code 1994.<sup>497</sup>

The Civil Code 1994 priorities were as follows: (i) claims arising out of personal injuries or death; (ii) salary-related claims and claims related to copyright agreements; (iii) claims of secured creditors; (iv) claims on payments to the (state) budget and off-budget funds; and (v) claims of other creditors, “*in accordance with the law*”.

### 3.C. Law on Insolvency 1998

The Federal Law No.6-FZ “On Insolvency (Bankruptcy)”, dated 8 January 1998 (the “**Law on Insolvency 1998**”) entered into force on 1 March 1998 and the operation of the new law in its early days should be put into context. Major events of the late 1990s were financial crises in Asia and Russia. The Asian financial crisis unfolded in mid-1997 and a number of Asian countries were affected. In August 1998, the Russian crisis followed. The Russian crisis is often associated with, *inter alia*, Russian “treasury bills and bonds” (the “**GKO**” and

<sup>496</sup> As it could be “defeated” by a subsequent security over a “typewriter”.

<sup>497</sup> See also the Resolution of the Plenary Session of the Presidium of the Supreme Court of the Russian Federation and the Plenary Session of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.6/8 “On Some Questions, Related to Application of Part I of the Civil Code of the Russian Federation”, dated 1 July 1996.

“OFZ”).<sup>498</sup> On the infamous day, the Russian “black Tuesday”, 17 August 1998, the Russian Government and Central Bank adopted a declaration, which stated that, *inter alia*:

*“Expenses on [the payment of principal] on the earlier issued state notes and the payment of interest on [such] notes [in the circumstances] of low tax collections became an unbearable burden for the state budget. The Government of Russia is forced to decrease internal state debt, cutting the expenses of the federal budget and entering into foreign borrowings. ...*

*However, the deepening crisis in Asia, a new fall in world oil prices did not allow for the trust in Russian securities to be restored, and, consequently, to improve the [state] budget. The depletion of foreign currency reserves is ongoing and the banking system started to experience certain difficulties.”<sup>499</sup>*

In their declaration the Government and the Central Bank announced a new exchange rate “corridor” for the devalued Ruble and their intention to restructure the GKO and OFZs; in addition, it was declared that for the residents of the Russian Federation, a moratorium on foreign exchange transactions of “capital nature” (*i.e.*, on movements of capital) was introduced. More importantly, the declaration also provided for: (i) a moratorium of ninety days on payments (of principal) on “financial credits” (*i.e.*, loans) obtained from non-residents and on payments on “term foreign currency contracts” and (ii) a prohibition for non-residents on investing in Ruble-denominated assets with maturity of one year or less. Essentially, the Government announced default on Russian state bonds and tried to adopt measures intended to protect (if that was possible) the Ruble exchange rate.

In these conditions, many companies found themselves in financial difficulties and, indeed, many were unable to pay their debts when such became due and payable. Hence, the number of initiated insolvency proceedings was bound to increase and the importance of a sound insolvency regime was elevated to new levels.<sup>500</sup> However, as discussed below in sub-

<sup>498</sup> Russian treasury bonds at that time included *Gosudarstvennye Kratkosrochnye Obligatsii* – State Short-term Bonds and *Obligatsii Federal'nogo Zaima* – Bonds of Federal Borrowing. Generally, foreign investors were not allowed to directly invest in GKO; however, returns of up to 30% on the notes were sufficient to lure them into indirect investment into the paper. The crisis led to mass divestment and difficulties of the Russian Government in servicing its debt.

<sup>499</sup> The Central Bank’s refinancing rate (interest rate charged on lending to (commercial) banks) spiked from 50% in May 1998 to 150% during the first days of June. The official exchange rate for the US Dollar set by the Central Bank fell from 6.29 Rubles on 15 August 1998 to 20.82 Rubles on 9 September 1998. Data is quoted from the Central Bank’s database, available online at [www.cbr.ru](http://www.cbr.ru).

<sup>500</sup> It is also interesting to follow the statistics of insolvency cases considered by the Arbitrazh courts. For some of the years when the Insolvency Law 1992 was in force, the statistics on cases considered is as follows: 1994 – 240; 1995 – 1,108; and in 1996 – 2,618 cases (from O.Nikitina, “This Terrible Word: Bankruptcy”, *Business-Advocat*, No.9, 1997). The statistics for cases considered by the Arbitrazh courts when the Law on Insolvency 1998 was in force is as follows: 1998 – 2,628; 1999 – 5,959; in 2000 – 10,485; 2001 – 18,993; and in 2002 – 44,424 cases. It

section *Observation*,<sup>501</sup> the Law on Insolvency 1998 appears to have failed to fulfill the role of the “right law, in the right time”. It is largely remembered for its extensive use for the purposes of gaining corporate control in hostile takeovers.

**(i) Insolvency Test**

The Law on Insolvency 1998 made a 180-degree turn from the position of the Law on Insolvency 1992 and introduced a cash flow insolvency test (for bodies corporate). Generally, the Law on Insolvency 1998 differentiated in approach to individuals and companies. For individuals the Insolvency Law 1998 required that both cash flow and balance sheet insolvency criteria are satisfied in order to initiate bankruptcy proceedings; however, the regime for the bankruptcy of individuals is not considered here further.

According to the new test, a petition on the opening of insolvency proceedings with respect to a body corporate could be filed:<sup>502</sup> (i) in connection with the non-payment of “*monetary obligations*” or “*mandatory payments*”; and (ii) if the claims against the company were in aggregate five hundred minimal monthly wages<sup>503</sup> or more. For the purposes of the Law on Insolvency 1998, a company was considered to fail to pay, if its due and payable monetary obligations remained outstanding for three months (Article 3).<sup>504</sup> Furthermore, the Law on Insolvency 1998 expressly clarified what sums were included into the calculation of

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also interesting to consider how many petitions related to insolvency (bankruptcy) was filed with the arbitrazh courts: 1998 – 12,781, 1999 – 15,583; 2000 – 24,874; 2001 – 55,934; and in 2002 – 106,647 petitions. In 2003 the growth trend for petitions reversed and only 14,277 petitions were filed.

As the reader may note, the number of cases considered by the courts, generally, grew after the adoption of the Law on Insolvency 1992 and stabilized in 1996-1998 (pre-crisis). As could be anticipated, in 1999, after the 1998 crisis, the number of cases considered and petitions filed started to increase again (with growth year *per year* often as large as 200 *percent*) In 2003, however, petitions decreased almost tenfold. There may have been several reasons for this, including improvements in the Russian economy; however, the adoption of the new, significantly improved, Russian law on insolvency in late 2002 may have been an important factor. Source for statistics for years 1998-2003: database maintained by the Supreme Arbitrazh Court of Russia, available online at <http://www.arbitr.ru/press-centr/news/totals/>. Note: the law on insolvency adopted in 2002, generally, entered into force on 2 December 2002 and hence, the statistics for year 2002 relates in the major part to the Law on Insolvency 1998.

<sup>501</sup> P.152 below.

<sup>502</sup> The Law on Insolvency followed the approach of the Law on Insolvency 1992 in that that only arbitrazh courts had jurisdiction over insolvency proceedings (Article 29).

<sup>503</sup> Minimal monthly wage is set by the government; it is generally used as an index for calculation under statutes and not as a minimal monthly wage proper. In 1998 the minimal monthly wage was set at approximately 83 Rubles. Thus, 500 minimal wages converted to approximately 6,700 and 2,000 US Dollars at the official exchange rates on 1 July and 31 December 1998, respectively.

<sup>504</sup> Unlike the Law on Insolvency 1992, the Law on Insolvency 1998 included a definition for monetary obligations (generally, everything arising out of civil law relationships) and mandatory payments (generally, payments into the federal or local budgets and funds).

“*monetary obligations*”: for example, interest was counted in; penalties, however, were not (Article 4).<sup>505</sup>

As an immediate consequence of the changed approach towards the insolvency test (from mainly balance sheet to cash flow), it became easier for creditors to petition the courts for insolvency proceedings and more difficult for debtors to circumvent impending insolvency *via* manipulations with their balance sheets.<sup>506</sup> This change had mixed reception. In particular, authors often pointed out that in an economy where non-payment was commonplace and also, perhaps, in the circumstances of a financial crisis, the introduction of the cash flow insolvency test was lethal for far too many companies; and of course, considerations of social nature (*e.g.*, job security) were often raised by such authors.<sup>507</sup> However, the change to the cash flow insolvency test was, apparently, necessary so as to allow the legislation to “clean up” inefficient companies from the economy and improve management practices<sup>508</sup> and it was unfortunate that the introduction of the new insolvency test coincided with a deep economic crisis in Russia.

## **(ii) Insolvency Procedures**

The Law on Insolvency 1998 provided for the following insolvency procedures: (i) “*observation*”; (ii) external administration; (iii) liquidation proceedings; and (iv) settlement (Article 23).<sup>509</sup> As the reader may note, rehabilitation<sup>510</sup> was excluded from the list of insolvency procedures and observation was added.

<sup>505</sup> Generally, clarifications were aligned with the positions adopted by the courts prior to the entry of the Law on Insolvency 1998 into force. However, since there is officially no doctrine of *stare decisis* in Russian law, the inclusion of the clarification in the law was important.

<sup>506</sup> See p.140 above.

<sup>507</sup> For a critical view, see, *e.g.*, A.Gerasimov, “A Contract on the Debtor?”, *Business-advocat*, 2001, No.21. For a discussion of the Law on Insolvency 1992 and Law on Insolvency 1998 tests, see, *e.g.*, V.Vitryanskii, “Routes to Improvements of Legislation on Bankruptcy”, *Vestnik VAS RF*, 2001, No.3.

<sup>508</sup> See p.147 above.

<sup>509</sup> The Law on Insolvency 1998 left the door open for “*other procedures*” that were provided for in that law.

<sup>510</sup> See *Rehabilitation* on p.143 above. Since rehabilitation was rarely used, its exclusion as an insolvency procedure in the law had limited effect in practice. Nevertheless, rehabilitation was not excluded altogether from the Law on Insolvency 1998: Article 27 was dedicated to “*out-of-court rehabilitation*”. As the name implies, courts were not involved in out-of-court rehabilitations under the Law on Insolvency 1998. In out-of-court rehabilitation, a debtor’s shareholders/members, creditors or other persons provided financial assistance to the debtor, so that such financial assistance was sufficient for the debtor to pay its monetary obligations or mandatory payments. The provision stipulated that the debtor could accept obligations towards the person(s) providing financial assistance. Thus, provisions on out-of-court assistance did not carry much weight, except, perhaps, for the mentioned restriction on sufficiency of the financial assistance. It also appears that provisions on financial assistance could be used to circumvent the Russian Civil Code 1994 restriction on gifts between commercial companies (Article 575.1(4) of the Civil Code 1994). However, in the context of impending insolvency, it appears that there may have been also other ways to reschedule or swap debt obligations: see, for example, the Informational Letter of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.104 “Review of Practice of Application by Arbitrazh Courts of Rules of Civil Code RF on Some Grounds for Termination of Obligations”, dated 21 December 2005, where a creditor’s promise to forgive interest if the debtor (apparently, in financial difficulties) paid the principal without delay was not treated as a gift.

## Observation

According to the Law on Insolvency 1998, observation was introduced automatically when an arbitrazh court accepted a petition on insolvency (Article 56). Introduction of observation entailed a moratorium on the satisfaction of creditors' claims. Moratorium did not apply to certain judgment debts of social nature,<sup>511</sup> which arose before the insolvency petition was accepted by the court (Article 57).<sup>512</sup>

In interpretation of the provisions on moratorium, at that time Russian courts came to the conclusion<sup>513</sup> that, since in any liquidation proceedings the procedures (and priorities) for the satisfaction of creditors' claims is set forth by the law, any (insolvency) set-off was impossible.

According to Article 58, the debtor's chief executive officer and other management bodies continued to carry out their functions, albeit with restrictions provided in the law.

The restrictions on the debtor's own management were quite severe and could practically bring the operation of the company to a halt. These included, *inter alia*, restrictions on:

- transactions with real property (virtually all dealings were prohibited);
- transactions with asset(s) with balance sheet value of ten or more *percent*;
- transactions on granting/receiving of loans (credits), granting of suretyships and guarantees, assignments and novations;
- reorganizations (*i.e.*, mergers, acquisitions, splits, spin-offs and changes of corporate form);
- incorporation of, or participation in, (other) companies;
- payments of dividends;
- the issuance of bonds or other securities; and
- share buy-backs.

The decisions in the list above could only have been taken with the consent of the "*interim administrator*". The interim administrator was appointed by the court; and the candidates for the appointment were nominated by the creditors (Article 59).<sup>514</sup>

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<sup>511</sup> Wages, injury claims, *etc.*

<sup>512</sup> However, the courts limited the application of this provision. In the Resolution of the Presidium of the Supreme Arbitrazh Court No.2577/99, dated 7 December 1999, the court ruled that this applied only to "payment obligations" and "mandatory payments", as defined by the Law on Insolvency 1998.

<sup>513</sup> See, *e.g.*, the Resolution of the Presidium of the Supreme Court of the Russian Federation No.5951/99, dated 28 March 2000.

<sup>514</sup> There was also a fall-back option when no candidates were nominated: the court chose administrators from the list of administrators registered with that court. The reader may recollect that the same approach was adopted by the Law on Insolvency 1992; however, the problem was that often there were no administrators



The functions of the interim administrator were somewhat similar to that of the external administrator *per* Law on Insolvency 1992.<sup>515</sup> The interim administrator had powers to petition the court (in own name): to declare debtor's transactions void;<sup>516</sup> to adopt measures to ensure the preservation of the debtor's assets; to suspend the debtor's chief executive officer; and request any information and documents<sup>517</sup> (Article 60).

The arbitrazh court was given the power to "*suspend*" the debtor's chief executive officer if:

*"[it] did not adopt the necessary measures in order to ensure the preservation of the debtor's assets, or impediments for the fulfillment of the interim administrator's functions were created or other violations of Russian legislation were committed."*

The chief executive officer's functions were then carried by the interim administrator.

As was mentioned above, one of the functions of the interim administrator was to convene the creditors' first meeting. The creditors' first meeting had the authority to petition the court to introduce external administration or initiate liquidation proceedings. It is interesting to note that the Law on Insolvency 1998 provided for various outcomes of the creditors' first meeting and the steps that the court had to take, depending on the outcome; however, the eventuality that the creditors decided that the debtor should simply continue to operate was not provided for by the law.<sup>518</sup>

The reader may have been troubled so far by a suspicion lurking behind the black letter of the Insolvency Law 1998: was not the observation a convenient tool for hostile (and, perhaps, also unfair, if not quasi-illegal) takeovers/acquisitions? The answer is in the positive: indeed it was such a tool. It is sufficient to (re)consider the following to recognize the possible uses of observation in practice:

- observation was introduced *automatically* after the court accepted a petition on insolvency, the debtor could not even make any representations to the court at this stage;
- the interim administrator was, generally, nominated by the creditor filing the petition;

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registered with the court. The Law on Insolvency 1998 remedied this with a provision allowing to appoint a candidate nominated by the government insolvency authority.

<sup>515</sup> See p.143 above.

<sup>516</sup> Essentially, these were transactions that could be declared void pursuant to provisions of the Law on Insolvency 1998.

<sup>517</sup> And there was a corresponding obligation of the managing bodies of the debtor to provide any requested information to the interim administrator.

<sup>518</sup> That is to say the Law on Insolvency 1998 dealt with the situations when the creditors petitioned for external administration, liquidation proceedings or took no decision at all. There was no provision for the case, when the creditors decided that the insolvency proceedings should be terminated.

- the interim administrator had access to *all* information of the debtor (including any sensitive/confidential information);
- the debtor was deprived of the ability to carry out financial transactions without the consent of the administrator (restriction on loans, *etc.*, pursuant to Article 58);
- the interim administrator could transfer debtor’s financial assets to third parties (*e.g.*, transfer the debtor’s funds to other, more administrator-“friendly”, banks);
- the interim administrator could petition the court to remove the chief executive officer if the chief executive officer did not cooperate with the administrator (the lack of cooperation would only have been natural under the circumstances); and
- once the chief executive officer was removed, the interim administrator could enter into any transactions on behalf of the debtor (thereby, for example, transferring the debtor’s “crown jewels” to the “sponsors” of the takeover).

The timeline of an insolvency law-led takeover could be: (i) a petition on insolvency was filed with a court that “sympathized” to the interests of the bidder; (ii) the court accepted the petition (with observation automatically setting in) and appointed an interim administrator; (iii) in reliance on its wide powers, the interim administrator “interfered” with the operations of the target; (iv) the chief executive officer of the target was removed and replaced with the interim administrator; (v) the interim administrator either inflicted financial damage on the target thereby forcing its shareholders to cede control to the bidder or assets of the target were transferred to the bidder at below-the-market prices.

The following quote is appropriate at this point:

*“Since 1998, the major targets of hostile takeovers have been:*

- *Profitable export-oriented enterprises (e.g., aluminum, steel or cellulose production, electric machine-building);*
- *Enterprises of the so-called “fuel and energy complex” (oil and gas mining facilities, oil processing plants, electric power plants, etc.);*
- *Ore-processing plants (vanadium, strontium, etc.) and similar enterprises that supplied vital ingredients to metallurgical enterprises and were, therefore, vital for creating vertically integrated business groups;*
- *Enterprises in consumer industries that have a stable market for its products (alcohol, food, cosmetics, and the like); and*

- *Any enterprise possessing valuable assets that could be profitably sold.*<sup>519</sup>

There were numerous cases where the Law on Insolvency 1998 was used to “take over” major companies; such takeovers often were widely covered in the press and conflicts between shareholders of the “bidder” and the target “filtered” through to political levels.

If the defects in the Law on Insolvency 1998 were put into the context of a jurisdiction that had introduced the principles of free market only recently and where the independence of courts<sup>520</sup> was something that was only being created, it is then easy to understand why the insolvency law of that period was a failure. One explanation is that the legislator could have been misled by the perception that under the Law on Insolvency 1992 regime, the debtors, once insolvency petition was filed, immediately started to dissipate their assets or otherwise made their assets unavailable to the creditors.<sup>521</sup> Some characteristics of the observation appear to have been designed to remedy these perceived problems: *e.g.*, the “automaticity” of observation and the powers of the interim administrator to access information related to the debtor. However, it is simply astonishing how ill-conceived the purported remedy was; and it should not surprise the reader that the Law on Insolvency 1998 did not have a long life.<sup>522</sup>

In 2001, some of the shortcomings of the Law on Insolvency 1998 were officially recognized. The Constitutional Court of the Russian Federation ruled that the provisions of the Insolvency Law 1998 that did not allow the debtor any representation in the acceptance of the petition on insolvency and, in that way, the introduction of observation, were unconstitutional. The provision was declared unconstitutional, as:

*“at the stage of the invoking [in court] of the insolvency proceedings, it allowed to introduce observation on the basis of the petition on insolvency, without providing the debtor with an opportunity to make its representation or to appeal the resolution [of the court] that accepted the petition on insolvency, which introduced observation in relation to the debtor.”*<sup>523</sup>

<sup>519</sup> From an excellent article on the subject V.Volkov, “Hostile Enterprise Takeovers: Russia’s Economy in 1998–2002”, 29 (4) *Review of Central and East European Law* (2004) 527-548.

<sup>520</sup> With the qualification that the accuracy of the following indicator may be disputed and, generally, is of limited usefulness, according to the Corruption Perception Index (Transparency International), the 1998 results for the Russian Federation were sufficient to rank it number 76 out of 85 positions. Available online at [http://www.transparency.org/policy\\_research/surveys\\_indices/cpi/previous\\_cpi/1998](http://www.transparency.org/policy_research/surveys_indices/cpi/previous_cpi/1998).

<sup>521</sup> This indeed could be done, for example, *via* the use of shell companies. See p.140 above.

<sup>522</sup> The Law on Insolvency 1998 was replaced by the Federal Law No.127-FZ “On Insolvency (Bankruptcy)”, dated 26 October 2002.

<sup>523</sup> The Resolution of the Constitutional Court No.4-P, dated 12 March 2001.

A year after the provision in question was declared unconstitutional, the Law on Insolvency 1998 was repealed and replaced with new legislation.<sup>524</sup>

#### External administration

External administration *per* the Law on Insolvency 1998 was an insolvency procedure similar to that provided for by the Law on Insolvency 1992.<sup>525</sup>

External administration was introduced by the court pursuant to a decision made at a creditors' meeting (Article 68). Generally, such a decision would have been taken at the creditors' first meeting (during observation). However, the court also could introduce external administration either on its own initiative (if there was no creditors' decision available), or notwithstanding the decision of the creditors to the contrary, if the court was satisfied that the debtor had the potential to restore its solvency (Article 67). The duration of external administration was limited to twelve months, but this could be extended by a further six months.

During external administration a moratorium was available (Article 70). Provisions on the moratorium under Law on Insolvency 1998 differed from those of the Law on Insolvency 1992.<sup>526</sup> A moratorium under the Law on Insolvency 1998 covered monetary obligations and mandatory payments which became due and payable *before the onset* of external administration;<sup>527</sup> and the law expressly provided that that neither interest,<sup>528</sup> nor penalties applied during external administration. Similarly to the Law on Insolvency 1992, the Law on Insolvency 1998 excluded certain claims of social nature for the scope of a moratorium.

Also similarly to the regime of the Insolvency Law 1992, the debtor's chief executive officer and (other) management bodies were "*suspended*" from their functions and the management of the debtor was vested with the external administrator (Article 69).

The Law on Insolvency 1992 included provisions on "claw-backs", which allowed a liquidation administrator to petition the arbitrazh court to void debtor's transactions. The Law on Insolvency 1998 granted similar powers also to an external administrator (Article 78). For transactions with an interested party, there was no specific "suspicious" period and any such transaction could be declared void, if it caused, or could cause, losses to creditors. For other types of voidable transactions, the "suspicious" period was six months from the

<sup>524</sup> Federal Law No.127-FZ "On Insolvency (Bankruptcy)", dated 26 October 2002.

<sup>525</sup> See *Law on Insolvency 1992. Insolvency Procedures. External administration* on p.142 above.

<sup>526</sup> See p.142 above.

<sup>527</sup> Under the Law on Insolvency 1992, there was no exception for claims that arose after the introduction of the moratorium.

<sup>528</sup> Under the Law on Insolvency 1992 regime, interest continued to apply.

initiation of insolvency proceedings, or the onset of external administration (depending on the type of the transaction).

### Liquidation proceedings

Liquidation proceedings were initiated once the court decided that the debtor was insolvent (Article 97). The law limited liquidation proceedings to a term of one year, which could be extended by the court, if necessary.

With the onset of liquidation proceedings all monetary obligations of the debtor became due and payable and the same applied to the suspended mandatory payments; however, interest and penalties ceased to apply;<sup>529</sup> and the performance of any obligations of the debtor, and transactions connected with the transfer of debtor's assets to third persons, could only be carried out as provided for by the Law on Insolvency 1998 (Article 98).<sup>530</sup> In addition, information related to the financial position of the debtor ceased to be confidential. Russian courts decided that there was no reciprocating rule on the acceleration of debts owed to the insolvent.<sup>531</sup>

The debtor's management bodies (including the chief executive officer) were "*suspended from [their] functions*"<sup>532</sup> and the affairs of the debtor were managed by the liquidation administrator.

There was also a requirement to publish a notification on the debtor's insolvency and the law expressly provided that this should be paid from the debtor's funds. (Article 100).<sup>533</sup>

By way of illustration of the liquidation administrator's functions, the Law of Insolvency 1998 referred, *inter alia*, to the following: inventory reconciliation; collecting the debtor's receivables; notification of the employees on the impending termination of employment;

<sup>529</sup> Liquidation proceedings could have been preceded by external administration. External administration could last up to and including eighteen months, during which interest and penalties also did not accrue. Therefore, the creditors could lose several years worth of interest payments.

<sup>530</sup> That is to say that the Law on Insolvency 1998 took priority over: any provision of a contract entered into by the debtor; and any rule of the civil legislation.

<sup>531</sup> See the Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation, No.1020/99, dated 15 June 1999. The case concerned the insolvency of a bank and the court found that the bank's loans could not be accelerated by reason of the insolvency of the bank.

<sup>532</sup> Such a suspension could happen earlier, either at the observation (at court's discretion), or external administration, stages. See *Observation* on p.152 above and *External administration* p.156 above, respectively.

<sup>533</sup> According to the Law on Insolvency 1992, such a publication was paid for from the "deposit account" of the court. The deposit account was generally funded by the creditor(s) and later reimbursed from the debtor's assets. If the debtor was a shell, or abandoned, company, the creditor had no prospects of being reimbursed. Therefore, the provision in the Insolvency Law 1998 better served the interests of the creditors. Notwithstanding the Law on Insolvency 1998 proviso, if the debtor was absent and had no assets at all, the insolvency administrator would have to raise the funds for the publication elsewhere. The Law on Insolvency 1998 included specific "simplified" insolvency procedure for an "absent" debtor (Paragraph 2 of Chapter X). Regrettably, the simplified insolvency procedure did not consider the question how the insolvency administrator raised the funds for the publication.

and disclaiming the debtor's agreements.<sup>534</sup> The liquidation administrator also could claim against persons who were liable for the "*driving the debtor into insolvency*".<sup>535</sup>

Creditor priorities were dealt in the Law on Insolvency 1998 in the following way. Court expenses, administrators' compensation, current utility bills and creditors' claims that arose during observation, external administration and/or liquidation proceedings were super-priority claims (Article 106). Other creditors were prioritized in the following way: (i) claims related to death and injury; (ii) employment-related claims; (iii) claims having the benefit of security; (iv) claims related to mandatory payments into (state) budget and off-budget funds; and (v) claims of other creditors. With respect to the fifth order of priority, the Law on Insolvency 1998 introduced a two-tier structure. Damages and penalties were kept on a separate claims' register and were subordinated to the payments of claims for principal and interest. Claims arising out of "*the holding of shares or participating in the company*" were specifically excluded from the fifth order of priority, and essentially, were subordinated to a lower, "sixth" level, though such a language was not used by the Law on Insolvency 1998. The insolvency administrator paid out the creditors' claims in their order of priority, and if there were insufficient funds to satisfy the claims of a certain order of priority, all claims of that order were satisfied *pro rata* (Article 114).<sup>536</sup>

With respect to the third order of priority, the reader would have immediately noted the unusual provisions of the law and wondered whether the secured creditors in effect had to share their security. The Law on Insolvency 1998 expressly answered this question (Article 109); and the answer was the one that financiers did not find appealing: indeed, all secured creditors' claims were aggregated and satisfied *pro rata*. Furthermore, secured creditors were subordinated to any claims with super-priority and the preceding, first and second, priorities.

Another peculiarity of the Law on Insolvency 1998 was even more staggering: secured claims (more precisely, the claims of third priority, since, as mentioned above, only the secured

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<sup>534</sup> Insolvency administrator could petition the court to disclaim the debtor's agreements on the same grounds as external administrator.

<sup>535</sup> According to Article 56 of the Civil Code 1994, a company's shareholder(s) or person(s) which could issue directions mandatory for the company could be held liable for "*driving the company into insolvency*".

<sup>536</sup> There were certain exceptions from the *pro rata* rule in the Law on Insolvency 1998.

The Law on Insolvency 1998 also provided that creditors whose claims were not fully satisfied in insolvency could claim against person(s) who "*illegally received*" assets of the debtor. The right to claim remained for a period of ten years after the insolvency proceedings were complete. In order to form an opinion on the ten year period provided for by the law, it must be compared to the general statute of limitations in the Civil Code 1994, Article 181: three years for void transactions and one year for voidable transactions. Given this context, it appears that ten years was an excessively long period which created significant uncertainty and unquantifiable risks for creditors dealing with the debtor before its insolvency.

part of a claim had the benefit of the third order of priority) were appropriated to *all* assets of the debtor and not just the assets over which security was held. For a practitioner familiar with the western concept of security, this provision of the Law on Insolvency 1998 on priority of secured claims may seem absurd. Consider the case of a project lender(s) financing a US Dollar 100 million development of a trade center with the tenor of the facility of twenty-five years: the project lender(s) would have required security over, *inter alia*, land, construction materials and the building itself (as it was erected). Let us assume that there also were ten other creditors providing to the borrower 364-day overdraft facilities of US Dollar 5 million each, and each having security over one and the same borrower's office typewriter. Let us also assume that after the super-priority claims and claims of the first and second orders of priority were paid out, there was only the trade center (worth US Dollar 100 million) left to satisfy the claims of other creditors. Pursuant to the Law on Insolvency 1998, *all* secured creditors had the same dividend ratio: 66.6 cents in a dollar. The project lender(s) would have received US Dollar 66 million and each of the remaining creditors (mind the reader, with security over a typewriter) would have received US Dollar 3.3 million. The overdraft creditors' claims would have "eaten into" the trade center, which had been financed by the project lender.

In the above scenario, why should a project lender burden itself with the (complicated) taking of security over land and buildings? Security over an office typewriter would have been just as good. In addition, anyone taking subsequent security over any asset of the borrower "shared" the proceeds of the sale of the assets that had been earlier financed by the project lender(s). Thus, why a lender should burden itself with long-term projects? The shorter the tenor of the loan, the less there is the chance that the borrower provides any other security to other creditor(s). Arguably, the approach adopted by Russian law in relation to the priority of secured claims was inadequate.<sup>537</sup>

In order to satisfy the creditors' claims, assets of the insolvent debtor had to be sold by the liquidation administrator. The administrator was not at freedom to sell the assets as he/she saw fit: pursuant to a general rule, the mechanism and the timeline for the sale must have been approved by the creditors. The Law on Insolvency 1998 required that the assets of the

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<sup>537</sup> The position of Russian jurists at that time on the Law on Insolvency 1998 rules on priorities of secured claims is not clear. For example, a prominent Russian jurist, Vasilii Vitryanskii (at the time of writing, a Deputy Chairman of the Supreme Arbitrazh Court of the Russian Federation) in his "New [Developments] in Legislation on Insolvency (Bankruptcy)", *Economy and Law*, No.3, 1998, refers to the secured claims' priority but remains silent on its disadvantages.

debtor were sold at a public auction;<sup>538</sup> however, pursuant to a creditors' decision, other procedures could also be used for the sale of the debtor's assets (Article 112). The rule on holding an auction made no exception for the secured creditors, and so they had to wait until the liquidation administrator completed the sales.<sup>539</sup> If an asset could not be sold at the first auction, the liquidation administrator was entitled to sell the asset without a further auction; alternatively, a second auction could also be held.

### **3.D. Law on Insolvency 2002**

As has been discussed in *Law on Insolvency 1998* above, the insolvency regime that was adopted in the late 1990s in Russia was deficient.<sup>540</sup> For example, pursuant to that regime, a debtor was deprived of the right to contest in court the commencement of the insolvency proceedings. At the same time, the opening of insolvency proceedings could significantly affect the debtor's operations; and this was often used by debtor's competitors in *mala fide*. The rule, according to which the debtor had no representation in the opening of insolvency proceedings, was ultimately declared unconstitutional in 2001.<sup>541</sup> Not long after the respective decision of the Constitutional Court, a new law on insolvency, the Law on Insolvency 2002, was adopted.<sup>542</sup> The Law on Insolvency 2002 is the main current Russian source of insolvency law.

#### **(i) Insolvency Test. Insolvency Petition**

The insolvency test under the regime of the Law on Insolvency 2002 is a variation of the cash flow approach; and the language of the Law on Insolvency 2002 is similar to that of the Law on Insolvency 1998.

The Law on Insolvency 2002 defines insolvency as:

*"... the inability of the debtor to satisfy in full its monetary obligations to the creditors and (or) fulfill the obligations to pay mandatory payments, as established by the arbitrazh court."*<sup>543</sup>

<sup>538</sup> Russian law provides for a regime for assets that cannot be traded freely (Article 129 of the Civil Code 1994). Such assets could not be sold at a public auction and a special procedure was provided for by the Law on Insolvency 1998.

<sup>539</sup> That is to say, that the creditor had no powers to appoint an administrator to realize the respective secured assets on behalf of that creditor.

<sup>540</sup> See also the discussion in V.Vitryanskii, "Routes to Improvements of Legislation on Bankruptcy", *Vestnik VAS RF*, 2001, No.3.

<sup>541</sup> The Resolution of the Constitutional Court No.4-P, dated 12 March 2001. See for more information p.155 above.

<sup>542</sup> The Law on Insolvency 2002 has been amended on numerous occasions. This discussion here refers to the Law on Insolvency 2002 as amended on 19 July 2009 – the latest version at the time of writing.

<sup>543</sup> Article 2.



A monetary obligation is defined as the obligation of the debtor to pay to the creditor an amount certain pursuant to a civil law transaction and/or on another basis provided for by the Civil Code 1994 or budgetary law.<sup>544</sup> Mandatory payments, generally, are taxes, state fees, fines and penalties related thereto, and administrative and criminal penalties.

With respect to a body corporate,<sup>545</sup> and taking into account the definitions above, the insolvency test under the Law on Insolvency 2002 is: whether any monetary obligation and (or) mandatory payment remain(s) outstanding for three months after becoming due and payable. The Law on Insolvency 2002 follows the approach adopted earlier by the Law on Insolvency 1998 and sets a threshold amount of overdue indebtedness that the creditor(s) filing the insolvency petition must prove to the court: 100,000 Rubles<sup>546</sup> (for a debtor, which is a body corporate).

The law requires that a monetary obligation or claim is confirmed by a judgment on recovery of debt.<sup>547</sup> It is easy to appreciate the consequences of this requirement. On the one hand, it complicates insolvency procedure for the creditors. A creditor has to involve courts at least twice: to obtain the ruling on recovery of debt; and to consider the insolvency petition.<sup>548</sup>

There are two sets of rules in the Law on Insolvency 2002 related to the determination of the amounts of payment obligations and mandatory payments taken into account in insolvency proceedings: (i) what is taken into account; and (ii) when the respective amounts “crystallize” for the purposes of the insolvency proceedings.

What payment obligations and mandatory payments are taken into account in insolvency proceedings? Relevant payment obligations include overdue payments for goods delivered, services rendered, loans outstanding (including interest), debts arising out of unjust enrichment, debts arising out of torts related to creditors’ assets. Super-priority claims<sup>549</sup>

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<sup>544</sup> Broadly speaking, “budgetary law” is concerned with relationships involving state budget.

<sup>545</sup> As has been mentioned on p.150 above, insolvency regimes for individuals are not considered here. However, it is interesting to note that the insolvency test for individuals is different and requires that: (i) overdue indebtedness remains outstanding for three months; and (ii) the individual’s assets are less than his/her liabilities. Thus, both balance sheet and cash flow tests apply to individuals.

<sup>546</sup> Equivalent to approximately 3,400 US Dollars at the time of writing.

<sup>547</sup> Despite this requirement of the Law on Insolvency 2002, the courts adopted the view that a creditor’s claim declared in insolvency proceedings, is a “means of protection of right”, and, therefore, interrupts the running of the statute of limitations. See the Resolution of the Plenary Session of the Supreme Arbitrazh Court of the Russian Federation No.29 “On Some Questions of the Practice of Application of the Federal Law “On Insolvency (Bankruptcy)”, dated 15 December 2004. It is an interesting discussion topic whether the requirement on court judgments supporting an insolvency petition will be relaxed in the future.

<sup>548</sup> This may be compared to English law statutory demand procedure in Insolvency Act 1986, Section 123(1)(a). Under the Insolvency Act 1986 a creditor simply has to serve a written demand requiring to pay the sum due (which has to be over £750).

<sup>549</sup> Personal injury, wages, and copyright-related claims, etc.

and shareholders' (members') claims, which are related to the participation in the company, are excluded from this category.

The Law on Insolvency 2002 stipulates that any penalties (arguably, including default interest)<sup>550</sup> which apply on non-performance or improper performance of an obligation, interest on late payments,<sup>551</sup> pure economic losses, and other pecuniary or financial sanctions, including those applicable on non-payment of mandatory payments, are not taken into account.

At what time the amounts of payment obligations and mandatory payments become "fixed"? The starting point is the date when the insolvency petition was filed (Article 4).<sup>552</sup>

Special rules apply to obligations denominated in a foreign currency. Such an obligation is converted into Rubles at the exchange rate set by the Central Bank of Russia at the date of the onset of each insolvency procedure (provided that the payment obligation arose prior to that insolvency procedure). The rule on the conversion of obligations in foreign currency is interesting in that it "locks" the creditor into a fixed obligation in Rubles, and eliminates currency exchange rate fluctuations during the respective insolvency procedure.

The rules of the Law on Insolvency 2002 outlined in the above paragraphs covered claims that existed at the date when the insolvency petition was filed. The naturally flowing question is what treatment is afforded to monetary claims and mandatory payments arising after the petition? Such claims and payments are referred to by the law collectively as "*current payments*" and are not considered to be insolvency claims proper and are not included into the register of creditors' claims (Article 5).<sup>553</sup> A current payments' creditor does not participate in the insolvency proceedings; however, if its right(s) is/are affected, such a

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<sup>550</sup> Russian courts appear to have adopted the view that default interest is a penalty, rather than a genuine price for the increased risk on continuing to lend to a debtor in default. See also footnote 612 on p.176 below.

<sup>551</sup> Generally, late payment is a breach of obligation, so sums payable in connection therewith may be viewed as penalties under Russian law. However, there are specific rules on interest that accrues on "*use of other's funds*" – see *Penalty* on p.129 below.

<sup>552</sup> The drafting of the provision was not very successful, it appeared to refer also to claims that did not exist at the date when the insolvency petition was filed; and the Russian Supreme Arbitrazh Court had to rule that the rule applied only to claims existing at the day when the petition was filed. The Resolution of Plenary Session of the Supreme Arbitrazh Court of the Russian Federation No.4 "On some Questions, Related to the Entry into Force of the Federal Law "On Insolvency (Bankruptcy)"" , dated 8 August 2003.

<sup>553</sup> Cf. Insolvency Act 1986, Section 233, related to the supply of gas, water, electricity, etc., which could be equated to "current payments". Section 233 states that the supplier may require a personal guarantee from the "*office holder*" (e.g., the administrator); however, the supplier may not condition the continuation of supply on payments of charges related to the period prior to the "*effective date*" (e.g., insolvency). Though the Law on Insolvency 2002 provides for some form of protection of the suppliers' interests, it lacks the latter part – the "anti-extortion" provision.

creditor is given the power to seek review of the actions of the insolvency administrator<sup>554</sup> in court.<sup>555</sup> Generally, current payments' creditors enjoy special treatment; they are, *inter alia*: not subject to the moratorium during external administration (Article 95) and are allowed super-priority in liquidation proceedings (Article 134).

**(ii) Obligation to File Insolvency Petition. Subsidiary Liability**

In addition to a creditor or a (government) authority, the debtor itself is entitled, or required, as the case may be, to file an insolvency petition. There are several cases, when the debtor is required to file for insolvency; however, for the purposes of this work only three such cases are relevant.

First, the obligation to file an insolvency petition arises if the satisfaction of claim(s) of a creditor, or several creditors, will lead to the inability of the debtor to pay in full the mandatory payments and/or other payments to other creditor(s). The second relevant case is where enforcement action against debtor's assets "*would significantly impede or make impossible the [continuation of the debtor's] business activities*". Finally, a petition must be filed when the debtor meets the cash flow, or balance sheet, insolvency test. The debtor's chief executive officer must file an insolvency petition as soon as possible and, in any case, within a month from the date when any circumstance mentioned above arose (Article 9).<sup>556</sup>

In many cases, Russian law does not expressly provide for a remedy or liability for the breach of an obligation; however, not so with respect to the Law on Insolvency 2002 rules on mandatory insolvency petitions: in fact, there are two avenues for action by the aggrieved creditors. First, the law stipulates that if, *inter alios*, the chief executive officer, or members of the management bodies of the debtor, breach its/their respective obligation to file for insolvency, it/they become(s) liable for damages arising out of such a breach (Article 10). This venue, of course, requires that the creditor proves damages.<sup>557</sup> The other avenue is *via* the subsidiary liability of the persons in breach of its/their obligations to file for insolvency: the Law on Insolvency 2002 provides that such person(s) incur(s) liability subsidiary to that of the company with respect to the obligations (of the company) that arose after the

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<sup>554</sup> An insolvency administrator is a collective term used by the Law on Insolvency 2002 to refer to administrators who perform various functions with respect to the debtor and its assets, depending on the current insolvency procedure. For example, an administrator in external administration replaces the management of the debtor.

<sup>555</sup> This important provision was introduced into the Law on Insolvency 2002 only in December 2008. Generally, it is easy to imagine a situation where current payments creditors may be dissatisfied with conduct of the insolvency administrator; however, prior to the amendment, they had no remedies. See the Federal Law No.296-FZ "On the Making of Amendments to the Federal Law "On Insolvency (Bankruptcy)"" , dated 30 December 2008.

<sup>556</sup> Generally, Article 9 is directed at the prevention of an insolvent company continuing to trade (and, perhaps, incurring new debts, which will apparently never be paid).

<sup>557</sup> On the contrary, the chief executive officer may advance arguments to the effect that no damages were caused, as the position of the claimant creditors was not prejudiced with the delay.

insolvency petition should have been filed.<sup>558</sup> The attractiveness of this option lies in the fact that the creditors do not need to prove damages; however, they must demonstrate that the debtor became insolvent before the obligation(s) were incurred.<sup>559</sup>

The liability provisions of the Law on Insolvency 2002 also extend to “*persons, who control the debtor*” (Article 10). The respective provisions are convoluted and, generally, refer to the compensation of damages caused by the debtor in complying with the directions of its controlling persons. The liability of controlling persons is joint and several.

Not only the Law on Insolvency 2002 includes rules on the liability of controlling persons and the chief executive officer, but also the Civil Code 1994 includes a provision that the creditors may find helpful when the debtor becomes insolvent. The respective article of the Civil Code 1994 operates through the notions of a “*parent*” and “*subsidiary*” company. A parent company is defined as a company that can issue mandatory directions (through a “*dominant*” stake, agreement or otherwise) to the other, subsidiary company. In the insolvency context, if the subsidiary company becomes insolvent “*at the parent’s company fault*”, the parent company becomes subsidiary liable for the debts of the subsidiary company (Article 105).<sup>560</sup>

### ***(iii) Observation. First Creditors’ Meeting***

The rules of the Law on Insolvency 1998 on observation were the focal point of its shortcomings and, perhaps, the main reason for its repeal.<sup>561</sup> The Law on Insolvency 2002, however, does not dispense with observation altogether; however, rules are now different.

Observation is now defined as:

*“a procedure that applies to the debtor in insolvency proceedings with the aim to ensure the preservation of its assets, the carrying out of the analysis of the debtor’s*

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<sup>558</sup> Cf. the offence of wrongful trading and the requirement to contribute to a company’s assets under English Insolvency Act 1986, Section 214: “... [a director] knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvency liquidation ...” See also, e.g., *DKG Contractors Limited* [1990] B.C.C. 903.

<sup>559</sup> There is also a “mirror” provision, which operates to protect the creditors’ interests against a debtor that: (i) files for insolvency, despite having the ability to make payments (*i.e.*, “*fraudulent insolvency*”); and (ii) does not contest unsubstantiated claims of the creditor that petitions for insolvency. The Law on Insolvency 2002 provides for civil law liability; there is also criminal liability for “*deliberate*” and “*fictitious*” insolvency/bankruptcy – Articles 196 and 197 of the Criminal Code of the Russian Federation No.63-FZ, dated 13 June 1996. Directors may also be disqualified for breaches related to insolvency under the Criminal Code of Russia (see also English Company Directors Disqualification Act 1986).

<sup>560</sup> The drafting of the article is not entirely satisfactory: it is unclear how the concept of “*fault*” can be applied here.

<sup>561</sup> See, generally, *Observation* on p.152 above; and, specifically on shortcomings, p.155 above.

*financial condition, the drawing up of the register of creditors' claims and the holding of the creditors' first meeting".*<sup>562</sup>

Observation can be introduced by the arbitrazh court as an outcome of the initial review of the grounds for the making of the insolvency petition (Article 42, item 6).<sup>563</sup> In a change from the unfortunate regime of the Law on Insolvency 1998, the new law allows and, indeed, requires the debtor to participate in the review of the grounds for the petition: the debtor must file a response to the insolvency petition (Article 47). If the arbitrazh court decides in the hearing (the debtor can also participate) that the insolvency petition has grounds, observation is introduced (Article 48).

With the onset of observation: all claims on payment obligations and mandatory payments can be only made in insolvency proceedings; enforcement actions are suspended (and freezing orders are lifted);<sup>564</sup> exits by members (where otherwise possible)<sup>565</sup> are restricted; and the payments of dividends<sup>566</sup> are prohibited (Article 63). Also with the onset of observation, and for the purposes of the insolvency proceedings, all obligations, which arose before the court accepted the petition, become due and payable. This is an important rule and it allows the creditors that may be affected by the prospective insolvency of the debtor to have their say in the proceedings from the beginning.

The debtor's chief executive officer and other managing bodies continue to operate during observation; however, there are significant restrictions put in place. For example, the written consent of the interim administrator is required for transaction(s) connected with, *inter alia*, the acquisition, disposal, or the possibility of disposal, of the debtor's assets with five or more *percent* of balance sheet value. Consent is also required for the granting or receiving of any loan (credit), suretyship, guarantee or assignment. Some transactions are prohibited at all, including, *inter alia*: reorganization, establishment of new juridical persons

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<sup>562</sup> Article 2.

<sup>563</sup> The court holds a special hearing to consider whether there are grounds for the filing of the insolvency petition.

<sup>564</sup> There were certain exceptions for claims of social nature.

With respect to observation, the Law on Insolvency 2002 covers Russian *arrests* (freezing orders) and other measures applied in enforcement proceedings. This may be compared with external administration (see *External Administration* on p.173 below), where all protective measures are lifted (see also footnote 591 on p.170 below). With respect to the discussed restrictions on enforcement, the Law on Insolvency 2002 does not use the term "moratorium", though some features of a moratorium are apparently present. "Moratorium" is used in the law with respect to external administration and liquidation proceedings.

It must be noted that the suspension of the enforcement documents and the rules on the register of creditors' claim appear to create an unfair situation for the creditors with claims for goods (as compared against with the creditors with claims on monetary obligations). See the discussion on p.170 below.

<sup>565</sup> For example, this rule does not apply in the case of a open joint stock company – there is no right of exit. However, such right exists for limited liability companies and closed joint-stock companies.

<sup>566</sup> Participation (Russian *pai*) is used here to refer to equity interests in partnerships, *etc.*

or participation in other juridical persons, the payment of dividends or distribution of profits, and the issuance of bonds. Clearly, these restrictions will stifle the operations of the debtor; and also they appear to complicate the use of the some of the common work-out/restructuring techniques. In some cases, the creditors and the debtor may wish to agree to swap loans into bonds. However, as has been mentioned, the Law on Insolvency 2002 includes an outright prohibition on the issuance of bonds, and this technique will be unavailable, even if the interim administrator could have been agreeable to it.<sup>567</sup>

An interim administrator may petition the court on the removal of the debtor's chief executive officer from office; if the court agrees, the interim administrator steps in the shoes of the removed director (Article 69). Commentators expressed views that if in observation the chief executive officer is removed, the interim administrator should have powers similar to that of a liquidation administrator;<sup>568</sup> however, there are also strong arguments against this.<sup>569</sup> Absent the express statutory provision, it must be assumed that the powers of interim administrator are not elevated to those of a liquidation administrator.

The debtor's burdens do not stop here. Within fifteen days from the approval by the arbitrazh court of the interim administrator, the debtor's chief executive officer has to provide to the interim administrator the register of the debtor's assets, including that of rights, and accounting and other documents reflecting the economic circumstances of the debtor for the three preceding years.<sup>570</sup> In addition the chief executive officer has to inform the interim administrator of changes in the assets of the debtor on monthly basis (Article 64).

Overall, it appears that the restrictions on the management bodies of a debtor in observation are such that they do not facilitate the return of the debtor to solvency and have some potential for abuse by an unscrupulous interim administrator.

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<sup>567</sup> The Supreme Arbitrazh Court issued the Informational Letter No.129 "On Some Questions of the Practice of Application by the Arbitrazh Courts of Paragraph 2 of Item 1 of Article 66 of the Federal Law "On Insolvency (Bankruptcy)", dated 14 April 2009. According to the letter, certain transactions are voidable and some are void. For example, a mere absence of the required consent of the interim administrator makes a transaction voidable; and members' exits and the payment of dividends are void *ab initio*.

<sup>568</sup> See *Liquidation Proceedings* on p.182 below.

<sup>569</sup> See for discussion B.Brusko, *Categories of Protection in Russian Insolvency Law*, Wolters Kluwer, 2006.

<sup>570</sup> This is a fairly new rule introduced by an amendment to the Law on Insolvency 2002 adopted 30 December 2008. Again, the drafting of the provision leaves much to be desired. The author, for example, struggles with the reference to the "*documents reflecting the substance of economic activity*". What are these documents? Do they include confidential documents, or perhaps, documents related to crucial contracts/pricing arrangements? In some cases, disclosure of such documents may mean the cessation (in the business sense) of the debtor's operations. It is also unclear how the debtor's chief executive officer will decide when its duties of disclosure are fulfilled.

The Law on Insolvency 2002 specifically authorizes the issuance and private placement of shares by the debtor in observation (Article 64, item 5). This provision is clearly desirable as equity issues could have been a common restructuring technique. However, there lies a problem: the Civil Code 1994, Article 100, prohibits the issuance of shares for the purpose of covering a company's losses. When the debtor finds itself in financial difficulties, arguably, in many cases the issuance of equity will indeed purport to cover losses. It is unclear how the rules of the Law on Insolvency 2002 and the Civil Code 1994 operate in such a scenario. Some Russian commentators suggest that an equity issue can be structured so as to promote the goals stated in the Law on Insolvency 2002 and thereby circumvent the restriction in the Civil Code 1994.<sup>571</sup>

During observation the court appoints an interim administrator to fulfill certain insolvency-related functions (the interim administrator does not replace the debtor's management). An interim administrator has rights to: petition the court on invalidation of transactions; object to the creditors' claims; participate in court hearings related to the verification of the debtor's objections to the creditors' claims; petition the court for additional protective measures or for the removal of the debtor's chief executive officer.<sup>572</sup> The interim administrator is also entitled, and the debtor's management is required, to request/provide any information on the operations of the debtor (Article 66). There are also obligations of the interim administrator, mainly to: analyze the financial condition of the debtor and call the first meeting of the creditors (Article 67).<sup>573</sup>

One of the main events of the observation proceedings is the first meeting of the debtor's creditors. The first meeting of the creditors is convened by the interim administrator (Article 72). The Law on Insolvency 2002 prescribes a fairly detailed procedure: a meeting is called

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<sup>571</sup> K.Lebedev in *Commentary to Federal Law "On Insolvency (Bankruptcy)"*, M.Popondopulo (ed.), 2003, p.178, also referenced in M.Tel'ukina, V.Tkachev and V.Tarasov, "Financial Rehabilitation as Passive Rehabilitation Procedure", *Advocat*, No.12, 2003.

<sup>572</sup> As a significant difference from the Law on Insolvency 1998, the Law on Insolvency 2002 provides that the chief executive officer is replaced not by the interim administrator but by the person nominated by the representative of the debtor. This provision, generally, is considered to create a conflict with the corporate law: ordinarily, a company's management is appointed in a general meeting or by the supervisory board. However, a representative in insolvency is either the chairman of the supervisory board, a person nominated by the supervisory board or the general meeting. See E.Dorokhina, "Problems of Solving of Corporate Disputes in Bankruptcy of Organization", *Entrepreneurial Law*, No.4. 2007.

There is another difficulty with this provision. Assume that the debtor gets into financial difficulties and an insolvency petition is filed. Furthermore, in these circumstances the shareholders/members/supervisory board decide not to replace the current chief executive officer. However, the interim administrator petitions that the officer is replaced: now a representative of the debtor is obligated to suggest a candidate. Why should the interim administrator be allowed to force the making of such a decision on a debtor's competent authority?

<sup>573</sup> Generally, the Law on Insolvency 2002 makes an interim administrator a figure that is in opposition to the management of the debtor.

*via* separate notices, or, where the creditors' number exceeds five hundred persons, *via* a publication in the media (Article 13).

In order to file an insolvency petition, a creditor first has to obtain a (debt) judgment against the debtor; and only debt confirmed by a judgment is recognized by the court in the initial review of an insolvency petition.<sup>574</sup> It would have been surprising if the same requirement was extended to creditors generally; and indeed it is not. For the purposes of the first creditors' meeting, a creditor may also provide "*other documents*" confirming its claim (Article 71). The claim must be presented to the arbitrazh court, which then decides whether the claim should be entered into the register of creditors' claims. The Law on Insolvency 2002 sets forth a relatively short period of time for the making of the application: thirty days from the date of publication of the notice on the onset of observation. Furthermore, there is no express prohibition to hold the first creditors' meeting before the expiration of the thirty-day period or shortly after it has expired. Taking into account that a creditor's claim has to be approved by the court, it may take a considerable amount of time before that claim actually appears on the register; and unless the claim is entered on the register, such a creditor cannot participate in the meeting.<sup>575</sup> The determination of the date for the first creditors' meeting is in the powers of the interim administrator (Article 72) and there is no direct court control over the date (the courts are not notified of the date).<sup>576</sup>

In connection with the possibility to contest the actions of the interim administrator, the Law on Insolvency 2002 provides no express route. An interim administrator may be removed from office by the court (Article 65); however, it is, generally, a discretionary remedy and the applicant must be a participant in the insolvency proceedings.<sup>577</sup>

The first creditors' meeting may petition the court to introduce one of the rehabilitation insolvency procedures or to declare the debtor insolvent and open liquidation proceedings. It is for the court to decide what would be the next procedure applied to the debtor; however, the Law on Insolvency 2002 provides that the court decides on the "basis" of the

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<sup>574</sup> See p.161 above.

<sup>575</sup> This must be put into the context further: under the rules of the Law on Insolvency 2002, once the liquidation proceedings commence, the register of creditors' claims is automatically "*closed*" in two months from the date of the publication of the notice on the commencement on the liquidation proceedings (Article 142). Any claims that were submitted late are satisfied in subordination to the creditors' claims of all other orders of priority. Hence, the timing for submitting a creditor's claim is crucial. It appears that tight deadlines provided for by the Law on Insolvency 2002 are designed to promote the expedient conclusion of insolvency proceedings, which, arguably, is valid reasoning in the circumstances.

<sup>576</sup> It would have been appropriate to directly provide protections for the creditors with respect to their participation in the first creditors' meeting.

<sup>577</sup> Thus, if the first meeting is held at the time when a creditor has not yet been recognized by the court to be an "insolvency creditor", such a creditor has no effective remedy against the decision of the interim administrator.



first creditors' meeting decision (Article 75). In particular, it appears that when the first creditors' meeting voted for external administration, the court has to decide accordingly.<sup>578</sup> There is also an option for the debtor, its owners or third parties to petition the court for a "lighter" procedure than the creditors have chosen.<sup>579,580</sup> In particular, if the debtor/owners/third parties provide a bank guarantee that exceeds by twenty *percent* the claims of the creditors on the register, it will be in the court's discretion to introduce financial rehabilitation. The law sets other conditions for rehabilitation: the debts of the debtor should be paid off *pro rata* within a year.<sup>581</sup>

**(iv) Financial Rehabilitation**

Financial rehabilitation is defined in the Law on Insolvency 2002 as an insolvency procedure, which is applied to the debtor with the aim of its returning to solvency and the paying off of its indebtedness in accordance with a schedule of payments (Article 2). The length of financial rehabilitation is limited to two years (Article 80).<sup>582</sup>

Financial rehabilitation is a measure that the debtor or other interested persons (the "sponsors")<sup>583</sup> must petition for. The petition ordinarily should be addressed to the first creditors' meeting, but there is also an option to petition the court.<sup>584</sup> Arguably, the essence of financial rehabilitation is expressed in two documents: the plan of financial rehabilitation and schedule of payments.<sup>585</sup> These documents must be attached to the petition. The ultimate decision on the introduction of the financial rehabilitation lies with the court; and, as a rule, the court follows the first creditors' meeting decision on the matter.<sup>586</sup>

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<sup>578</sup> Article 93, which is dedicated to external administration, also states that external administration is introduced on the "basis" of first creditors' meeting decision. See also the Resolution of the Supreme Arbitrazh Court of the Russian Federation No. 10768/08, on case No. A56-3211/2007.

<sup>579</sup> That is, if the creditors opted for external administration or liquidation proceedings (in both such cases, the management of the debtor is removed from office).

The Law on Insolvency 2002 also includes rules for the case where a decision of the first creditors' meeting is not forthcoming.

<sup>580</sup> The Law on Insolvency 2002 also includes rules for the case where a decision of the first creditors' meeting is not forthcoming.

<sup>581</sup> The period is counted from the start of payments to creditors, which should be not later than a month from the date of the introduction of rehabilitation.

<sup>582</sup> Some provisions of the Law on Insolvency 2002 refer to the maximum combined length of several insolvency procedures. For example, the combined length of financial rehabilitation and external administration cannot exceed two years (Article 92).

<sup>583</sup> The Law on Insolvency 2002 refers to members, participants and third party(ies).

<sup>584</sup> Presumably, this will occur when the creditors' meeting rejected the petition. In such a case, a bank guarantee exceeding by 20% the total of the claims on the register will be required.

<sup>585</sup> Article 84, 85, 85-1.

<sup>586</sup> Article 80. However, there is also the discretionary power of the court to introduce financial rehabilitation despite the creditors' decision. See *Observation. First Creditors' Meeting* above.

Simultaneously with the decision to introduce financial rehabilitation, the court appoints a “rehabilitation administrator”.<sup>587</sup>

In order to tempt the creditors to agree to financial rehabilitation, the petition may suggest that additional security is provided (Articles 79 and 89-91). The law sets limitations on what type of security may be granted for the purposes of rehabilitation<sup>588</sup> and stipulates that these are the obligations of the debtor under the payment schedule that are secured. There is some degree of certainty provided for by the law for the “sponsors”: their liability is limited to the security provided. However, the certainty of the risk “underwritten” by the “sponsors” is somewhat diluted. If the debtor goes into any other insolvency procedure (e.g., external administration), the secured assets are included into the assets of the debtor; and, as a consequence, the secured assets will be used to satisfy *all* claims of *all* creditors’ and not only those included into the payment schedule.

From the perspective of the debtor (and its shareholders/members), there are a number of benefits in financial rehabilitation. In financial rehabilitation, claims on monetary obligations and mandatory payments (with the exception of current payments)<sup>589</sup> may only be made pursuant to the procedure prescribed by the Law on Insolvency 2002 and any property-related enforcement documents are suspended.<sup>590</sup> Protective measures<sup>591</sup> imposed earlier are also lifted; and any new freezing injunctions may only be granted by the arbitrazh court in the course of the insolvency proceedings.<sup>592</sup>

As has been noted in the preceding paragraph, in financial rehabilitation, property-related enforcement documents are suspended. In this context, let us consider the case of a creditor that has a non-monetary claim against the debtor: perhaps, such a creditor lent to the debtor fungible goods and now wishes that the goods are returned. The creditor is not prevented from initiating a respective lawsuit against the debtor outside of the insolvency

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<sup>587</sup> *Administrativnyi upravlyayushchi* in Russian. A more precise translation of the Russian term into English is “administrative manager”; however, for the purposes of consistency of language throughout the various insolvency procedures, the term “rehabilitation administrator” is used here.

<sup>588</sup> The restrictions are logical. Under Russian law, default interest is, generally, also treated as security; and the law thus provides that only security proper can be used for the purposes of a rehabilitation petition.

<sup>589</sup> Certain obligations and payments of social nature are excluded from the moratorium.

<sup>590</sup> There is an exception for certain obligations of social nature. For example, this covers enforcement documents related to wages and issued prior to the commencement of insolvency proceedings and certain intellectual property-related payments to authors.

<sup>591</sup> “Protective measures” are measures ordered by the court in proceedings with a view to secure the claim or interests of the applicant. For Arbitrazh Courts, protective measures are covered by Chapter 8 of the Arbitrazh Procedural Code of the Russian Federation No.95-FZ, dated 24 July 2002. The Russian phrase used in the Code *obespechitel'nye меры* may also be translated into English as “interim measures”.

<sup>592</sup> As with observation, the Law on Insolvency 2002 does not use the term “moratorium” here. “Moratorium” is used in the law with respect to external administration and liquidation proceedings. Cf. English Insolvency Act 1986, section 1A (*Moratorium*) and Schedule A1, which actually speak of a “moratorium” in relation to voluntary arrangements.

proceedings (since its claim is non-monetary) and may obtain an enforcement document on the return of the goods. However, such an enforcement document is property-related and is suspended pursuant to the rules of the Law on Insolvency 2002. Could such an unfortunate creditor exercise its rights and have a degree of protection as a creditor in insolvency proceedings? That is to say, could the creditor vote at creditors' meetings? The answer is, there is no entitlement to vote. Voting at a creditors' meeting is determined by the register of creditors; and the creditors' claims are included into the register as they are expressed in Rubles (item 5 of Article 16). The creditor's claim is for goods and can be converted into Rubles only if viewed as damages of that creditor arising from the inability to receive the goods from the debtor. However, pursuant to paragraph 2 of item 3 of Article 12 damages are disregarded for the purposes of calculation of a creditor's vote at a creditors meeting. The net result is that the Law on Insolvency 2002 is unfairly prejudicial to the interests of a creditor with a claim for goods against the debtor (as compared to a creditor with a monetary claim). Though the courts may attempt to interpret the provisions of the Law on Insolvency 2002 in a way that recognizes the interests of a creditor with a claim for goods, the position would still remain unsatisfactory.<sup>593</sup>

These benefits of financial rehabilitation are counter-balanced by certain restrictions on the operations of the debtor. The debtor's members/participants cannot exercise their right to exit (if such a right exists); the payment of dividends or any other payment on securities is disallowed. The reader may recognize that this restriction, in fact, is not "new" for the debtor – very similar restriction is initially introduced with the onset of observation (*i.e.*, the first stage of insolvency proceedings) and simply continues on to rehabilitation.<sup>594</sup> In rehabilitation, penalties (with the exception of such on current payments)<sup>595</sup> for breaches of monetary obligations or (the non-making of) mandatory payments cease to apply. However, under the rules of the Law on Insolvency 2002, the official interest rate of the Central Bank of the Russian Federation applies to the outstanding sums as *per* the schedule of payments.<sup>596</sup>

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<sup>593</sup> The example is based on the discussion in M.Tel'ukina, V.Tkachev, V.Tarasov, "Financial Rehabilitation as Passive Rehabilitation Procedure", *Advocat*, No.12, 2003, which refers to a court judgment delivered in respect of a debtor in financial rehabilitation.

<sup>594</sup> However, there are meaningful differences. During observation, despite the restriction on the payment of dividends, the debtor may make (other) payments on its securities (*e.g.*, interest on bonds); in financial rehabilitation *all* payments on securities are prohibited.

<sup>595</sup> Russian courts took the view that default interest is a penalty, rather than a genuine payment for the disbursed funds. See footnote 550 on p.162 above for more information.

<sup>596</sup> There is an additional rule for interest that was due at the date when financial rehabilitation was introduced. These sums remain payable, however, they receive the lowest payment priority (must be paid after all other claims are paid). The Plenum of the Supreme Arbitrazh Court of the Russian Federation confirmed this treatment

An additional rule relates to the creditors' claims filed (and entered into the register) during financial rehabilitation: such claims, generally, must be satisfied within a month from the date when the obligations arising pursuant to the schedule of payments were paid off.

Furthermore, there are two other groups of restrictions put on the transactions of the debtor in rehabilitation: those that require the consent of the creditors and those that require the consent of the rehabilitation administrator (Article 82). The consent of the creditors (or the creditors' committee, as the case may be) is required for interested party transactions;<sup>597</sup> transactions involving assets with balance sheet value of five or more *percent*; the granting of loans, suretyships and issuance of guarantees.<sup>598</sup> The consent of the rehabilitation administrator is required for any transaction (or series of transactions) that: entails the increase of the indebtedness of the debtor by five or more *percent*;<sup>599</sup> involves an assignment of debtor's rights; involves the obtaining of a loan; and involves any disposition, or acquiring, of assets, except as in the course of usual business activities.<sup>600</sup>

In financial rehabilitation the chief executive officer of the debtor continues to exercise its powers, unless the creditors, rehabilitation administrator, or persons providing security

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of outstanding interest in its Resolution No.29 "On Some Questions of Practice of Application of the Federal Law "On Insolvency (Bankruptcy)""", dated 15 December 2004. In fact, the Plenum made a reference to Article 134, which governs the priorities of claims in insolvency. A similar guidance was delivered with respect to mandatory payments (with a further clarification that the restriction on penalties applied to payments that were not "current payments" in the meaning of the Law on Insolvency 2002) – see the Resolution of the Plenum of Supreme Arbitrazh Court of the Russian Federation No.25 "On Some Questions Connected with Qualification and Determination of Claims on Mandatory Payments and Penalties for Public Violations in Bankruptcy Cases", dated 22 June 2006.

<sup>597</sup> In this context, an "*interested party transaction*" refers to a transaction recognized as such under the Law on Insolvency 2002. A concept of interested party transactions in Russian corporate law also exists: for more information see footnote 644 on p.184 below.

Under the Law on Insolvency 2002, Article 19, the following persons, *inter alios*, are considered to be interested with respect to the debtor: persons in the same "*group of persons*" (as this term is defined by Russian competition law, in Law No.135-FZ On Protection of Competition, dated 26 July 2006) with the debtor; persons affiliated with the debtor; the chief executive officer; members of the supervisory board (and other management bodies of the debtor); the chief accountant; and relatives of the aforementioned persons. Similar rules apply to the determinations of interested persons with respect to an insolvency administrator (with the exception of references above to the management bodies, since an insolvency administrator is always an individual).

For a discussion of the issue in the context of Russian insolvency law, see N.Bochkarev, "Criteria for Forming of a Lawsuit on Declaration of Invalidity of Interested Party Transactions where a Counterparty to the Transaction is Bankrupt", *Corporate Lawyer*, No.4, 2008. However, the mentioned article principally refers to the now repealed Article 103 of the Law on Insolvency 2002.

<sup>598</sup> A reorganization receives even stricter treatment: it requires the consent of the creditors (or the creditors' committee) and of persons that provided security.

<sup>599</sup> Calculated with respect to the total indebtedness in the debtor as *per* the register of creditors' claims at the date of the introduction of the financial rehabilitation.

<sup>600</sup> There is a restriction that crystallizes after the monetary obligations that arise after the introduction of the financial rehabilitation exceed by 25% the obligations included into the register of creditors' claims. In such a case, any further obligation of the debtor requires the consent of the creditors' meeting. This rule is not sufficiently precise: does it cover claims as they exist from time to time, or claims as they existed at, say, the close of register? If significant sums have already been paid out to the creditors, then the outstanding claims on the register will decrease and 25% of such claims may be quite insignificant in comparison with what the debtor has already achieved.

petition the court. The grounds for the petition can be that the chief executive officer does not fulfill the rehabilitation plan or violates the rights of the creditors or the persons who provided security. The procedure for the removal of the existing chief executive officer and for its appointment is the same procedure that applies in observation.<sup>601</sup>

**(v) External Administration**

External administration is defined in the Law on Insolvency 2002 as a “*procedure, applied to the debtor being subject to insolvency proceedings with the aim of restoring of its solvency*” (Article 2).

A common procedure for the introduction of external administration would be the case where the first creditors’ meeting casts a vote in favor of external administration and the court concurs (Article 75). If the court finds that there are real prospects for the debtor to return to solvency, the debtor may also “shift” from financial rehabilitation to external administration (Article 92). In all scenarios, the court may exercise its discretion with respect to this insolvency procedure and any vote of the creditors is not conclusive.

The length of external administration is restricted initially to eighteen months, which can be extended by a further six months (Article 93). The law also sets forth a limitation for the combined length of financial rehabilitation (if introduced) and external administration: this must be two years or less.<sup>602</sup>

As has been discussed earlier,<sup>603</sup> in financial rehabilitation the operations of the debtor are restricted; however the debtor’s management may keep their positions. Not so in external administration – the debtor’s chief executive officer’s powers cease and the management of the debtor is passed on to an external administrator (Article 94).<sup>604</sup> Generally, all other managing bodies of the debtor (*e.g.*, the general meeting and supervisory board) lose their powers, too. Under the regime of the Law on Insolvency 2002, the managing bodies of the debtor retain some decision-making power; however, these powers are set out in the law itself and relate mainly to the issuance of common shares and agreements with third parties on the supply of funds necessary to discharge debtor’s obligations.

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<sup>601</sup> See footnote 572 on p.167 above.

<sup>602</sup> In fact, if financial rehabilitation lasted for 18 months or more, the court cannot introduce external administration. The rules on the extension by the court of the initial length of external administration are set out in Article 108 of the Law on Insolvency 2002.

<sup>603</sup> See p.172 above.

<sup>604</sup> An external administrator may “*issue an order*” dismissing the chief executive officer or offer him/her another job.

The main power of an external administrator is to dispose of the debtor's assets; and its duties include, *inter alia*, the duties to: raise objections to creditors' demands; take steps to enforce the debtor's receivables; and maintain the register of creditors (Article 99).

Since the debtor's shareholders/members effectively lose control over the operations of the debtor in external administration to the external administrator, they may, be concerned that the actions of the administrator are unfairly prejudicial to their interests. In such a case, the Law on Insolvency 2002 provides for the right of the shareholders/members to petition the court to remove the external administrator. The petitioner(s) must show that the administrator have not complied with his/her obligations, provided that this has breached the rights or legitimate interests of the petitioner *and* caused losses to the debtor or its creditors. Thus, the test that the petitioner needs to satisfy in order to remove an external administrator is quite rigorous and in many cases shareholders/members will have no readily available options to influence the conduct of an external administrator.

From the economic perspective, the consequences of external administration include, *inter alia*: the termination of all protective measures adopted earlier;<sup>605</sup> the restriction on granting of a freezing injunction with respect to the debtor's assets outside of the insolvency proceedings (with the exception of those related to current payments); and the prohibition of any claims on monetary obligations or mandatory payments made outside of insolvency proceedings. In addition, a moratorium<sup>606</sup> is introduced in respect of monetary obligations and mandatory payments (unless an exception is available under the Law on Insolvency 2002).

A moratorium is defined as "*suspension of the performance by the debtor of its monetary obligations and payment of mandatory payments*" (Article 2). Moratorium does not extend to "*current payments*" (Article 95).

Since creditors on current payments may continue to enforce their claims notwithstanding any insolvency proceedings against the debtor, the definition of "*current payments*" has some urgency for the creditors of a debtor in distress. According to the provision currently in force, current payments cover: (i) payments that relate to obligations on monetary claims and mandatory payments that arose after the court accepted the insolvency petition; and (ii)

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<sup>605</sup> "Protective measures" are measures ordered by the court with a view to secure the claim or interests of the applicant. For a more detailed description see footnote 591 on p.170 above.

<sup>606</sup> The term "moratorium" is not used in the law with respect to the regime for creditors' monetary claims and mandatory payments in observation or financial rehabilitation. See also footnotes 564 on p.165 and 592 on p.170 above.

claims that arose after the commencement of the insolvency proceedings and that relate to the payment for goods delivered and services rendered (Article 5).<sup>607,608</sup>

Another significant exception from the scope of moratorium is the exclusion of claims related to the payments of wages. In the context of a labor-intensive enterprise (of which, there are a few in Russia), wages may constitute a significant proportion of its debts. There is also a history of monthly, if not yearly, “delays” in the payment of wages in Russia.<sup>609</sup> Therefore, in spite of the availability of a moratorium, the debtor may theoretically remain under considerable financial pressure from its employees.<sup>610</sup>

In relation to the claims covered by the moratorium, its introduction has the following consequences: (i) any property-related enforcement documents are suspended,<sup>611</sup> and (ii) penalties cease to accrue. Nevertheless, there is a substitute “statutory” rate provided for by

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<sup>607</sup> The provision on current payments was significantly revised by the 2008 amendment to the Law on Insolvency 2002 (Federal Law No.296-FZ “On the Introduction of Changes into the Federal Law “On Insolvency (Bankruptcy)”, dated 30 December 2008). The Law on Insolvency 2002 previously referred to payment obligations and mandatory payments that (i) arose after the insolvency petition was accepted by the court or (ii) became payable after each new stage of insolvency proceedings. The “old” definition was criticized because it put two creditors that entered into similar agreements at the same time in different positions if the claims on those agreements became payable before and after the onset of insolvency: see for a discussion S.Karelina, “Moratorium on the Satisfaction of the Creditors’ Claims as an Element of Recovery Mechanism”, *Law and Economics*, No.6, 2008. In addition, the courts adopted diverging interpretations of the “old” rules with respect to the current payments and the scope of moratorium: see M.Knyazev, “Priorities in Obligations”, *Ezh-Jurist*, No.6, 2007.

Clearly, the new definition is narrower. The main change relates to the treatment of financial agreements. Under the original wording, obligations to pay under a facility agreement entered into before the court accepted the insolvency petition were not “current payments”. Nevertheless, for example, interest payments that became payable after the introduction of, say, observation (external administration or liquidation proceedings) remained “current” as long as the debtor stayed in the same procedure.

<sup>608</sup> Cf. Insolvency Act 1986, Schedule B1 (*Administration*), paragraphs 42 (*Moratorium on insolvency proceedings*) and 43 (*Moratorium on other legal process*). Under English law, there is no general exception for claims that arose after a certain procedure (stage) of insolvency proceedings commenced. In this respect, the closest analogue is section 233 of the Insolvency Act 1986 (*Supplies of gas, water, electricity, etc.*), under which the suppliers may require the administrator (or other office-holder) to issue a guarantee with respect to the on-going (not past) supplies of utilities. Thus, English law makes a much narrower exception for the creditors on “current payments” and even then *via* the mechanism of a guarantee and not super-priority against the other creditors. Note also that under sub-paragraph 43(6) of Schedule B1, the administrator or the court may give consent to the institution of legal process against the company; no such option exists under Russian law.

<sup>609</sup> In 1999 Russian Criminal Code 1996 was amended to provide for criminal liability for the non-payment of wages for a period of two months or more (Article 145-1). However, the Criminal Code requires “*lucrative motive*” on the part of the perpetrator.

<sup>610</sup> In practice, this pressure may be of lesser importance: that is, the employees would have to obtain judgments in order to be able to enforce their rights against a debtor in distress. The time required to obtain judgments may give the debtor some breathing space, even if the total value of the overdue wages is significant.

<sup>611</sup> There is an exception for certain obligations of social nature. For example, this covers enforcement documents related to wages issued pursuant to court decision made prior to the commencement of insolvency proceedings and certain intellectual property-related payments to authors. In the context of external administration, the exceptions were specifically confirmed with respect to certain protective measures (see footnote 591 on p.170 above) in the Resolution of the Plenary Session of the Supreme Arbitrazh Court of the Russian Federation No.29 “On Some Questions of the Practice of Application of the Federal Law “On Insolvency (Bankruptcy)”, dated 15 December 2004.

The suspension of enforcement documents and the rules on the register of creditors’ claims appear to create an unfair situation for the creditors with claims for goods (as compared against with the creditors with claims on monetary obligations). See the discussion on p.170 above.

the law for the claims of insolvency creditors (*i.e.*, those that can be included into the register); generally, the substitute rate is calculated with reference to the official interest rate set by the Central Bank Russia on the date of the onset of external administration. Russian courts treat default interest as penalty rather than genuine price for the increased risk of continuing to lend to a debtor in default.<sup>612</sup> Thus, any provision for default interest in a loan agreement is not likely to withstand external administration. In the context of typical loan agreements used in the syndicated loan markets this may cause further complications. For example, with respect to the overdue amounts, a common wording of a default interest clause “replaces” the otherwise applicable interest (rate) with “default interest”, which is often two *percent* higher than the interest rate otherwise applicable. It is unclear whether Russian courts will view the whole of “default interest”, or only the “extra” portion (the two *percent*), as penalty. If the former approach is adopted, then default interest loses its “teeth” in external administration – an outcome with which the lenders would clearly be dissatisfied.

As was mentioned earlier,<sup>613</sup> with the onset of observation, a creditor, if it were to participate in the first creditors’ meeting, had to declare its claims to the debtor within thirty days from the publication of the respective notice. There is no similar restriction for external administration: creditors are entitled to declare their claims at any time. Claims are submitted to the arbitrazh court and the external administrator. It is not necessary for a creditor to enclose a judgment confirming the debt and “other documents” may also be used as evidence of the claim.<sup>614</sup>

The external administrator, and/or the representative of the debtor’s shareholders/members can submit its/their objections to the court. Even if no objections were received, the court, according to the letter of the Law on Insolvency 2002, has to examine whether the claims have grounds (Article 100).

The reader will already be familiar with the concept of restrictions on the debtor’s operations in insolvency: there are restrictions in observation and financial rehabilitation.<sup>615</sup>

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<sup>612</sup> See the Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No. 352/96, dated 29 August 2000. It is unclear whether the courts will apply the same approach to, say, an English law-governed loan agreement, where default interest would otherwise be a genuine price for the lender’s increased risk that does not fall foul of *Dunlop Pneumatic Tyre Co Ltd v Selfridge & Co Ltd* [1915] AC 847. Arguably, however, English-law default interest fits within the definition of Russian-law penalty: a monetary sum payable on a breach of obligation (Civil Code 1994, Article 330) and thus the courts will treat it as a penalty. However, Russian law does not treat penalties negatively, and, as a rule, “Russian penalties” are enforceable.

<sup>613</sup> See p.168 above.

<sup>614</sup> See on page 161 above.

<sup>615</sup> Discussed earlier on pp.165 and 171, respectively.



There are also restrictions in external administration; though the circumstances in which the restrictions apply are different: in external administration the management of the debtor is removed; in observation and rehabilitation, the debtor's management, generally, continues to exercise their powers (unless removed by the court pursuant to a petition).

In external administration restrictions apply to: (i) major transactions; (ii) interested party transactions;<sup>616</sup> and (iii) certain financial transactions. Both major and interested party transactions require the consent of the creditors' meeting or committee of the creditors, as the case may be. In this context, major transactions are defined by the Law on Insolvency 2002 as transaction involving debtor's assets with ten or more *percent* balance sheet value. An interested party transaction is defined as a transaction with party(ies) which is/are interested in relation to the external administrator or an insolvency creditor. Unless the following financial transactions are carried out pursuant to the plan of external administration, the consent of the meeting of creditors (the committee of creditors) is required for: the granting/receiving of loans, issuance of suretyships, assignments, novations of debt, and disposal, or acquisition, of shares in companies (Article 101).

In specified circumstances the Law on Insolvency 2002 empowers the external administrator to disclaim transactions of the debtor<sup>617</sup> within three months from the onset of external administration (Article 102).<sup>618</sup> The disclaimed transactions must: (i) be executory at least in part; and (ii) impede the return of the debtor to solvency or cause losses to the debtor when compared to similar transactions entered into comparable circumstances.<sup>619</sup> The party that "suffers" as the result of "disclaiming" by the external administrator is entitled to damages.<sup>620</sup> Of course, the power to disclaim transactions may cause significant difficulties to the party "losing" the bargain. The arguments of such a party may often be that it accepted the credit risk of the debtor (who had unclear financial prospects) and in return

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<sup>616</sup> See footnote 597 on p.172 above.

<sup>617</sup> Under English law, there is a power to disclaim "onerous property" in general pursuant to section 178 of the Insolvency Act 1986 (which allows to disclaim "(a) any unprofitable contract, and (b) any other property of the company which is unsaleable or not readily saleable or is such that it may give rise to a liability to pay money or perform any other onerous act"). However, it is available to liquidators and not administrators.

<sup>618</sup> On the application of this provision in liquidation proceedings see main text and footnote 641 on p.184 below. On disclaiming of the debtor's transactions, see T.Borisenkova, "Topical Problems of Interaction of Private and Public Interests in Disclaiming of a Debtor's Transactions in Bankruptcy Procedures", *Civil Law*, No.3, 2006.

<sup>619</sup> There a specific exception for transaction entered into with the consent of the interim administrator during observation or financial rehabilitation: unless entered into contrary to the provision of the Law on Insolvency 2002, such transactions cannot be disclaimed.

<sup>620</sup> The Law on Insolvency 2002 specifically refers to "damages" and not (economic) losses.

The courts have delivered judgments on the provision in question. For example, the Supreme Arbitrazh Court of the Russian Federation, in its Resolution No. VAS-3965/09 on case No. A54-3482/2005c9, dated 8 April 2009, found that a lease agreement was "onerous" for the lessee and precluded its return to solvency; and the court upheld the lower courts' decisions on the disclaiming of the lease.

demanded a higher premium. The debtor, however, will argue that the benefits for the counterparty were more generous than available elsewhere on similar transactions. Furthermore, if a contract is disclaimed, it remains for the court to decide what will be the appropriate amount of damages; and, presumably, the damages for the counterparty will be much lower than the benefits it expected to receive if the contract was upheld.

It has been mentioned earlier that the degree of control that can be exercised by shareholders/members over the external administrator is minimal;<sup>621</sup> and that creditors may exercise some control over the external administrator *via* the approval of, *e.g.*, interested party and major transactions.<sup>622</sup> In addition to this, the external administrator has some disclosure-type obligations towards creditors which provide for some checks and balances on his/her activities. According to Article 106, an external administrator has to produce a plan of external administration within a month from his/her appointment. The plan is then submitted to the creditors' meeting for approval. In spite of the requirement that the creditors have to approve the plan, it is also here that the Law on Insolvency 2002, perhaps for the first time, mentions that the external administrator should be concerned with the debtor's operations as an on-going concern: the plan, *inter alia*, must include measures on the restoration of the debtor's solvency, expenses for such measures and other expenses of the debtor (Article 106).<sup>623</sup> The creditors' meeting or the creditors' committee may demand

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<sup>621</sup> See p.174 above.

<sup>622</sup> See p.177 above.

<sup>623</sup> This of course, creates a conflict: it should not be presumed that the creditors are concerned with the future well-being of the debtor, and, hence, they may not be particularly interested in the approval of a plan which purports to save the debtor, rather than simply to pay off its debts.

Cf. Insolvency Act 1986, Schedule B1 (*Administration*), sub-paragraph 3(1):

*The administrator of a company must perform his functions with the objective of—*

(a) *rescuing the company as a going concern, or*  
 (b) *achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or*  
 (c) *realising property in order to make a distribution to one or more secured or preferential creditors.*

Note that the Insolvency Act 1986 now provides for a hierarchy of objectives, rather than a single objective.

Furthermore, with respect to a plan of administration, the relevant Insolvency Act 1986 provisions are paragraph 49 (*Administrator's proposals*) – "(1) *The administrator of a company shall make a statement setting out proposals for achieving the purpose of administration*" and sub-paragraph 53(1) (*Business and result of initial creditors' meeting*):

*An initial creditors' meeting to which an administrator's proposals are presented shall consider them and may—*

(a) *approve them without modification, or*  
 (b) *approve them with modification to which the administrator consents.*

Note that there is no option in 53(1) for the creditors to reject the proposals (according to Article 107 of the Russian Insolvency Act 2002, the creditors do have an option to reject a plan of external administration). Perhaps, this is an illustration that the English Insolvency Act 1986 recognizes that the conflict of the debtor's and creditors' interests exists. In fact, according to sub-paragraph 3(2) of Schedule B1 of the Insolvency Act 1986:

*Subject to sub-paragraph (4), the administrator of a company must perform his functions in the interests of the company's creditors as a whole.*

Thus, the Insolvency Act 1986 generally resolves the conflict of the debtor's and creditors' interests in the favor of the creditors.

that the external administrator reports to the creditors on the progress of the external administration and realization of the plan.

It is interesting to note that when the Law on Insolvency 2002, with respect to the plan of external administration, refers to measures on the restoration on a debtor's solvency, this is not an "empty" reference. Article 109 sets out a non-exhaustive list of such measures: (i) re-profiling of production; (ii) closure of unprofitable operations; (iii) enforcement of debts due (to the debtor); (iv) sale of a part of debtor's assets; (v) assignments of debtor's rights; (vi) the discharge of the debtor's obligation by shareholders/members or third persons; (vii) increase of charter capital *via* contribution(s) of shareholders/member or third persons; (viii) issuance of debtor's additional common shares; (ix) sale of the debtor's enterprise; and (x) replacement of debtor's assets.

The Law on Insolvency 2002 contains detailed rules with respect to some of the measures referred to in Article 109; and, at least a brief overview of such rules is justified. For the purposes of item (ix) in the list above, the law defines "enterprise" as a "*proprietary complex*"<sup>624</sup> that is intended for the carrying out of entrepreneurial activity. The law also allows selling debtor's subsidiaries and departments (Article 110).<sup>625</sup> A management body (which one depends on the charter documents) of the debtor has to consent to the sale and must stipulate the lowest selling price. The default position under the Law on Insolvency 2002 is that monetary obligations and mandatory payments of the debtor are not passed with the enterprise to the purchaser (*i.e.*, the enterprise is sold cash- and debt-free); however, the option to transfer the debts with the enterprise is also available, and this must be expressly agreed upon. Generally, the sale of enterprise must be conducted at an auction or tender.<sup>626</sup> In this respect, the law adopts a somewhat restrictive approach and stipulates that the purchase price must be paid within a month from the auction. Although a rule on the maximum period for the payment of the purchase price is a welcome addition to the law, in cases where the enterprise that is being sold is an undertaking of significant size, one month may turn out to be an insufficient period from the perspective of a prospective buyer.

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On the other hand, arguably, the Insolvency Act 2002 fails to adopt a consistent approach on the balance of the debtor's and creditors' interests as must be taken into account by the external administrator.

<sup>624</sup> That is to say, a "collection of assets".

<sup>625</sup> For a discussion of Article 110, see D.Egorov, "On some Questions Related to the Sale of a Debtor's Enterprise in Bankruptcy Procedure", *Jurist*, No.11, 2007.

<sup>626</sup> The 2009 amendments to the Law on Insolvency 2002 (the Law of the Russian Federation No.73-FZ "On the Making of Amendments to Certain Legislative Acts of the Russian Federation", dated 28 April 2009) require that the sale is conducted electronically. However, the entry into effect of the respective provisions is conditional on certain regulations being adopted. At the time of writing no such regulations were adopted.

An assignment of the debtor's rights requires the consent of the meeting of the creditors (or the creditors' committee, as the case may be). The law provides that an assignment is effected by way of "sale" and refers to selected provisions related to the sale of a part of debtor's assets.<sup>627</sup> The Law on Insolvency 2002 sets forth a number of mandatory conditions for a contract of "sale" including a condition that a payment must be received within fifteen days from sale and that the assignment takes effect only after the payment is received in full.

One of the commonly used tools in debt work-outs is share issuance. Bearing in mind that in external administration the debtor's management is removed from office, it is clear that, with the onset of this procedure, the nature of issuances changes. A share issuance must be included in the plan of external administration (and therefore, requires the consent of the creditors' meeting). However, it is not just the creditors who control the issuance of shares: the law prescribes that an issuance can only be included into the plan of external administration pursuant to a request of a body of the debtor (which body depends on the circumstances: *e.g.*, the general meeting or supervisory board). The role of the external administrator is somewhat limited: once he/she receives a request, the request must be submitted to the creditors' meeting for consideration. The issuance can only be carried out *via* a closed subscription, the debtor's shareholders have pre-emptive rights, and shares must be paid for in cash (Article 114).

"*Replacement of assets*" is a measure in which assets of the debtor are transferred to one or more newly incorporated open joint stock companies and shares in such company(ies) are issued to the debtor (Article 115).<sup>628</sup> The Law on Insolvency 2002 provides that the acquired shares *may* be sold at an auction; and, one view would be that the intention of the law is that the shares must be sold, so that the debtor receives cash. The Law on Insolvency 2002 does not include an express provision requiring that the replacement of assets is included

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<sup>627</sup> Unlike in respect of a sale of a part of the debtor's assets, the Law on Insolvency 2002 does not expressly require that an assignment is included into the plan of external administration; however, there are views that such a requirement may be implied by law, since rights of the debtor are also a "part of its assets": see M.Tel'ukina, *Commentary to the Federal Law dated "On Insolvency (Bankruptcy)"*, 2003 (prepared for, and available in, *ConsultantPlus*).

<sup>628</sup> The origins of this measure can be traced back to the Law on Insolvency 1998 and the Resolution of the Government of the Russian Federation No.476 "On Measures on the Increase of the Efficiency of the Application of the Procedure of Bankruptcy", dated 22 May 1998.

The Law on Insolvency 2002 provides that in the case where only one open joint stock company is created, all assets of the enterprise are transferred to such company. Thus, the language of the provision, for a reason unknown, assumes that the debtor has only one enterprise. M.Tel'ukina, *Commentary to the Federal Law dated "On Insolvency (Bankruptcy)"*, 2003 (prepared for, and available in, *ConsultantPlus*). In spite of the position of the legislator on the number of the enterprises that the debtor may operate, further provisions of the law stipulate that several joint stock companies may be set up so that assets related to separate activities of the debtor were transferred to separate entities.

into the external administration plan; however, the language of the law suggests that such an inclusion is necessary (consequently, the creditors would have to vote on it). In any case, the inclusion of the replacement of assets into the plan is subject to the unanimous vote of all creditors benefiting from pledge over the debtor's assets. Quite unfortunately, the law does not provide for the consequences of the transfer of assets to the new company(ies) with respect to pledge.<sup>629</sup>

The authority to decide on the exit from (or the extension of, as the case may be) external administration lies with the court. As a rule, the starting point for any such decision is the external administrator's report (Article 117). The external administrator has to prepare a report if: (i) there are grounds for early exit from external administration; (ii) persons entitled to call a creditors' meeting so demand; and (iii) enough funds are accumulated to pay off all claims included into the register of creditors. In the majority of cases, the external administrator's report has to be considered by the creditors' meeting and their decision is also submitted to the court (Article 119). The court then has several options available, including, *inter alia*: (i) if all creditors' claims are satisfied in accordance with the register, the termination of insolvency proceedings; (ii) transfer to "settlements with creditors"; (iii) if a respective petition is lodged, the extension of the period for external administration; and (iv) if the court disapproves the external administrator's report or the creditors petition the court accordingly, the opening of liquidation proceedings (Article 119). The Law on Insolvency 2002 lays down a complicated procedure that must be carried out prior to the court considering the external administrator's report and deciding on the next steps in insolvency proceedings.

With the exception of "settlements with the creditors", the decisions that the court may take are self-explanatory. What is the "settlements with the creditors" then? Essentially, the court gives the external administrator a direction to commence payments to the creditors. Payments must be made in accordance with the register of the creditors' claims and in order of priority as prescribed for the creditors' claims by the insolvency rules (the order of distribution is the same as in liquidation proceedings). The court in its resolution sets the period for the settlements to be completed, which cannot be longer than six months; and if

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<sup>629</sup> This must be put in the context of Article 353 of the Civil Code 1994, which provides that, generally, a pledge survives the transfer of secured assets to a third party. Pursuant to Article 353, it appears that pledge over the assets transferred to the new company(ies) continues. If this is indeed the case, then it is impossible to carry out a "clean transfer" of assets to the new company and this is likely to have a chilling effect on any potential investors in that company.

by the end of the stipulated time, the creditors' claims are not paid in full, the court declares the debtor insolvent and initiates liquidation proceedings (Articles 120 and 121).<sup>630</sup>

**(vi) Liquidation Proceedings**

Liquidation proceedings are defined by the Law on Insolvency 2002 as an insolvency procedure, which is applied to an insolvent debtor, with a view to satisfy the creditors' claims *pro rata* (Article 2).<sup>631</sup>

Once the court rules that a debtor is insolvent, liquidation proceedings automatically commence. The length of liquidation proceedings is determined by the court and initially should not exceed six months,<sup>632</sup> unless a subsequent extension of not more than six months is granted (Article 124).<sup>633</sup>

Information on the introduction of liquidation proceedings must be published in the manner prescribed by the Law on Insolvency 2002: currently the chosen media for the insolvency-related publications is a newspaper with state-wide circulation, *Kommersant* (Articles 28 and 128).<sup>634</sup>

The consequences of the onset of liquidation proceedings are as follows: (i) monetary obligations and mandatory payments that came into existence before the liquidation

<sup>630</sup> Some authors consider that settlements with the creditors is a separate (quasi-) insolvency procedure. For a discussion, see B.Koraev, "Legal Status of Liquidation Creditors in External Administration", *Jurist*, No.5, 2008.

<sup>631</sup> Interestingly, Russian law does not have rules on re-use of the trading name of the liquidated company similar to that in English section 216 of the Insolvency Act 1986 (see also *Ricketts v Ad Valorem Limited* [2003] EWCA Civ 1706).

<sup>632</sup> The provision on the length of liquidation proceedings has been amended in 2008 (Federal Law No.296-FZ "On the Making of Amendments to the Federal Law "On Insolvency (Bankruptcy)""", dated 30 December 2008). Under the pre-amendment version, the "initial" length of insolvency proceedings was set as one year.

<sup>633</sup> There is no clear-cut answer whether the total length of liquidation proceedings can be extended beyond a year. The Plenum of the Supreme Arbitrazh Court of the Russian Federation considered the respective provision, but gave no directions whether the proceedings can be extended more than one time. According to its Resolution "On Some Questions related to the Entry into Force of the Federal Law "On Insolvency (Bankruptcy)""", dated 8 April 2003:

*"According to the meaning of [the respective provision of the Law on Insolvency 2002], after the specified period of one year has elapsed, in exceptional cases and pursuant to a petition of the liquidation administrator the length of liquidation proceedings can be extended by the court..."*

L.Pulova (a judge of the Arbitrazh court of Moscow) in her article "On the Question of the Length of Conducting of Liquidation Proceedings in Respect of the Debtors Subject to the Bankruptcy Procedure", *Bulletin of the Arbitrazh Court of Moscow*, No.4, 2006, refers to a (lower instance) court case where it was held that longer extensions were possible. Therefore, presumably, there are some arguments available in favor of the possibility of insolvency proceedings extending beyond a period of 12 months. Pulova also mentions that the reasoning of the legislator behind the restriction of length of liquidation proceedings was the wish to shorten the unreasonably protracted liquidation, which could last as long as seven years (since liquidation administrators had vested interests in having as long as possible "tenure").

<sup>634</sup> The respective media is set by the secondary legislation: the Resolution of the Government of the Russian Federation No.1049-r, dated 21 July 2008.

Article 28 was amended by the Federal Law No.296-FZ "On the Making of Amendments to the Federal Law "On Insolvency (Bankruptcy)""", dated 30 December 2008. It provides now, *inter alia*, for "Unified Federal Registry of Bankruptcy Information" and online access to (at least some) information; however, this is subject to the adoption of the respective secondary legislation (and, of course, to the rolling out of the database), which is yet to occur.

proceedings are accelerated (*i.e.*, become due and payable); *(ii)* with the exception of current payments, interest, penalties and other sanctions cease to accrue; *(iii)* information on financial position of the debtor ceases to be confidential (*i.e.*, becomes potentially available to the public); *(iv)* enforcement actions are suspended;<sup>635</sup> *(v)* with the exception of current payments and certain claims of social nature, all claims against the debtor must be made in liquidation proceedings; and *(vi)* freezing orders are lifted and no new orders may be granted. Furthermore, all obligations of the debtor may be discharged only if, and in the manner, prescribed by the rules on liquidation proceedings.<sup>636</sup>

With the onset of liquidation proceedings management bodies of the debtor, including the chief executive officer, lose their powers.<sup>637</sup>

The management of the debtor is transferred into the hands of a liquidation administrator (Article 129).<sup>638</sup> A liquidation administrator has not only the powers of the chief executive officer of the debtor, but also the powers of the debtor's other bodies (*e.g.*, the general meeting or supervisory board). The liquidation administrator is expressly empowered by the Law on Insolvency 2002 to dispose of the debtor's assets, dismiss the debtor's employees (including the chief executive officer) and petition the court on behalf of the debtor on the declaration of invalidity of transactions and/or decisions of the debtor.

The liquidation administrator may petition the court to disclaim transactions of the debtor, as an external administrator could;<sup>639</sup> however, the law specifically provides that such a power is subject to there being "*no circumstances that preclude the return of the debtor to solvency*" (item 3 of Article 129). This provision appears to contradict the nature of insolvency proceedings: arguably, if liquidation proceedings commenced, the debtor is unlikely to return to solvency. However, the courts interpreted the provision quite literally: the administrator must prove to the court that there are no circumstances precluding the

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<sup>635</sup> Cf. with external administration, where enforcement documents related to certain claims of social nature (wages and payments to authors) if issued prior to the onset of external administration, remained enforceable. See p.175 above.

It is interesting to note that in the context of legislation on the insolvency of banks, in V.Kainov and U.Kainova, "Banking Secrecy and Bankruptcy: Arguable Issues of Disclosure of Information", *Banking Law*, No.2, 2007, come to the conclusion that the regime of banking secrecy falls away on the opening of liquidation proceedings.

<sup>636</sup> This is wider than the scope of the moratorium available in external administration. In external administration, the moratorium covers, generally, monetary obligations and mandatory payments. However, external administration moratorium is, in reality, wider than monetary obligations and mandatory payments, since it also precludes enforcement of any property-related enforcement documents. For more detailed discussion of the effects of this provision, see p.170 above.

<sup>637</sup> The only power that remains is that of shareholders/members – to vote on the terms of an agreement with a third party(ies) on the extension on funds for the purpose of the discharge of debtor's obligations.

<sup>638</sup> For a dedicated, though concise review of the functions of a liquidation administrator see O.Kruglova, "Powers of a Liquidation Administrator on the Forming of Liquidation Assets of an Insolvent Debtor and Forms of Control over their Exercise", *Russian Justitia*, No.5, 2008.

<sup>639</sup> See p.177 above.

return of the debtor to solvency in order to disclaim a transaction.<sup>640</sup> In the context of liquidation proceedings, it appears then, that there is little scope for the disclaiming of the debtor's transactions, since in the case where the return of the debtor to solvency was likely, an external administration, instead of liquidation, would have been the appropriate insolvency procedure.<sup>641</sup>

Russian courts also decided that the power to disclaim transactions does not extend to disclaiming agreements on pledge; a liquidation administrator, however, remains entitled to disclaim the underlying secured obligation, which would also defeat the pledge.<sup>642</sup> In addition, the respective provision is vague, which is of course is neither helpful for the liquidation administrator, nor the debtor's counterparties.

Importantly, a liquidation administrator can initiate lawsuits against the debtor's management in respect of any losses caused by their actions.

As mentioned above, in external administration the administrator has to seek the consent of the creditors' meeting or the committee of the creditors, as the case may be, for major, interested party, and certain financial, transactions.<sup>643</sup> From this perspective, liquidation proceedings are less onerous for the (liquidation) administrator and only interested party transactions<sup>644</sup> require the consent of the creditors' meeting or the creditors' committee, as the case may be.<sup>645</sup>

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<sup>640</sup> "Review of the Practice of Consideration by Arbitrazh Courts of Disputes on Federal Law No.127-FZ "On Insolvency (Bankruptcy)", dated 26.10.2002, from 1 January 2007 to 31 December 2007", Centre for Methodology of Accounting and Taxation, 2008, prepared for, and available in, *ConsultantPlus*.

<sup>641</sup> See, e.g., M.Tel'ukina, *Commentary to the Federal Law dated "On Insolvency (Bankruptcy)" 2003* (prepared for, and available in, *ConsultantPlus*).

<sup>642</sup> The Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.58 "On Some Questions, Related to the Satisfaction of Demands of the Pledgee in Bankruptcy of the Pledgor", dated 23 June 2009.

On the relationship between the main obligation and pledge, see *Pledge* on p.71 above.

<sup>643</sup> See p.177 above.

<sup>644</sup> An interested party transaction is a concept with roots in Russian corporate law: fairly clear definitions of interested parties for transactions of joint stock and limited liability companies can be found in: Article 81 of the Federal Law No.208 "On Joint Stock Companies", dated 26 December 1995 and Article 45 of the Federal Law No.14-FZ "On Limited Liability Companies", dated 8 February 1998.

The purpose of these provisions is to control self-dealing by a company's management and/or controlling shareholders. With respect to corporate "regulation" of interested party transactions, the Supreme Arbitrazh Court of the Russian Federation in its Plenum's Resolution No.40 "On some Questions of Practice of Application of Provision of Legislation on Interested Party Transactions", dated 20 June 2007, adopted the view that, in order to declare such a transaction invalid, the court must be satisfied that there were negative consequences for the respective company; however, it is the defendant's burden to prove the absence of negative consequences. The mentioned Resolution No.40, on the face of it, does not extend beyond corporate legislation, and is also limited to joint stock companies only; however, it is relatively easy to advance arguments that a similar approach should be applied by the arbitrazh courts in insolvency proceedings and to other categories of company.

<sup>645</sup> The exclusion of major and financial transactions from this list of transactions requiring the creditors' consent has arguments for and against. On the one hand, the liquidation administrator, presumably, sells *all* assets of the debtor in order to satisfy the creditors' claims; and thus, major transactions are quite common in liquidations. On the other hand, the "purpose" of the debtor's assets in liquidation changes – they are no longer used in the



An important power is given by the Law on Insolvency 2002 to the creditors' meeting: the meeting may decide that the debtor shall cease business activities.<sup>646</sup> In such a case, the liquidation administrator "*must [cause to] cease*" the production of goods and/or rendering of services by the debtor within three months from the date of the decision.

The Law on Insolvency 2002 operates with two specific categories with respect to liquidation proceedings that must be introduced at this point: "*liquidation creditors*" and "*authorized bodies*". A liquidation creditor is any creditor on a monetary obligation with the exception of: (i) authorized bodies; (ii) citizens who have claims against the debtor for personal, or moral, injury; (iii) citizens who have claims related to intellectual property payments; and (iv) shareholders/members in relation to claims arising of their "*shareholding or membership*" (Article 2). It is easy to note that this definition excludes: creditors who are placed in a separate category, though generally are of equal priority (*i.e.*, various state bodies); super-priority creditors (*e.g.*, individuals with injury claims); and "subordinated" creditors (*i.e.*, shareholders/members). An authorized body is defined as a body of the executive branch<sup>647</sup> which is authorized by the Government to lodge claims of the State on mandatory payments in insolvency proceedings; this definition is further extended to include similar bodies at the level of constituencies and municipalities.<sup>648</sup>

A rule that was only recently introduced into the Law on Insolvency 2002 provides for interest on the claims of liquidation creditors and authorized bodies.<sup>649</sup> The respective interest rate is that of the Central Bank of Russia, and it applies from the commencement of the liquidation proceedings and until payment. The rate is fixed as at the date when the liquidation proceedings commenced and is not re-adjusted later.<sup>650</sup> This "statutory" interest "replaces" any other interest that may have otherwise been applicable (as has been mentioned earlier, "ordinary" interest and penalties cease to apply in liquidation

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debtor's business, but to repay the creditors' claims. Thus, creditors have a direct economic interest in the debtor's assets. The creditors may be cautious about major disposals of the debtor's assets and find it comforting to have a degree of control over transactions with value over a certain threshold. With respect to financial transactions, the scope of financial activities of a liquidation administrator is potentially narrower than that of an external administrator, simply because it is almost inevitable that the debtor shortly ceases to exist. Even so, any new agreements entered into by the liquidation administrator, as a rule, will entail "current payments", which enjoy a super-priority, and thus, the creditors may also be keen on having a degree of control here.

<sup>646</sup> There are exceptions to this power: it cannot be exercised if this will cause disruptions to the operation of schools, healthcare institutions, infrastructure systems, *etc.*

<sup>647</sup> See *Executive Branch* on p.212 below.

<sup>648</sup> See *Federative Organization* on p.210 below.

<sup>649</sup> The Federal Law No.296-FZ "On the Making of Amendments to the Federal Law "On Insolvency (Bankruptcy)""", dated 30 December 2008.

<sup>650</sup> This may pose an issue for creditors or the debtor, as the case may be, in an economy where the rate fluctuates widely. For example, in 1998 the interest rate set by the Central Bank, swung from the lowest of 28% *per annum* to the highest of 150% *per annum* (data available online through [www.cbr.ru](http://www.cbr.ru)). In recent years, the interest rate has been relatively stable: in 2007-2009 it fluctuated from 8.75% (end of 2009) to 13% *per annum*.

proceedings), and, indeed, which is somewhat peculiar, this also applies to claims where no interest was provided for in the respective agreement.<sup>651</sup> The “statutory” interest does not count for the purpose of votes in a creditors’ meeting; however, it is given the same priority in payment as the underlying claim (item 2.1 of Article 126).

### ***(vii) Priorities and Security***

Once (potential) insolvency of the debtor appears on the horizon, it often becomes a self-fulfilling prophecy: it is difficult for the debtor to operate when it is refused new credit or when counterparties demand quicker payments on goods and service delivered/supplied. Thus, a creditor who discovered information related to potential insolvency of a debtor is often concerned with only one question: “How much will I recover?” The major factor to consider here is the priority of the respective claim(s).

The Law on Insolvency 2002 sets forth the following hierarchy of claims: *(i)* super-priority (current payments); *(ii)* first priority (claims of social nature); *(iii)* second priority (wages);<sup>652</sup> *(iv)* third priority (other creditors); and *(v)* Chapter III.1 claims<sup>653</sup> (Article 134). As explained below, most priorities can be also divided into “sub-priorities”.

Current payments include: *(i)* payments that relate to obligations on monetary claims and mandatory payments that arose after the court accepted the insolvency petition; and *(ii)* claims that arose after the commencement of the insolvency proceedings and that relate to the payment for goods delivered and services rendered (Article 5).<sup>654</sup> In addition to current payments, super-priority is afforded to expenses specified in law. In particular, if the cessation of the operations of the debtor may cause catastrophes (technical and ecological) or death, expenses directed at their prevention are super-priority claims.

Current payments are not a homogenous collection of claims and are sub-divided into four orders priority. The four sub-priorities are: *(i)* court expenses (costs) related to the insolvency, insolvency administrator(s) fees and fees of other insolvency professionals; *(ii)* wages, fees of other persons engaged by the insolvency administrator; *(iii)* communal and

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<sup>651</sup> The interest rate set by the Central Bank is a rate that it lends on to banks, and in many cases, the creditors will be worse-off receiving statutory interest rather than interest provided for by the contract.

The Law on Insolvency 2002 opened the door for agreements by the creditor(s) and the liquidation administrator to change the rules on interest. However, the interest may only be lowered in any such agreement.

<sup>652</sup> Claims in *(ii)* and *(iii)* may be compared to English Insolvency Act 1986, section 386 and Schedule 6, which set out preferential creditors with respect to *floating charges* (and not *all* secured creditors, who are generally not affected in this way).

<sup>653</sup> See *Chapter III.1: Contesting Debtor’s Transactions* on p.195 below.

<sup>654</sup> Current payments were initially discussed with respect to external administration and moratorium. See main text and footnotes 607 and 608 on p.175 above.

infrastructure payments necessary for the debtor's business; and (iv) other current payments. Claims falling within one order of priority are satisfied in "*calendar order*".<sup>655</sup>

First priority claims include claims for personal injuries and moral damages.<sup>656</sup>

Second priority claims include wages and termination payments to employees and payments to authors of objects of intellectual property. The third priority claims include the claims of all other creditors. Finally, once the third priority creditors have been paid off, payments are made pursuant to Chapter III.1 provisions (claims on contested debtor's transactions).<sup>657</sup>

Third order of priority often includes claims of the majority of commercial creditors and, indeed, may include a significant proportion of tax-related claims. Quite inconveniently, rules on the third priority claims are dispersed among different parts of the Law on Insolvency 2002. The purpose of the next paragraph is to provide a summary of the respective provisions.

Claims of the third order of priority include the claims of liquidation creditors and authorized bodies.<sup>658</sup> Simply put, a liquidation creditor is a creditor on a monetary obligation and an authorized body is a governmental body with a claim on a mandatory payment. A monetary obligation is an obligation to pay pursuant to a civil-law transaction<sup>659</sup> and/or on another basis provided for by the Civil Code 1994 or budgetary law. Mandatory payments, generally, are taxes, state fees, fines and penalties related thereto, and administrative and criminal penalties.<sup>660</sup> What happens to the non-monetary obligations? They remain outside the insolvency law and are enforced accordingly (obviously, insolvency priorities do not apply to such obligations). As a rule, the value (amount) of monetary obligations and mandatory payments is determined as at the date of the insolvency petition; and there are also specific rules on conversion of foreign-denominated obligations into Rubles.<sup>661</sup> The Law on Insolvency 2002 expressly provides that the claims of the creditors of third priority related to

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<sup>655</sup> It is unfortunate that the law uses the simple phrase "*calendar order*". As has been discussed earlier, the Law on Insolvency 2002 distinguishes between the time when a claim comes into existence and when it becomes payable. "*Calendar order*" does not allow to deduce whether the law refers to the time when the claim arose or became payable.

<sup>656</sup> Moral damages is a concept of Russian law that, generally, reflects the damages arising out of the suffering (physical or moral) of an individual caused by the breach of his/her non-proprietary rights (Article 151 of the Civil Code 1994).

<sup>657</sup> See *Chapter III.1: Contesting Debtor's Transactions* on p.195 below.

<sup>658</sup> For the definition and discussion of liquidation creditors and authorized bodies see p.185 and *infra* above.

<sup>659</sup> See *Branches of Law* on p.218 below.

<sup>660</sup> Monetary obligations and mandatory payments were initially introduced in the discussion of the insolvency test in *Insolvency Test. Insolvency Petition* on p.160 above.

<sup>661</sup> This is also discussed in *Insolvency Test. Insolvency Petition* on p.160 and *infra* above.

economic losses and penalties<sup>662</sup> are accounted for separately in the register of creditors' claims and are satisfied only after the principal sums and interest are paid. This must be viewed in the context of the provisions on moratorium in external administration and liquidation proceedings: in both cases, contractual interest ceases to apply and instead a "statutory" interest, equal to the official rate set by the Central Bank of the Russian Federation, applies.<sup>663</sup>

It must be stressed that creditors cannot contract out of the priorities as set by the Law on Insolvency 2002.<sup>664</sup> Perhaps, subordination among creditors can be achieved *via* a turnover clause (trust subordination), but this would not be recognized by Russian insolvency law and is likely to have undesired tax consequences for entities taxable in Russia.

Arguably, from a financier's perspective, the most important insolvency rules are those related to security. All Russian security laws (the Laws on Insolvency 1992, 1998 and 2002) recognized only one category of security: pledge.<sup>665</sup> Thus, for the purposes of this discussion, a reference to security or a secured creditor below means a pledge or a pledgee only.<sup>666</sup>

Under the original provisions of the Law on Insolvency 1992, the secured creditors' position was acceptable: in the insolvency of a debtor their claims were satisfied "outside the insolvency priorities"; however, with the adoption of the Civil Code 1994, the situation changed and all secured creditors claims were "pooled together" into the third order of priority and satisfied *pro rata*.<sup>667</sup> Under the rules of the Law on Insolvency 1998, the secured creditors' claims were also satisfied *pro rata* in the third order of priority; moreover, secured creditors, as long as the debtor's obligation was secured in principle (meaning that there was (any) security for such an obligation, irrespective of whether the value of secured assets was sufficient to cover the (outstanding) obligation), could enforce against *all* assets of the debtor (not only secured assets).<sup>668</sup> Thus, under the (earlier) Russian insolvency law regime,

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<sup>662</sup> Russian courts took the view that default interest is a penalty, rather than a genuine payment for the disbursed funds. See footnote 550 on p.162 above for more information.

<sup>663</sup> See pp.175 and 185 above.

<sup>664</sup> Cf. English law where the creditors can agree among themselves on the priority of payment in insolvency: *Maxwell Communications Corporation plc (No.2)* [1994] 1 All ER 737).

Subordination in Russia is possible, however, with respect to loans to banks under the banking insolvency legislation (apparently, this was introduced in the recognition of the Basel capital requirements (see "Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework").

<sup>665</sup> See *Pledge* on p.71 above.

<sup>666</sup> Of course, references to pledge and pledgee could have been used instead; however, this would make the language more cumbersome.

<sup>667</sup> See p.147 above.

<sup>668</sup> See p.158 above. A similar approach was set forth even earlier as *per* item 25 of the Resolution of the Plenary session of the Presidium of the Supreme Court of the Russian Federation and the Plenary session of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.6/8 "On Some Questions, Related to Application of Part I of Civil Code of Russian Federation", dated 1 July 1996 (*i.e.*, also with respect to the Law on

there was no direct link between the secured assets and secured obligation. In some circumstances, the creditor could benefit from the ability to enforce against *all* debtor's assets; however, this would not be common. The shortcomings of the regime were obvious: a creditor also shared *its* security with *all* other creditors.

Did the position of a secured creditor change with the adoption of the Law on Insolvency 2002? The original wording of the Law on Insolvency 2002 changed the situation with respect to the ability to enforce against *all* assets – this was revoked; however, the “pooling” of all creditors' claims remained. According to the original version of the Law on Insolvency 2002, the secured creditors' claims were ranked in the third order of priority. On insolvency, secured assets were sold at a public auction, and the proceeds were initially distributed to the creditors of the first and second orders of priority, provided that their claims arose earlier than the security agreement was entered into, and the remainder was distributed among the secured creditors.<sup>669</sup> Hence, the adoption of the Law on Insolvency 2002 was not particularly good news for the creditors. In the preceding descriptions of the Law on Insolvency 1992 and Law on Insolvency 1998, a reference was made to an example where a creditor obtained security over an office typewriter, and, therefore had an insolvency dividend ratio equal to that of a project finance lender, who had security over, say, the debtor's shopping mall. Arguably, this approach did not promote large-scale financing deals, cheap credit and, ultimately, investment. However, after more than a decade when security essentially did not protect the creditors' interests, the legislator's approach has changed.<sup>670</sup>

The Law on Insolvency 2002 now distinguishes between security provided to “general” creditors and security provided for a “*credit agreement*”.<sup>671</sup> With respect to a “general” creditor, seventy *percent* of monies received on the sale of the secured assets may be used to satisfy the secured creditor's claims.<sup>672</sup> According to the Law on Insolvency 2002, seventy

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Insolvency 1992, though it was not clear at all that that statute provided for the ability of the secured creditors to claim against *all* assets).

<sup>669</sup> And this created another problem – for each secured creditor this essentially created its own “personal” order of priority, depending on when the respective security agreement was entered into (and not (only) as in relation to any subsequent security over the same secured assets, as the reader may have expected, but as in relation to the creditors of first and second priorities).

<sup>670</sup> The Federal Law No.296-FZ “On the Making of Amendments to the Federal Law “On Insolvency (Bankruptcy)”, dated 30 December 2008.

<sup>671</sup> According to the definition of the Civil Code 1994, Article 819, a credit agreement is an agreement, pursuant to which a bank or other credit organization agrees to provide monies to the borrower in an amount and conditions set out in a contract, and the debtor agrees to return the sum received and pay interest.

<sup>672</sup> Under English law (Section 176A, Insolvency Act 1986 and Insolvency Act 1986 (Prescribed Part) Order 2003), there is a provision with a similar mechanism with respect to a share of assets made available for unsecured creditors. The carve-out leaves 50% of assets up to and including the threshold of £10,000 and 20% of sums above £10,000. However, the crucial difference is in that under English law the provision applies to floating charges and not fixed security, as it does *per* Russian law. Arguably, with respect to floating charges, there are valid reasons for having a carve-out; these reasons are not evident in connection with a carve-out for fixed

*percent* of proceeds is available to the secured creditors to the extent that it covers the “*main sum of indebtedness*” and accrued interest. At this point, it is appropriate to note that the Law on Insolvency 2002 does not define the “*main sum...*”. The Civil Code 1994 does operate with the term the “*main sum of indebtedness*” in the context of the order of discharging of obligations if a payment is made less than for the full amount (Article 319); however, there is no definition of the “*main sum...*” provided there either. Why such a definition may be important? Consider the case where a bank lends to a borrower on a condition that all lender’s expenses related to the loan are paid for by the borrower. If the borrower becomes insolvent, one may expect that the bank would incur (significant) legal and other adviser’s fees in the process of recovery. Russian law does not provide an express answer whether such additional sums are also “*main sum of indebtedness*”; it seems that there are arguments that such sums can be, if the loan agreement is drafted appropriately, “*main sums...*”;<sup>673</sup> however, a contrary interpretation cannot be discounted altogether.

Monies, which remain after the discharge of the secured creditors’ claims (*i.e.*, at least twenty-five *percent* of the secured assets’ sale proceeds), are used to pay the creditors of the first and second orders of priority (they are entitled to twenty from the twenty-five *percent*) and the court and insolvency administrator’ fees/expenses/wages (the remaining five *percent*).

If security was provided in respect of a credit agreement, than the proportion of the sale proceeds available to the secured creditor increases to eighty *percent* maximum; the remaining sum is divided between the creditors of the first and second priorities (they are entitled to fifteen *percent*) and the court’s and insolvency administrator’ fees/expenses/wages (the remaining five *percent*). Thus, in the case of credit agreement, the lender receives a better treatment on insolvency (as compared to a lender on, say, a loan agreement).

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security. The Russian carve-out applicable to fixed security affects the availability of project- and asset-financing for a debtor.

<sup>673</sup> The argument can be made in the following way: the law refers to the main sum and interest. Legal expenses and other professional expenses are not interest; and hence, they must be the “*main sum*”. This argument of course, holds true as long, as there can be only the “*main sum*” and interest to the exclusion of any other categories. Strictly speaking, the law also recognizes at least one “*additional*” category: “*statutory*” interest pursuant to Article 395 of the Civil Code 1994. This “*statutory*” interest does not accrue on “*genuine*” interest, unless an agreement provides otherwise (see item 51 of the Resolution of the Plenary session of the Presidium of the Supreme Court of the Russian Federation and the Plenary session of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.6/8 “*On Some Questions, Related to Application of Part I of Civil Code of Russian Federation*”, dated 1 July 1996). Therefore, this “*statutory*” interest may be considered a category, additional to “*main sum*” and interest.

Legal and other professional expenses are not pure economic losses, which are excluded from the insolvency proceedings by virtue of Article 4; therefore, the respective claims can be made in insolvency proceedings by the creditor(s).

Under Russian law not all lenders have the capacity to enter into credit agreements. Under an agreement that qualifies as a “credit agreement”, the monies must be advanced to the borrower by a bank or a credit organization.<sup>674</sup> The terms “bank” and “credit organization” are defined in Article 1 of the Federal Law No.395-1 “On Banks and Banking Activities”, dated 2 December 1990, and it is not difficult to determine whether a Russian company is a “bank” or “credit organization” – it is a necessary and sufficient condition that such an entity has the respective (banking) license. However, given the respective provisions of the Law “On Banks and Banking Activities”, “loan/credit” agreements entered into by foreign banks may pose a problem. On the one hand, Russian law includes a definition of a “foreign bank”: a foreign bank is a “bank recognized as such by the legislation of the State where such a bank is registered”.<sup>675</sup> On the other hand, in giving the definition of a “bank” *per se* the law refers only to Russian banks. Thus, one of the interpretations is that the terms “bank” and “foreign bank” refer to two different sets of entities and there is no entity can be treated as both a “foreign bank” and also a “bank” (*i.e.*, “banks” do not include “foreign banks”). If such an interpretation is applied by courts (this would be somewhat illogical, but again cannot be discounted altogether), foreign banks will be at a disadvantage in insolvency proceedings as against (Russian) banks, since foreign banks would not have the capacity to enter into “credit agreements” (as this term is understood in Russian law).

In both cases (non-credit and credit agreements), if any proceeds from the secured assets’ sale remain after the satisfaction of the claims of the creditors of the first and second orders of priority, such proceeds are used to pay off the claims of the respective secured creditor. Then, any remaining sums are included into the assets available for other creditors generally. Conversely, if the proceeds from the sale of secured assets turn out to be insufficient to discharge the secured creditor’s claim in full, the (part of the) claim that remains outstanding is included into the third order of priority and is satisfied accordingly.

The recent changes in Russian security/insolvency law may be summarized as follows. The creditors now enjoy a more predictable position: the link between the secured assets and the secured obligations is now recognized in Russian law. From a macro-level perspective, one may say that this certainty results in more accurate measurements of, and prices for, risk. This, in turn, should promote more efficient investment and, more generally, a more efficient economy.

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<sup>674</sup> Article 819 of the Civil Code 1994.

<sup>675</sup> Article 1 of the Federal Law No.395-1 “On Bank and Banking Activities”, dated 2 December 1990.

From a micro-level perspective, borrowers may find that their creditors are more willing to lend, and, in certain cases, that interest charged on loans decreased. Business projects, which earlier would have been considered implausible, may now be re-considered; and this is especially true with respect to non-recourse (or limited recourse) deals.

The issue that remains to be proven by practice is whether the ratio of secured obligation/*percent* claim on proceeds of the secured assets sale is adequate.<sup>676</sup> As discussed earlier, the secured creditor should receive at least seventy or eighty *percent*, as the case may be, of the proceeds from the sale of the secured assets. The fact that twenty-five or twenty *percent*, as the case may be, of the proceeds from the secured assets is made available to the creditors of the first and second orders of priority, arguably, reflects the perceived preferences of the society and the need to ensure that the interests of, *inter alios*, employees are protected and that there are sufficient funds to implement an appropriate insolvency process. Notwithstanding that the jury is still out on the question of whether the correct balance of private/public interests was struck by the legislator, the recent revisions to the Law on Insolvency 2002 are an evident and welcome improvement on the earlier regime.

Let us now return to the other, non-security-related, provisions of the Law on Insolvency 2002.

The law regulates with detail the sale of the debtor's assets (Article 139). The respective provisions were changed considerably in December 2008;<sup>677</sup> and one more time in July 2009.<sup>678</sup> The original version of the Law on Insolvency 2002 allowed the liquidation administrator to sell the debtor's assets separately; however, there was no express provision allowing the liquidation administrator to sell the debtor's enterprise, similar to that in external administration.<sup>679</sup> The December 2008 revision of the Law on Insolvency 2002

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<sup>676</sup> Clearly, the newly introduced ratios will have an effect on the lenders' approach to the overcollateralization. The effect of overcollateralization may be significant. By way of example, let us assume that a lender in a non-insolvency context requires 120% overcollateralization. This may be due to a number of factors, not least that assets' sale price on insolvency is ordinarily lower than can be assumed in other circumstances. However, in insolvency, the lender is aware of the fact that it can only count on, say, 80% of the sale price. Thus, the required overcollateralization ratio, taking insolvency into account, increases to  $120\%/80\% = 150\%$ . The increase may just tip the scales for a borrower, which had just enough assets to give security at 120% ratio. Of course, in practice the effects of the introduction of the 70%, or 80%, ratio need to be viewed in the context of the change from the "pooling of secured assets" for all secured claims to the ability to claim against proceeds from "own" secured creditor's security.

<sup>677</sup> The Federal Law No.296-FZ "On the Making of Amendments to the Federal Law "On Insolvency (Bankruptcy)""", dated 30 December 2008.

<sup>678</sup> The Federal Law No.195-FZ "On the Making of Amendments to Certain Legislative Act of the Russian Federation", dated 19 July 2009.

<sup>679</sup> Article 110, see p.179 above. Arguably, the liquidation administrator could still sell the enterprise; however, without the benefit of certain specific provisions, *e.g.*, those related to the transfer of licenses.



provided that the debtor's assets in liquidation must be sold through the procedures prescribed for the sale of the debtor's enterprise in external administration. There were two exceptions for this rule: (i) assets with balance sheet value of less than 100,000 Rubles<sup>680</sup> were sold as the creditors' meeting or the creditors' committee, as the case may be, decided; and (ii) finished goods produced by the debtor were not subject to the rules prescribed by Article 139. The surprise of the December 2008 revision was in that it excluded any reference to the possibility to sell the debtor's assets separately, unless they came under one of the two mentioned exceptions. It is not clear what the intention of the legislator behind this change was. July 2009 amendments to the Law on Insolvency 2002 reinstated the possibility to sell debtor's assets separately. The July 2009 revision is somewhat surprising as well. The revised wording specifically refers to a provision in the Law on Insolvency 2002 that deals only with electronic sales of the debtor's assets; however, at the time of writing, this provision has not entered into force.<sup>681</sup> Thus, until electronic sales of assets become available, a liquidation administrator appears not to be able to generally sell only a part of the debtor's assets. In most cases, the sale of a business enterprise as a whole could attract a higher purchase price (not least because in such a case the goodwill and client/supplier relationships are included in the sale); however, the flexibility to sell only a part of the debtor's assets may be an added benefit to the powers of a liquidation administrator.

In addition to the sale of the debtor's assets, the liquidation administrator may use the following procedures: assignment (of debtor's claims) (Article 140); and replacement of debtor's assets (Article 141). Both procedures are similar<sup>682</sup> to those available in external administration and thus will not be described here further.

The creditors' claims are paid off sequentially in their order of priority; and if the available funds are not sufficient to pay off all creditors' claims of a certain priority, such claims are satisfied *pro rata* (Article 142).

The liquidation administrator makes payments in accordance with the register of creditors' claims; the register is closed automatically in two months from the date of the publication of

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<sup>680</sup> Equivalent to approximately 3,400 US Dollars at the time of writing.

<sup>681</sup> The introduction of electronic sales is subject to certain regulation being adopted, see footnote 626 on p.179 above.

<sup>682</sup> With the necessary changes reflecting the different nature of liquidation proceedings as compared to external administration.

the notice on the commencement of liquidation proceedings.<sup>683</sup> Generally, the two months' deadline may seem somewhat short; however, this is justifiable on the grounds of the need for expedient conclusion of the proceedings. Any claims that were submitted after the prescribed time are satisfied in subordination to all other creditors' claims (that is to say, claims that were submitted within the deadline); among the claims that were submitted late, the otherwise applicable order of priority remains.

In order to be included into the register, each creditor's claim must be approved by the court.<sup>684</sup> What happens if, absent the delay of a creditor of third order of priority (*i.e.*, business creditors) in submission, its claim(s) is/are approved by the court only after the register was "closed" and payments of third order of priority began? Such creditors should be paid equally with the (other) creditors of third order of priority.<sup>685</sup>

An important issue in any insolvency proceedings is the availability of set-off. Set-off, arguably, allows to significantly decrease risks in insolvency by reducing mutual exposures of counterparties to the residual value of the difference in their claims. However, set-off, and the closely related netting, are topics of their own self and their detailed discussion is beyond the scope of this work.<sup>686</sup> It is often argued that if a set-off is available on insolvency, a creditor is put in a better position than it would have otherwise been, since a smaller part of its claim will remain undischarged after the set-off, and it is that smaller part that will be subject to the reduction *via* the insolvency dividend ratio. Perhaps unfortunately, the soil of Russian law was not hospitable to the insolvency set-off.<sup>687</sup> Initially, with respect to the Law

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<sup>683</sup> There are exceptions to this rule with respect to the claims of the first and second order of priority; even if submitted late, they receive a preferential treatment and are, generally, elevated over the not yet paid off claims of lower orders of priority.

Also *cf.* the respective timing in observation: see the main text and footnote 575 on p.168.

<sup>684</sup> Article 100, initially reviewed on p.176 above.

<sup>685</sup> Unfortunately, the Law on Insolvency 2002 does not provide an answer for the situation where the creditors of third order of priority with claims, which have been approved by the courts with a delay, cannot be paid *pro rata* with other creditors of third priority simply because there are insufficient funds left. One solution is to make the payments to the extent that the funds are available; and the other is to require the creditors of third order of priority to return a proportion of funds that has been paid to them in the excess of the appropriate ratio. Strict interpretation of the law, despite the apparent practical difficulties, seems to suggest that the excessively received monies must be returned.

<sup>686</sup> A comprehensive work on set-off is by P.Wood, *English and International Set-off*, Sweet and Maxwell, 1989; see also the newer P.Wood, *Set-off and Netting, Derivatives, Clearing Systems*, Sweet and Maxwell, 2007.

On Russian rules on set-offs in the context of finance, see, *e.g.*, S.Solomin, *Applying Set-off in the Termination of an Obligation to Repay a Credit*, *Law and Economics*, No.1, 2009.

<sup>687</sup> *Cf.* English Insolvency Rules 1986/1925, rule 4.90:

(1) *This Rule applies where, before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation.*

...

(2) *An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other.*

on Insolvency 1992 and Law on Insolvency 1998, insolvency set-off was expressly disapproved by the courts.<sup>688</sup> The Law on Insolvency 2002 followed this approach: according to Articles 63 and 81, starting with the onset of observation or financial rehabilitation, respectively,<sup>689</sup> insolvency set-off is not available for monetary claims,<sup>690</sup> if the insolvency priorities are disregarded by such a set-off.<sup>691</sup> Article 142 (applies in liquidation proceedings) adds to this that the requirement of “proportionality” must also be observed (which requirement the legislator regrettably omitted to expressly specify in Articles 63 and 81).

**(viii) Chapter III.1: Contesting Debtor’s Transactions**

Significant amendments were made to the Law on Insolvency 2002 in December 2008. The respective changes related, *inter alia*, to: the protection of the rights of current payments’ creditors;<sup>692</sup> the definition of current payments;<sup>693</sup> the shortening of the liquidation proceedings;<sup>694</sup> online access to insolvency-related information;<sup>695</sup> the accrual of interest on liquidation creditors’ claims;<sup>696</sup> and sale of the debtor’s assets.<sup>697</sup> The most important change introduced by the December 2008 amendments relates to the improvement of the treatment of secured creditors in insolvency.<sup>698</sup>

The focus of this sub-section is on another significant amendment to the Law on Insolvency 2002, the July 2009 amendment; and, more specifically, on a new chapter inserted into the law: Chapter III.1, which relates to “*contesting debtor’s transactions*”.<sup>699</sup> Chapter III.1 does not prevent claimants from using any other available avenues to contest a debtor’s

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See also *MS Fashions Ltd v Bank of Credit and Commerce International SA (in liq) (No 2)* [1993] Ch 425 for the effect of set-off in insolvency (the effect of an insolvency set-off is a net payable sum).

Thus, in English law, generally, insolvency set-off is mandatory (though there are rules as to which claims are covered by the set-off).

<sup>688</sup> See the Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.6110/98, dated 23 February 1999 and the Resolution of the Presidium of the Supreme Court of the Russian Federation No.5951/99, dated 28 March 2000 (footnotes 489 on p.146 and 513 on p.152 above).

<sup>689</sup> Set-off in external administration is prevented by virtue of moratorium (Article 95).

<sup>690</sup> The Civil Code 1994 allows a set-off for “*mutual homogenous claims*” generally (Article 410). Thus, the Law on Insolvency 2002 does not prevent a set-off of non-monetary obligations. This is logical, since non-monetary obligations are, generally, outside the scope of Russian insolvency law (Item 5 of Article 4 of the Law on Insolvency 2002).

<sup>691</sup> According to the Informational Letter of the Presidium of the Supreme Arbitrazh Court of the Russian Federation, No.129 “On Some Questions of the Practice of Application by the Arbitrazh Courts of the Provisions of paragraph 2 of item 1 of Article 66 of the Federal Law “On Insolvency (Bankruptcy)””, a purported insolvency set-off is a voidable transaction, which means such a set-off can be invalidated by a court’s decision, but is not void *ab initio*.

<sup>692</sup> See footnote 555 on p.163 above.

<sup>693</sup> See footnote 607 on p.175 above.

<sup>694</sup> See footnote 632 on p.182 above.

<sup>695</sup> See footnote 634 on p.182 above.

<sup>696</sup> See p.185 above.

<sup>697</sup> See p.192 above.

<sup>698</sup> See p.189 above.

<sup>699</sup> *Osparivanie sdelok dolzhnika* in Russian, which can also be translated as “setting aside of the debtor’s transactions”.

transaction; it supplements such otherwise available means with grounds specifically applicable in insolvency proceedings. Chapter III.1 allows to contest (and set aside) transactions: (i) at an undervalue (item 1, Article 61.2); (ii) damaging creditors' (proprietary) interests; and (iii) creating preferences (Article 61.3). Transactions mentioned in (i) and (ii) are collectively referenced by the law as "*suspicious transactions*".

The tools provided for by Chapter III.1 are available to external administrators and liquidation administrators (and thus, the respective proceedings must be initiated during external administration or insolvency proceedings) (Article 61.9).

The "suspicious" period for a transaction at undervalue is one year prior to the acceptance by the court of an insolvency petition and onwards. A transaction at undervalue is a transaction where the counterparty provides "unequal" consideration. Unequal consideration, for the purposes of the law, includes, *inter alia*, the cases where the value of the goods transferred significantly exceeds the value of the counterparty's consideration as determined taking into account the terms and circumstances of such consideration. Chapter III.1 goes on to provide that a transaction with a "*price*" or other terms significantly worse for the debtor as against analogous transactions carried out in comparable circumstances, is also a suspicious transaction. Thus, the law introduced a "significance" test into the rules on suspicious transactions. Since the whole of the Chapter III.1 is new for Russian law, it is difficult to foresee how the courts will apply this test. Taking into account the potentially deteriorating credit of the debtor prior to the insolvency petition being filed, the deals offered to such a debtor may be worse than otherwise available. This situation is only natural, but it remains to be seen how the courts will respond and whether such deals will be successfully attacked as undervalue transactions.<sup>700,701</sup>

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<sup>700</sup> Cf. English Insolvency Act 1986, Section 238 (Transactions at an undervalue (England and Wales)):

*"(1) This section applies in the case of a company where—*

*(a) the company enters administration, or*

*(b) the company goes into liquidation; ...*

*(4) For the purposes of this section and section 241, a company enters into a transaction with a person at an undervalue if—*

*...*

*(b) the company enters into a transaction with that person for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the company..."*

Thus, the "significant" test is also used in English law.

Setting aside of debtors' transactions was earlier available in external administration in Russia, too: prior to Chapter III.1 being introduced into the Law on Insolvency 2002, rules on setting transactions aside were provided by Article 103 (now repealed). Article 103 applied in external administration only, rather than in external administration and liquidation proceedings (as the new Chapter III.1 does). In addition, Article 103 did not cover transactions at an undervalue (it was aimed at interested party transactions and transactions creating preferences).

For transactions “*damaging creditors’ proprietary interests*”, the “suspicious” period is three years prior to the acceptance of the insolvency petition; transactions after the petition can also be “*damaging*”. As the terms “*damaging creditors’ proprietary interests*” suggest, it is necessary to establish: (i) the purpose of causing damage to the creditors’ interests; (ii) that the debtor’s counterparty knew that the transaction was entered into with such a purpose; and (iii) damage to the creditors’ interests.

Chapter III.1 includes rules on when presumptions on the existence of elements in (i) and (ii) above are made. For example, knowledge is assumed if the counterparty to the transaction: (i) was an interested party;<sup>702</sup> (ii) knew or should have known that creditors’ interests are infringed; or (iii) knew or should have known that there were indications of the debtor’s insolvency or knew about the insufficiency of the debtor’s assets. The rules on the availability of the assumption on the respective purpose are fairly complicated. Perhaps, the most important cases are where the respective accounting documents were damaged or destroyed and when, after assets were transferred to a third party, the debtor continued to use, or had a degree of control over the use of, such assets. An assumption is also made when a transaction involves assets or obligations with twenty-five or more *percent* balance sheet value. The latter assumption may cause difficulties in connection with transfers of valuable assets within a group of companies: such a transaction will raise the assumption of knowledge (as it occurs between interested parties); and the assumption of purpose (if the assets are valued at twenty-five *percent* or more). However, from a practical viewpoint, it is not a given fact that such a transaction was not *bona fides* when contemplated, especially taking into account the long suspicious period (three years).

Turning to transactions creating a preference, Chapter III.1 defines them as transactions, which entail, or may entail, preferential treatment in satisfaction of a creditor’s claims.<sup>703</sup>

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With respect to granting of security (as a transaction at undervalue), see *Re MC Bacon Limited* [1990] BCC 78 and the more restrictive *Hill v Spread Trustee Company & another* [2006] EWCA Civ 542. English law also includes specific rules for floating charges (Section 245 of the Insolvency Act 1986); there are no equivalent specific rules for Russian pledge of goods in circulation (see *Pledge of goods in circulation* on p.95 above).

Furthermore, the Insolvency Act 1986 includes provisions on setting aside of extortionate transactions (section 244). Extortionate transactions are, generally, those which required “*grossly exorbitant payments ... in respect of the provision of the credit*” or “*grossly contravened ordinary principles of fair dealing*”.

<sup>701</sup> Another interesting point is the view that Russian courts will adopt on linked transactions, *i.e.*, whether such transactions will be considered as a whole for the purpose of the valuation of consideration. English courts may take into account the aggregate consideration on linked transactions (*Phillips (Liquidator of AJ Bekhor & Co) v Brewin Dolphin Bell Lawrie Ltd (formerly Brewin Dolphin & Co Ltd)* [2001] UKHL 2). See also *Rolled Steel Products Limited v BSC* [1985] 3 All ER 52 and *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250 on cases where security may be “saved”.

<sup>702</sup> See footnote 597 on p.172 above.

<sup>703</sup> *Cf.* English Insolvency Act 1986, section 239, which also allows the court to set aside transactions creating preference. Preference arises if a company gives a preference to a creditor, surety or guarantor and this puts that person in a better position if the company goes into liquidation. The company must “*desire*” to create the

Preferential treatment, *inter alia*, may include: (i) providing security to a creditor on an obligation, which arose prior to the transaction in question; or (ii) the paying off of claims, which had not matured by the time of payment, provided that there were other obligations outstanding at that time, which had not been paid when due and payable.

Suspicious period for a transactions creating a preference is one month before the acceptance of the insolvency petition and onwards; however, if both (i) and (ii) mentioned above are present, then the suspicious period is six months before the acceptance of the insolvency petition and onwards. Similarly, the suspicious is period is six months if the counterparty knew of an indication of insolvency or the insufficiency of assets of the debtor (and this is presumed for an interested person).

The consequences of a transaction being set aside pursuant to Chapter III.1 are quite drastic, at least for the debtor's counterparty. "Everything" that was transferred from the debtor is returned into the asset pool generally available for the creditors; if the transferred assets are no longer available, the counterparty has to reimburse their value (without any diminution that could have taken place since the assets were transferred).<sup>704</sup>

It is only logical that when a transaction is set aside pursuant to Chapter III.1, it is not only the creditor that has to "return" assets. There is a reciprocal obligation imposed on the debtor; however, the effects of this obligation, since the debtor is insolvent, differ. Essentially, the creditor acquires a claim against the debtor and such a claim is subject to the priority and *pro rata* rules of the Law on Insolvency 2002. The priority of the so acquired claim depends on the grounds for the setting aside of the transaction; by way of a brief outline, if there was some form of *mala fides* on the part of the creditor, its claims are subordinated below the third order of priority, otherwise, the claims are afforded the third order of priority (Article 61.6).

The legislator did not omit to provide that the arbitrazh court may refuse to set aside a transaction if the value of the assets that can be (potentially) returned into the liquidation assets is less than the value originally received by the debtor pursuant to the transaction

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preference. See also *In the matter of Parkside International Limited (in administration)* [2008] EWHC 3654 (Ch), *Re Sonatacus Ltd* [2007] EWCA Civ 31 and *Re MC Bacon Limited* [1990] BCC 78 on the approach of English courts to Section 239 transaction. Generally, Russian law appears to be narrower, though it remains to be seen how wide an interpretation of Russian preference transactions will be adopted.

<sup>704</sup> It is interesting to note that Russian law does not have an equivalent to fraudulent trading under section 214 of the English Insolvency Act 1986 (see also *Re Patrick and Lyon Ltd* [1933] Ch 786 and *In re Overnight Ltd; Goldfarb v Higgins and others* [2009] WLR (D) 49). English fraudulent trading covers cases where the business of the company was carried on with the intent to defraud creditors after the winding up order was made.

(*i.e.*, the court has the discretion to set a transaction aside only when this is beneficial for the debtor) (Article 61.7).

## CONCLUSIONS

This thesis has analyzed modern Russian laws of security and insolvency. The focus of the analysis was put on the Russian regime as it may be applicable in the context of international financing transaction involving Russian economic interests. The international banking market is capable of providing sophisticated large-scale financing at lower cost and it is therefore important that Russian law does not impede cross-border financing transactions. The analysis of modern Russian law has been accompanied by a review of its predecessor, Soviet law, the life of which spanned over the period of more than seven decades, and, arguably, influenced modern Russian approach.

The history of reforms of U.S.S.R./R.S.F.S.R./Russian law during the Soviet period is breathtaking. Perhaps, its overall path reminds that of the movement of a swing: from the policy of revolutionary expropriation and denial of private property in 1918 over to privatization and other “free-market” reforms of the early 1990s.

In the early stages of the Soviet period the objectives of the Revolution and the context of World War I aggravated by the civil war within the borders of the State demanded radical measures. The period of 1917-21 was characterized by mass expropriation, the denial of private property on means of production, dismantling of the existing court system and refusal by the State to afford judicial protection to the pre-revolution dated rights. It is evident that civil law, and commercial relationships were not primary concerns of the government at that time.

During 1922-28 the Soviet law experienced significant reforms. Soviet civil law and civil procedural law were codified. The negative attitude of the government towards private property and commerce, to a degree, was toned down. With a view to re-build the devastated economy, limited commerce<sup>705</sup> and private property were tolerated. In fact, the Civil Code 1922, promulgated to facilitate the New Economic Policy, was reminiscent of the earlier, imperial *Civil Ulozhenie*, and “western” civil legislation (the Swiss Code of

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<sup>705</sup> See, for example, footnote 17 on p.11 above.



Obligations). This relaxation of the policy should not be overestimated, and, perhaps, viewed only as a temporary concession.<sup>706</sup>

Following the cessation of the New Economic Policy in the late 1920s, the state policy returned to its origins and the negative attitude to private property and commerce was reinstated. The Constitution of the U.S.S.R. 1936 banned private property and replaced it with “*personal property*”.<sup>707</sup> Individuals could have the right of personal property over assets, and then only over assets that were designed for personal use. Notwithstanding the adoption of a number of several significant documents in the period ending with year 1985, including, *inter alia*, the new Civil Code 1964 and the U.S.S.R. Constitution 1977, a degree of continuity existed among such documents and the law remained relatively stable. Beginning with 1960s the policy of the State was adjusted to provide economic incentives based on profit and cost; and, consequently, the law reflected this “commercialization”.

The new period in Soviet law started in 1985 with the rise to power of Mikhail Gorbachev. Gorbachev’s major political and social reforms – *Perestroika* and *glasnost’* – received worldwide attention. The economic policy shifted away from the stifling restrictions of a planned economy. The process started with gradual relaxation of the views on “private” ownership of means of production in the Laws on Individual Labor Activity 1986 and On Cooperation in the U.S.S.R. 1987. The process culminated with the adoption of the Law on Privatization in the R.S.F.S.R. 1991, which dealt the final blow to the socialist economy.

Privatization changed Soviet economy beyond recognition. In no time vast quantities of productive assets found their way from public ownership into private hands. The results of this distribution were skewed: few persons received control over the majority of the then ex-Soviet enterprises. Critics often argue that mechanisms that led to the uneven distribution of property must have been unjust and were, therefore, unacceptable. However, this must be put into the context of the acute economic crisis in Russia at the time of privatization and the resulting desire of the Government to run the process as quickly as possible. The privatization legislation was far from flawless, but it purported to offer fair opportunities<sup>708</sup> and favored the enterprise’s employees as the potential purchasers in privatization.<sup>709</sup> Those opportunities were not exercised by the majority of the population (being unprepared to become shareholders rather than just employees); and the advantage

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<sup>706</sup> See, for example, fn.16 on p.10 above.

<sup>707</sup> See *U.S.S.R. Constitution 1936* on p.19 above.

<sup>708</sup> For example, privatization cheques were distributed by the government equally among adult citizens: one cheque to a person.

<sup>709</sup> For example, the availability of 30% discount for employees and payments in installments over a period of three years. See p.60 above.

of the favorable terms for the purchases of state assets was then taken by a small group of nascent “entrepreneurs”.

With the exception of short periods after the Bolshevik Revolution and during the reforms of the 1980s, the banking system in the U.S.S.R. was state-run; investment business was directed by state authorities, and, from a certain viewpoint, was non-commercial. Hence, Soviet law of finance was undeveloped.

In particular, under the rules of the Civil Code 1964 charging interest on loans was prohibited, unless a credit organization was a party to the agreement; and the main means of production<sup>710</sup> of a state enterprise could not be pledged.<sup>711</sup>

Finally, under the Soviet rules, a contractual obligation (for example, a sale-purchase agreement between two enterprises) changed if the directives of the state plan that the obligation was based on were amended. Thus, a Soviet obligation was “flexible” – it flexed to conform to the state plan.

Modern Russian legislation is based on different principles: the Constitution 1993 protects private property and the Civil Code 1994 declares the freedom of the parties to enter into contracts as they see fit. There is no longer any “flexibility” in obligations as dictated by the state plan. Does it mean that modern Russian law severed all ties with Soviet law? There are two perspectives to this question. The first perspective is that modern Russian law indeed does not have any socialist underpinning. The second perspective is more subtle. Soviet legislatures and courts developed a certain approach to drafting, interpreting, and applying, laws. Soviet law was not concerned with the efficiency of commercial practice and, thus, was not receptive to innovations. Disregard for business logic was inherent to Soviet law. And this attitude towards business interests seemed, at times, to weigh over modern Russian law. For example, within the ambit of the laws of security and insolvency, until December 2008, the position of secured creditors was not satisfactory and, arguably, impeded efficient lending (see below).

As discussed, in *Security, Insolvency and Conflict of Laws* above, there are two major areas of Russian law which cannot be insulated from in the context of a cross-border financing transaction concerning economic interests in Russia: law of security and law of insolvency.

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<sup>710</sup> For more detail, see main text and footnote 100 on p.32 above.

<sup>711</sup> The Civil Code 1922 was more liberal and allowed both interest on loans (with the exception on compound interest, unless a credit organization was a party to the agreement) and pledges of main means of production.

Enforcement against assets located in Russia must be carried under Russian laws; and the respective security documents, as a rule, must be governed by Russian law, too.<sup>712</sup>

Several forms of security are expressly recognized in Russia. However, only pledge can be referred to as security proper, as only it survives in the insolvency of the pledgor.<sup>713</sup> Pledge may take either possessory or non-possessory form and in both cases, the pledgee, arguably, has a form of a right *in rem* (or, at least, a claim) against the pledged asset. Russian law distinguishes between pledges of moveable assets and pledges of immovable property, which are also referred to as mortgages. Generally, a public security register exists only for mortgages; and the obligation to maintain records of pledges of moveable property rests with the pledgors. This situation is unfortunate, since it exposes pledges of movables to attacks by alleged prior pledgees or other abuses related to subsequent pledges. Russian commercial practice would benefit considerably from the introduction of public registration of pledges of movables.

Russian law is not settled on the question whether future obligations can be secured by pledge. Some comfort to the lenders may be provided by a case where the court recognized that the obligation to lend under a credit agreement arose at the time when the agreement was concluded and *before* the first disbursement. Thus, the common practice of making the execution of a pledge agreement a condition precedent to the first utilization may be acceptable for the purposes of Russian law. However, careful approach is required so as to ensure that obligations to lend arise prior to the creation of the pledge.

The position of Russian law on pledges of future assets is less uncertain: though there are contradictions in the statute, courts' interpretation allows pledges of future (tangible) assets. However, pledges of future rights have not been tested and may fail for the lack of certainty in the description of the pledged right.

The long-time Achilles' heel of Russian law remains the pledge of deposited cash (cash in bank accounts). There is no restriction on pledges of deposited cash in the statutes; however, Russian courts adopted a negative view on the possibility of such pledges.<sup>714</sup>

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<sup>712</sup> Rules applicable to immovable and moveable assets differ: see *Security, Insolvency and Conflict of Laws* on p.68 above.

<sup>713</sup> Lien also survives in the insolvency of the pledgor. However, lien is non-consensual form of security and is therefore less important for the purposes of this work. In addition, lien survives insolvency only by virtue of application of rules on enforcement of pledges to enforcement of liens. See Lien on p.133 above.

<sup>714</sup> Recent amendments to Russian law may have changed the position on pledges of deposited cash. See the discussion in *Bank accounts* on p.84 above.

Russian law does not provide for a direct equivalent to the English law floating charge. A close mechanism is pledge of goods in circulation; however, such a pledge can be granted over goods only.<sup>715</sup>

Finally, repo transactions have been consistently invalidated by the courts. Simple repo transactions are structured as back-to-back sale and purchase agreements; however, their commercial effect is somewhat similar to pledge. This led the courts to conclude that repos are disguised pledge agreements and then invalidate repos for non-compliance with rules on pledges. Russian law has been recently amended to allow repos in the securities market. In addition, changes to the rules on enforcement against pledged assets may have made some of the courts' reasoning for invalidating repos obsolete. However, it is prudent to assume that repos outside the securities market are still unlawful.

Historically, Russian enforcement against assets was a flawed and creditor-unfriendly process: as a rule, enforcement must have been carried out through courts and only the power of sale existed: assets must have been sold at a public auction. Thankfully, amendments of December 2008 allowed extensive use of the out-of-court enforcement procedures and forfeiture of pledged assets.<sup>716</sup>

In financing transactions assignments are often used as security. Russian law allows for assignments, but does not treat them as security. The position of the courts on assignments changed dramatically: initially, the use of assignment was limited only to cases where a naked right of the creditor had existed and was fully and unconditionally assigned. The current position seems to be that partial assignment and assignment of future rights are possible. Cautious approach to such assignments is nevertheless warranted. In addition, it is likely that an assignment of rights to the lenders and a later re-assignment of same rights to the debtor will receive the "repo treatment" – will be invalidated. The use of assignments as security in financing transactions remains an area of high legal risk.<sup>717</sup>

Russian law also recognizes suretyship (which is close to the English law guarantee) and bank guarantee (which is somewhat close to the English law indemnity). Under Russian law, both are treated as security, but in fact are *quasi* security. Suretyship is a secondary obligation and depends on the existence of the main, secured, obligation. Suretyship may be issued in

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<sup>715</sup> See *Pledge of goods in circulation* on p.95 above.

The law also allows to pledge an enterprise as a whole, with all its assets and liabilities (which then may include intangibles, etc.)

<sup>716</sup> See *Enforcement* on p.106 above.

<sup>717</sup> See *Assignment* on p.113 above.

respect of future obligations. A bank guarantee<sup>718</sup> may be issued only by banks or insurance companies and has a degree of independence from the main obligation (though courts found ways to reduce such independence). The use of Russian law suretyships and bank guarantees is limited in the context of cross-border financings.<sup>719</sup>

The last form of Russian security that deserves mentioning is penalty. Penalty in fact is not security or *quasi* security; it is rather a *quantum* of liability matter. Russian law does not require that penalty is a genuine pre-estimate of losses and allows penalties to be claimed in addition to damages. However, the courts may reduce the amount of payable penalty if it is disproportionate in the circumstances. According to Russian conflict of laws rules, Russian law on penalties will apply to obligations governed by Russian law (and thus may be relevant for security documents governed by Russian law).<sup>720</sup>

With respect to the balance of interests of pledgors and pledgees, the general observation is that traditionally Russian law favored the pledgor to the detriment of the pledgee. Enforcement was cumbersome and ineffective. Moreover, pledges were ineffective if the pledgor became insolvent (see also below). The approach of Russian law was changed in December 2008. Enforcement is now an easier and more effective process. Arguably, for the first time since 1993-4, pledges received protection from insolvency of the debtor. Generally, the interests of pledgors and pledgees are more justly balanced, and, overall, the reliability of pledges has been improved. This may have a positive effect on borrowing costs and should be welcome in the lending market.

In general, Russian law of security suffers from the inflexible approach of the courts to the needs of commerce and restrictive interpretation of statutes (as vividly demonstrated, for example, by the treatment of repos). Such rigidity might have been appropriate in relationships involving consumers, but it clearly impedes the development of business to business practices. Hopefully, the tendency to adopt more liberal views on the parties' freedom to enter into contracts, as can be observed in recent cases, will continue into the future.

Turning to modern Russian law of insolvency, it is clear that the task before the legislature in the early 1990s was simply monumental: to create the law of insolvency from scratch. During the Soviet period insolvency law and state-run economy were, in principle, almost

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<sup>718</sup> One of the uses of Russian bank guarantees is in connection with corporate acquisitions. It is generally understood that a Russian bank guarantee must be issued in connection with a mandatory offer for a Russian joint stock company.

<sup>719</sup> See *Bank Guarantee* on p.123 and *Suretyship* on p.127 above.

<sup>720</sup> See *Penalty* on p.129 above.

mutually exclusive; and thus, when the market reforms commenced, there were no foundations to build upon. Generally, insolvency law is a controversial subject: it impacts on private and public interests and the conflict between such interests is openly visible. Should the legislator shield the debtor and its employees from the callous creditors or should the interests of the creditors, who entrusted the debtor with their monies, prevail?

The first attempt of the Russian authorities at insolvency, the Law on Insolvency 1992,<sup>721</sup> should not be judged too strictly. As can be expected, the law was not particularly complex and omitted to deal with certain aspects in the appropriate degree of detail. The Law on Insolvency 1992 adopted a balance sheet insolvency test.<sup>722</sup> Initially, the balance sheet test was vague; however, this was rectified in secondary legislation. The adopted balance sheet test also allowed companies to manipulate accounts so as to circumvent involuntary liquidation. As a consequence, many *de facto* insolvent companies continued to operate. Arguably, this has also contributed to the so-called “*non-payment crisis*” of the early 1990s in Russia. The balance sheet test was often criticized in literature; however, an opinion in its defense can also be advanced. In a crisis-stricken economy, where economic links had been severed, legislating for a cash-flow test would have been lethal for the majority of enterprises. The Law on Insolvency 1992 provided for several insolvency procedures, including, *inter alia*: rehabilitation, external administration and liquidation. In rehabilitation, control over the debtor remained with its chief executive officer and shareholders/members; in external administration control was ceded to a court-appointed insolvency official, external administrator. In fact, these procedures (or rather, the underpinning ideas) were to a large extent inherited by the later Russian insolvency legislation.

The treatment of security in insolvency was settled during the years of the Law on Insolvency 1992. From the outset, the law stipulated that secured obligations were not subject to insolvency rules; and thus, apparently, the secured creditors’ position was immune to the insolvency law restrictions. However, the Civil Code 1994 took any such advantages from the secured creditors away: their claims were subordinated into the third order of priority; furthermore, all secured creditors claims were then pooled together and satisfied *pro rata*.<sup>723</sup> As a result, a creditor taking security could not know how much risk it was actually accepting (more precisely “how much” security was available), since *all* secured assets were shared among *all* secured creditors: the link between the secured obligation and

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<sup>721</sup> See *Law on Insolvency 1992* on p.139 above.

<sup>722</sup> See the main text and footnote 507 on p.151 above.

<sup>723</sup> See p.147 above.

the respective secured assets was severed. It is difficult to advance reasons that could justify the decision of Russian lawmakers to provide for the sharing of security.

During the life of the Law on Insolvency 1992 the courts took the view that insolvency set-off was, generally, not available to the creditors.<sup>724</sup> This approach has been put since on statutory basis and applies today.<sup>725</sup> The difficulty with the unavailability of insolvency set-off is that it may substantially increase exposure: the creditor remains liable to pay the full amount to the insolvent debtor, but will recover only a proportion of its claims against the debtor. This increases net losses in insolvency for businesses in general and makes creditors especially vulnerable where complex financial arrangements exist.

In 1998 the Russian economy experienced the shock of a deep economic crisis: the Government defaulted on its bonds and the value of Ruble collapsed.<sup>726</sup> It is at that time that a new insolvency statute replaced the Law on Insolvency 1992. However, the much needed Law on Insolvency 1998 failed to live up to the expectations. In fact, the law was, from a certain perspective, a failure: its rules on observation (the first stage in insolvency proceedings) made it a perfect tool for hostile (and, allegedly, unjust and forceful) takeovers. According to the Law on Insolvency 1998, the debtor could not make representations to the court in the opening of insolvency proceedings. The commencement of insolvency proceedings automatically triggered the onset of observation, which entailed restrictions on the operations of the debtor and made it an easy target for a hostile bidder.<sup>727</sup> The respective provision was declared unconstitutional in 2001;<sup>728</sup> however, this did not stop the discredited Law on Insolvency 1998 from being repealed as a whole in the following year.

The rules on security in insolvency were amended by the Law on Insolvency 1998 to the effect that *all* secured creditors, subject to the claims of superior orders of priority, had a *pro rata* claim on *all* (and not only secured) assets of the debtor.<sup>729</sup> One might struggle again to find an explanation for this approach.

On the positive side, the Law on Insolvency 1998 introduced the cash flow approach instead of the much criticized balance-sheet insolvency test: generally, cash flow test is viewed as a recipe for a healthier economy.<sup>730</sup>

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<sup>724</sup> See the main text and footnote 489 on p.146 above.

<sup>725</sup> See p.194 above.

<sup>726</sup> See introduction to *Law on Insolvency 1998* on p.148 and footnote 499 on p.149 above.

<sup>727</sup> See p.153 above and *infra*.

<sup>728</sup> See the main text for, and footnote 523 on p.155 above.

<sup>729</sup> Technically, the same approach was adopted by the courts in interpreting the Civil Code 1994 and Law on Insolvency 1992.

<sup>730</sup> See *Insolvency Test* on p.150 above.

The Law on Insolvency 1998 was replaced by the now-in-force Law on Insolvency 2002, a more detailed and comprehensive piece of legislation. The cash flow insolvency test now requires three-months' overdue indebtedness of 100,000 Rubles<sup>731</sup> in aggregate or more.<sup>732</sup> A commercial creditor, prior to the filing of an insolvency petition must obtain a judgment on the respective indebtedness. This makes the initiating of insolvency proceedings a slower process (to the detriment of creditors), but helps to discard *mala fide* applications (and, thus, protects the debtor).

The Law on Insolvency 2002 offers a choice of the following insolvency procedures (stages): observation, financial rehabilitation, external administration, and liquidation proceedings. Technically, a moratorium is available in external administration only; however, creditors' enforcement powers are similarly restricted in observation and financial rehabilitation.

The Law on Insolvency 2002 was amended on several occasions: substantial changes were made only recently, in December 2008<sup>733</sup> and July 2009.<sup>734</sup>

The law of security in insolvency has been re-written by the December 2008 amendments, which should be welcomed by the creditors and the debtors alike. As was mentioned earlier, the link between the secured obligation and the respective secured assets was broken in Russian law: not any longer. According to the amendments, a secured creditor can now count on receiving at least seventy or eighty *percent* of the proceeds from the sale of assets that secured the obligations due to *that* creditor (the rest is "reserved" for creditors with claims of social nature, *e.g.*, employees, and for the costs of the proceedings). "Pooling" of secured assets and satisfaction of all secured claims *pro rata* is now history. For the creditors the benefit of the December 2008 amendments is in that overcollateralization ratio is now a "knowable" value. This should help to better assess and price risk. Arguably, projects, which were not earlier perceived as viable, may be now re-considered and brought to fruition.<sup>735</sup>

July 2009 amendments have changed the law with respect to the setting aside of the debtor's pre-insolvency transactions (Chapter III.1 of the law). The new rules are sufficiently detailed and, arguably, grant administrators and creditors a powerful weapon against an insolvent debtor's iniquitous transactions.<sup>736</sup>

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<sup>731</sup> Equivalent to approximately 3,400 US Dollars at the time of writing.

<sup>732</sup> See *Insolvency Test. Insolvency Petition* on p.160 above.

<sup>733</sup> The Federal Law No.296-FZ "On the Making of Amendments to the Federal Law "On Insolvency (Bankruptcy)""", dated 30 December 2008.

<sup>734</sup> The Federal Law No.195-FZ "On the Making of Amendments to Certain Legislative Act of the Russian Federation", dated 19 July 2009.

<sup>735</sup> See p.189 above.

<sup>736</sup> See *Chapter III.1: Contesting Debtor's Transactions* on p.195 above.



A fundamental issue in a given legal system is whether it favors the debtors', or the creditors', interests in insolvency. Which of those views is adopted in Russian law? It is rather difficult to give an answer with respect to the early Russian legislation – it was in the constant state of flux and its defects made it neither creditor, nor debtor, friendly. In fact, such a situation was beneficial for corporate predators, rather than debtors or creditors. The current position is that the interests of the debtors and creditors are balanced against each other: on the one hand, Russian external administration,<sup>737</sup> in which a moratorium is available, may give the debtor the ability to return to solvency; on the other hand, secured creditors now have the ability to claim directly against the respective secured assets.<sup>738</sup>

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To conclude, Russian laws of security and insolvency have made quite a journey from the days of Soviet law: starting with the inability to give security over capital assets and absence of a basic insolvency regime to relatively comprehensive dedicated statutes on security and insolvency.

Even in the post-Soviet period, for a long time, Russian laws of insolvency and security were not favorable from the perspective of a cross-border financing transaction. One major defect – the inability to claim against secured assets – has been rectified in December 2008. Other limiting factors still remain: few available forms of security (and sometimes, their formalism) and the resistance of the courts to innovations. However, the thrust of recent reforms and judgments appears to demonstrate the changing approach of the legislature and courts to security and insolvency and a better understanding of the commercial interests involved. One may expect that Russian law, being a young and developing system, still has a long journey and new heights to conquer ahead of it.

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<sup>737</sup> External administration is somewhat similar to English law administration.

<sup>738</sup> It may be argued that the interests of the creditors are prejudiced by the requirement to obtain a debt judgment before petitioning on commencement of insolvency proceedings. However, this appears to be necessary in the light of the difficulties of application of the Law on Insolvency 1998: see *Law on Insolvency 1998* on p.148 above.

## Annex.

### Modern Russian State and Law

Chapter 1 *Soviet Law* above reviewed the history of Soviet/Russian law. The purpose of this Annex is different: it reviews modern Russian law. In fact, *Modern Russian State and Law* can be treated as a “primer” on Russian legal system. Such a “primer” is necessary, since Russian laws of security and insolvency discussed in the main body of this work cannot be viewed outside the context in which they operate. The review starts with a general explanation of the federative organization of Russia. The separation of powers is then discussed (as the reader will see, there is certain overlapping between the powers of the executive and the legislative branches). Chapter 2 *Security Law* and Chapter 3 *Insolvency Law* above referred extensively to Russian statutes and court judgments: the division of the body of Russian law into branches, sources of law (including the status of “case law”) and the court system are explained in C. *Branches of Law*, D. *Sources of Law* and E. *Courts*<sup>739</sup> below, respectively.

#### A. Federative Organization

Article 1 of the Constitution of the Russian Federation (the “**Constitution 1993**”)<sup>740</sup> provides:

*“The Russian Federation – Russia is a democratic federative rule-of-law state with a republican form of government.”*

Being a federal state, Russia is made up of constituencies,<sup>741</sup> which are currently eighty three in number.<sup>742</sup> Russian law recognizes different forms of constituencies: a republic,<sup>743</sup> territory, region, federal city, autonomous region and autonomous area. It may seem

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<sup>739</sup> Arbitration is often used in cross-border financing transactions. However, its review in Russia would require substantial volume of analysis and is beyond the scope of this work. For a review of arbitration in Russia, see, e.g., R.Chapaev and V.Bradautanu, “International Commercial Arbitration in the CIS and Mongolia”, 17(3) *The American Review of International Arbitration* (2006) 411.

It must be noted that Russia is a party to the New York Convention 1958 (Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958) and has a dedicated arbitration statute conforming to the UNCITRAL Model Arbitration Law (in the original, non-amended, version).

<sup>740</sup> The Constitution 1993 was adopted in general referendum on 12 December 1993. It is interesting to note that the Declaration on State Sovereignty of the Russian Soviet Federative Republic was adopted in June 1990 and the U.S.S.R. was *de facto* dissolved in December 1991 – see *Transitional Period* on p.36 above. Thus, the new constitution was adopted only two years after the collapse of the U.S.S.R. Two drafts of the constitution were submitted to the referendum: the so-called “presidential” and “parliamentary” drafts. The presidential draft was adopted.

There is some controversy related to the adoption of the Constitution 1993. For example, the then technically still in force Law of the R.S.F.S.R No.241-1 “On Referendum”, dated 16 October 1990, required the absolute majority of all registered votes for an amendment to the constitution. The Constitution 1993 received the absolute majority of those attending the referendum; however, this number was less than the majority of those entitled to vote. See, e.g., L.Okun’kov (ed.), *Commentaries to the Constitution of the Russian Federation*, 2<sup>nd</sup> ed., BEK, 1996.

<sup>741</sup> Russian *sub’yekty*, also often translated as “subjects”. The use of “subjects” is closer to Russian *sub’yekty*; however, such translation is somewhat counter-intuitive and “constituencies” are used in this work.

<sup>742</sup> Article 65 of the Constitution 1993 sets forth the full list of Russian constituencies.

<sup>743</sup> On the status of a republic, see footnote 748 on p.212 below.

unusual that cities are treated as federal constituencies in their own right. Nevertheless, taking into account that only two largest Russian cities – Moscow and Saint Petersburg – are recognized as federal cities, this approach may have a good explanation.<sup>744</sup>

Though constituencies may differ in their economic, and, perhaps, political, influence in Russia, they are declared equal in law.<sup>745</sup>

Law-making power is vested at both the federal and constituencies' level. Legislation at each level must be adopted within the prescribed boundaries of competency.

For example, the following issues are under the federal jurisdiction:

- the Constitution of Russia;
- federal laws;
- human rights;
- legal framework for a single market;
- financial, monetary, credit and customs regulation;
- monetary policy;
- federal taxes;
- federal power grids, nuclear energy, fissionable materials;
- federal transport, railways, information and communications;
- international treaties;
- courts; and
- criminal and civil law.<sup>746</sup>

The Constitution also sets forth the issues, which are under the joint jurisdiction of Russian federal and local authorities, which includes, *inter alia*:

- measures on protection human rights;
- possession, use and management of the land, mineral resources, water and other natural resources;
- management of natural resources, protection of the environment and ecological safety;
- general guidelines for taxation and levies in the Russian Federation;

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<sup>744</sup> According to the Russian Federal Service for Statistics, the estimated population of Moscow and Saint Petersburg in January 2009 was 10.5 and 4.58 million, respectively. Information is available online at <http://www.gks.ru>.

<sup>745</sup> As a matter of law, a republic may have its own “*constitution*”; other constituencies are entitled to have a “*charter*” only (Article 5 of the Constitution 1993).

<sup>746</sup> Article 71. On civil law, see *Branches of Law* on p.214 below.

- administrative, administrative-procedural, labor, family, housing, land, water and forestry legislation; and
- legislation on the sub-surface (resources) and environmental protection.<sup>747</sup>

The competence of local authorities is determined on the residual basis: issues that are not in the competence of the federal authorities, or joint competence of the federal and local authorities, remain with local authorities.<sup>748</sup>

This work is concerned primarily with civil legislation, which is in the competence of federal authorities; and, therefore, only the federal level of authority is reviewed in this Annex. Nevertheless, some issues, which may be relevant in cross-border financings, *e.g.*, the use of natural resources are in joint competence of federal and local authorities. Thus, in practice, local legislation must not be automatically discarded as irrelevant in a financing transaction.

## **B. Executive and Legislative Powers**

According to Article 10 of the Constitution 1993, state power in Russia is separated into independent legislative, executive and judicial branches. The judicial branch, being more important to the subject of this work, is discussed in a separate sub-section below.<sup>749</sup>

### **(i) Executive Branch**

State authority is exercised by the President of the Russian Federation, Federal Assembly, Government and the courts of Russian Federation. Generally, the President and the Government are viewed as the executive branch (more on this below). The Federal Assembly is the legislative branch of the State. The discussion below proceeds from the executive to legislative powers.

The President of the Russian Federation is referred to in the Constitution 1993 as the “*head of State*”. Furthermore, according to Article 80:

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<sup>747</sup> Article 72.

<sup>748</sup> Article 73.

The Constitutional Court was asked to rule on whether Article 73 should be interpreted so as to mean that a constituency in the Russian Federation has residual, limited, sovereignty. In its Resolution No.250-O “On Request of State Assembly – *Kurultai* of the Republic of Bashkortostan on the Interpretation of a Line of Provisions of Articles 5, 11, 71, 72, 73, 76, 77 and 78 of the Constitution of the Russian Federation”, dated 6 December 2001, the Constitutional Court decided that there was no such residual sovereignty, and the only manifestation of sovereignty was embodied in the Russian Federation (*i.e.*, at the federal level).

The applicant, a constituency of the Russian Federation – republic, also pointed out that being a “republic” must entitle it to such “limited” sovereignty (perhaps, unlike other forms of constituency). The Constitutional Court disagreed with this and pointed out that all constituencies are equal and neither of them has “limited” sovereignty.

<sup>749</sup> See *Courts* on p.224 below.

*“The President is the guarantor of the Constitution ..., and of human and civil rights and freedoms. [The President] ... defends the sovereignty of the Russian Federation, its independence and State integrity, and ensures coordinated functioning and cooperation of all bodies of state power.”*

Thus, the President is the *head of state*, as opposed to the head of executive branch of state power.<sup>750</sup> In fact, not once the Constitution 1993 expressly refers to the President in the context of executive branch. It is also interesting to note that the President: is the “*guarantor*” of the Constitution; and is entrusted with the coordination of *all* bodies of state power. This places the President in a unique position of being responsible for the Constitution as a whole (no other body of state power has such a responsibility, even the Constitutional Court) and also of being able to “*coordinate*” not only the bodies of the executive, but also of legislative and judicial, branches.

Other general areas of the responsibility of the President include domestic and foreign policy and questions of war and peace.

The more specific powers of the President include, *inter alia*:

- appointing the Chairman of the Government (subject to the consent of the State Duma);
- appointing and dismissing deputy chairmen of the Government and federal ministers as proposed by the Chairman of the Government;
- submitting to the Federation Council candidates for the offices of judges of the Constitutional Court of the Russian Federation, the Supreme Court of the Russian Federation and the Supreme Arbitration Court of the Russian Federation; and
- appointing judges of other federal courts.<sup>751</sup>

Perhaps, the most important of the President’s powers is to issue decrees and resolutions (Article 90). There is no distinction between decrees and resolutions in law; however, decrees are often regarded as normative documents and resolutions are viewed as

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<sup>750</sup> See discussion, *e.g.*, in K.Bobyleva, “Interaction of the President with Federal Bodies of Executive Branch of the Russian Federation”, *Administrative Law and Process*, No.2, 2007.

<sup>751</sup> Though the President appoints the judges of lower courts, one of the safeguards against President’s influence on the judiciary is that judges can be removed only in cases as prescribed by law. According to Article 15 of the Federal Constitutional Law No.1-FKZ, “On Court System of the Russian Federation”, dated 31 December 1996, a judge’s authority may cease or be suspended only pursuant to a decision of a (judges’) qualification board (there some exceptions, but they also do not involve the President’s powers).

documents adopted on an individual matter. The President's office also distinguishes between decrees and resolutions in that way.<sup>752</sup>

A "normative act" is a term of art in Russian law. At a certain stage, the Supreme Court of the Russian Federation provided the following definition:

*"A normative act is an act of a competent state authority or local self-government issued in the prescribed manner that sets legal norms (rules of behavior), which are mandatory for unspecified set of persons, designed for multiple application and remaining in force irrespective of whether specific relationships, referred to in the act, ceased."*<sup>753</sup>

An amendment later deleted the definition above and it is technically no longer applicable; however, it still may be a useful guide in understanding the concept of a "normative act".

The Constitution expressly provides that the decrees and resolutions of the President are mandatory throughout Russia. Decrees and resolutions must not contradict the Constitution and federal laws (Article 80). Thus, the President's decrees and resolutions have higher authority than any local act (including local legislation *per se*).

Theoretically, there is no restriction on the President to adopt decrees on important matters, including, for example, matters of civil law. In fact, in the early years following the collapse of the Soviet Union, the President's decrees and resolutions were important sources of law and were used extensively. The official reason for such a use of decrees was the filling of "gaps" in the then existing legislation.<sup>754</sup> The Constitutional Court confirmed the wide powers of the President to issue decrees and resolutions.<sup>755</sup>

Let us now turn to the Government of the Russian Federation. Unlike with respect to the President (the head of State), the Constitution 1993 expressly provides that the executive power is exercised by the Government (Article 110). As was mentioned with respect to the powers of the President above, the Chairman of the Government is appointed by the

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<sup>752</sup> The Resolution of the President of the Russian Federation No.85-rp, dated 5 February 1993. See also O.Ordina, "Legal Acts of the President of the Russian Federation as Sources of Administrative Law", *State Authority and Local Self-governance*, No.9, 2009.

<sup>753</sup> The Resolution of the Plenum of the Supreme Court of the Russian Federation No.2 "On Some Questions in Connection with the Adoption and Introduction into Force of the Civil Procedure Code of the Russian Federation", dated 20 January 2003.

A simpler definition is contained, for example, in A.Melekhin, *Theory of State and Law*, Market DS, Moscow, 2007: "a normative act is an act adopted by the State and containing general rules of behavior..."

<sup>754</sup> See A.Zuikov, "Russian Model of the Institute of the President under the Constitution 1993: Main Provisions" *Comparative Constitutional Review*, No.5, 2008.

<sup>755</sup> See the Resolution of the Constitutional Court of the Russian Federation No.11-P, dated 30 April 1996.

President with the consent of the State Duma (Article 111). It is interesting to note that the structure of the Government and the appointment of the deputies of the Chairman and ministers must be approved by the President, too. From a certain perspective, the President is heavily involved with the operation of the Government and has a degree of control over it, but it is not a part of the Government.

The Government's responsibilities include, *inter alia*:

- federal budget;
- uniform financial, credit and monetary policy;
- management of federal property;
- defense, state security and foreign policy; and
- law and order, rights and freedoms of citizens, protection of property.<sup>756</sup>

The functions and powers of the Government are set in more detail in the Federal Constitutional Law No.2-FKZ On the Government of the Russian Federation, dated 17 December 1997 (the "**Law on Government**"). The important functions/areas of responsibility of the Government under the Law on Government law include:

- socio-economic sphere;
- freedom of economic activity, free movement of goods, services and payments;
- customs regime;
- protection of domestic producers;
- financial and credit policies;
- tax policy;
- regulation of the securities market; and
- protection of the environment.<sup>757</sup>

The Government issues resolutions and orders.<sup>758</sup> Normative acts of the Government take the form of a resolution; orders relate to operational and other current matters and do not have the nature of a normative act. Both the resolutions and orders are "*mandatory for performance*" (*i.e.*, must be complied with) throughout Russia (Article 23 of the Law on Government). It is interesting to note that the Law on Government also provides that the Government "*procures*" that its resolutions and orders are complied with. This can be contrasted with the provision on the President's decrees and orders, where there is no such

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<sup>756</sup> Article 114.

<sup>757</sup> Article 13-5, 18 of the Law on the Government.

<sup>758</sup> *Postanovleniya* and *rasporyazheniya* in Russian, respectively. English translations may differ.

obligation imposed on the President. It is also interesting to note that the President has the power to annul an act issued by the Government, if such an act “*contradicts the Constitution ..., federal laws, and the President’s decrees*” (Article 33 of the Law on Government). Essentially, these provisions give the President’s powers the primacy in the relationships with the Government.

The Government is headed by the Chairman. Though technically incorrect, in practice it is common to refer to the Chairman as the “Prime Minister” and this convention will be followed here. The Prime Minister, subject to the consent of State Duma, is appointed by the President (Article 111 of the Constitution 1993). The Prime Minister “*sets forth the guidelines for the activities of the Government ... and organizes its work*” (Article 113 of the Constitution 1993).

The Prime Minister has to follow the Constitution, federal laws, and also the decrees of the President. Furthermore, the Prime Minister does not have the power to appoint deputies and ministers; the candidates must be offered to the President, who makes the decision on the appointment (Article 9 of the Law on Government).

A large, mainly security-related, block from the Government is subordinated to the President and not to the Prime Minister. In particular, according to Article 32 of the Law on Government, the President “*directs*” the activities of the federal executive bodies entrusted with the functions of defense, security (which includes, for example, the Federal Security Service), internal affairs (*i.e.*, which includes the police), justice and foreign affairs (and some others).<sup>759</sup> Thus, it is the President, and not the Prime Minister, who has direct control over the respective ministries and bodies; and the Government only “*coordinates*” their activities.

The following observation may conclude the discussion of the executive branch of power in Russia. The President is not referred to as part of the executive branch: according to the Constitution 1993, the President is the head of state. However, the President’s powers are closely aligned with those of the Government (*i.e.*, with the executive power); and, in fact, there is a significant degree of control by the President over the Government. Both the President and the Government have the competence to issue normative acts, which can be viewed as secondary legislation in the sense that such acts cannot contradict federal legislation proper; however, it must be remembered that the authority for the “legislative”

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<sup>759</sup> Article 32 was amended in 1997 and 2004. It is after the 1997 amendment that the President obtained the power to direct the respective bodies; prior to that time, the President could “*set guidelines*” for such bodies. See the discussion in A.Mescheryakov, “Constitutional Methods of Influence of the President on the Executive Power and Related Peculiarities of Russian Form of Governance”, *Constitutional and Municipal Law*, No.5, 2005.



powers of the President and Government emanates not from the Federal Assembly (*i.e.*, the Russian Parliament), but from the Constitution 1993, which was adopted at a public referendum.

**(ii) Legislative Branch**

Russian parliament is the Federal Assembly, which consists of two chambers: the upper chamber – Federation Council and the lower chamber – State Duma (Articles 94-5 of the Constitution 1993).

The State Duma is the main body of legislative activity and its approval is a very important step in the adoption of a bill; following a vote by the Duma, the Federation Council also has to consider and approve certain bills.<sup>760</sup>

The Federation Council includes two representatives from each Russian constituency: one representing the local legislature and one – the local executive authority. The procedure for the elections/appointment of the representative is set out in the Federal Law No.113-FZ “On Order of Forming of the Federation Council of the Federal Assembly of the Russian Federation”, dated 5 August 2000: the representatives for the legislatures are elected by the respective legislature; and the representative for the executive authorities are appointed by the head of the respective authority (Articles 2 and 4).

In addition to its legislative functions, the Federation Council approves, *inter alia*, changes in borders of Russian constituencies, declarations of state of emergency, *etc.* The Federation Council also appoints the judges of the Constitutional, Supreme and Supreme Arbitrazh Courts pursuant to a suggestion of the President (Article 102 of the Constitution 1993).

The State Duma consists of four hundred and fifty “*deputies*” (*i.e.*, members of parliament). Rules on general elections are contained in the Federal Law No.51-FZ “On Elections of Deputies of the State Duma of the Federal Assembly of the Russian Federation”, dated 18 May 2005. Elections are based on the proportionate representation principle and now take place every five years (earlier – four years). Seats in the Duma are distributed among registered (and participating in the election) political parties,<sup>761</sup> which have to submit a candidate list for each election. A party has the right to a number of seats proportionate to the votes it received. A political party has to receive five or more *percent* of votes in order to have the right to any seats (Article 82 of the Law No.51-FZ).

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<sup>760</sup> See *Sources of Law* on p.219 below.

<sup>761</sup> See the Federal Law No.95-FZ, “On Political Parties”, dated 11 July 2001.

The election system has been changed in Russia over the course of the last decade and the changes are subject to some controversy, however, this topic is beyond the scope of this work.

The procedures in the State Duma are regulated in detail by the Regulations of the State Duma of the Federal Assembly.<sup>762</sup> Generally, the State Duma relies heavily on various permanent and *ad hoc* committees in its legislative work.<sup>763</sup>

### C. Branches of Law

In Russian legal theory law is traditionally divided into branches. This division is based on several criteria, *e.g.*, the kind of relationship being regulated and the predominant method for regulation.

This division of law into branches can be supported by reference to Article 118 of the Constitution 1993, which provides that judicial power is carried out *via* constitutional, civil, administrative and criminal (court) proceedings. These forms of court proceedings essentially refer to some of the branches of law as they are commonly distinguished by Russian commentators.<sup>764</sup>

In the context of a cross-border financing transaction, the most relevant branch is civil law. In a leading Russian treatise on civil law the following definition is provided:

*“[Civil law is] ... the main branch of law, regulating private (property-related and some non-property-related) relationships of owners of property (citizens and juridical persons), which are formed on the initiative of the participants [of such relationships] and are intended to satisfy their own (private) interests.”*<sup>765</sup>

The same text also points out that, as a rule, participants of civil law relationships are “*in a legally equal position with respect to each other*”. Indeed, taking the example of a borrower and lender, both parties are, generally, in equal position as a matter of law. A lender has no legal power to direct the borrower’s actions (and *vice versa*), unless such a power was negotiated and agreed by the parties.<sup>766</sup> This may be contrasted with the relationship of

<sup>762</sup> The Resolution No.2134-II GD, “On Regulations of the State Duma of the Federal Assembly of the Russian Federation”, dated 22 January 1998.

<sup>763</sup> See for more detail *Sources of Law* on p.219 below.

<sup>764</sup> See, *e.g.*, M.Abdulaev, *Theory of State and Law*, Magistr-Press, 2004. There are different approaches in literature to the division into branching of law and for a comprehensive discussion specialist sources must be consulted.

<sup>765</sup> E.Sukhanov (ed.), *Civil Law: in 4 vol. General Part*, vol.1, 3<sup>rd</sup> ed., Wolters Kluwer, 2008.

<sup>766</sup> In fact, the economic powers of the parties may be unequal and this may result on some form of compulsion on the borrower, or less frequently, on the lender. Furthermore, it would be incorrect to state that such

control and direction, as is the case when a governmental authority issues a mandatory direction addressed to company. Such kind of a relationship is most likely to fall within the scope of administrative law.<sup>767</sup> Examples of civil law relationships are: individual-to-individual transactions having monetary value (e.g., gifts, sale-purchases); consumer transactions; and business-to-business transactions.

Arguably, there are no hard boundaries between branches of law and a relationship may have characteristics incident to several branches at the same time; and it is the prevailing features that must be taken into account.<sup>768</sup>

A branch of law can be either substantive or procedural: using this approach civil law is further divided into civil (substantive) law and civil procedural law.<sup>769</sup> Substantive civil law sets forth the rules as to the rights and obligations of the parties; procedural civil law sets forth the rules with respect to the judicial proceedings related to the obligations arising under civil law. For example, the Civil Code 1994 contains substantive civil law is; and the Civil Procedural Code of the Russian Federation No.138-FZ, dated 14 November 2002, contains civil procedural law.

For the purposes of this work, which mainly adopts a transactional perspective, it is mainly the substantive law that is important.

#### **D. Sources of Law**

As discussed earlier, Russia is a federative State and legislation may be adopted at the federal level or at the level of a constituency; however, civil law – the most relevant branch of law for the purposes of this work – is in the competence of the federal authorities.<sup>770</sup> Thus, only federal-level sources of law are reviewed below.

The foundations for modern Russian legal system are set in the Constitution 1993. The Constitution was adopted at a public referendum, and so, according to theory, it reflects the will of the people of Russia. The Constitution 1993 states:

*“The Constitution ... has the highest legal authority, direct effect and is applicable throughout the territory of the Russian Federation. Laws and other legal acts*

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compulsion is irrelevant to, or overlooked by, law (including civil law). For example, Article 179 of the Civil Code 1994 invalidates onerous transactions entered into under “*adverse circumstances*”.

<sup>767</sup> See, e.g., D.Zvonenko, A.Malumov and G.Malumov, *Administrative Law*, Justiceinform, 2007.

<sup>768</sup> For example, it is common to find Russian textbooks on “*Business Law*” (e.g., N.Kruglova, *Business Law*, Yurait, 2010). Arguably, Russian substantive law generally does not make any principle distinction between business and non-business law; however the authors of such textbooks advance justifications for singling out “business law” from civil law.

<sup>769</sup> See, e.g., A.Kovalenko, A.Mokhova and P.Filippova, *Civil Proceedings*, Infra-M, 2008.

<sup>770</sup> *Federative Organization* on p.210 above.

*adopted in the Russian Federation must not contradict the Constitution...*" (Article 15).

Below the Constitution 1993 (in the hierarchy of Russian sources of law) lie certain international rules and treaties (more on this below) and federal constitutional laws and federal laws (Article 76). A federal law cannot "*contradict*" a federal constitutional law. Essentially, federal constitutional laws are adopted on matters which are more important from the constitutional perspective; technically, a constitutional law must be adopted on a matter when the Constitution 1993 so requires (Article 108). Examples of matters that require the adoption of a federal constitutional law are: procedures for the functioning of the Government, rules on state of emergency, adoption of a new constituency into the Russian Federation, *etc.*

The Constitution 1993 expressly "*incorporates*" generally recognized principles and rules of international law into Russian legal system. It is of course to be decided in each individual case, what is a "*generally recognized*" principle. International treaties entered into by the Russian Federation are also "*incorporated*" into Russian law and have primacy over laws (here meaning "*statutes*").

The right of "*legislative initiative*" – that is the right to submit a bill to the Parliament – is vested with the President, the Federation Council, a member of the Federation Council or State Duma, the Government and a constituency's legislature (*i.e.*, a "*local parliament*"). In addition, the Constitutional, Supreme and Supreme Arbitrazh Courts have a limited right of legislative initiative (Article 104 of the Constitution 1993).

Bills are submitted to the lower Federal Assembly chamber – the State Duma. The general rule is that a simple majority of *all* members of the State Duma is required for the adoption of a bill. For the adoption of a federal constitutional bill a super majority of two thirds of the members of the Duma is required (Article 108 of the Constitution 1993).

The State Duma adopted a regulation on its proceedings – the "**Duma Regulations**".<sup>771</sup> Generally, before the bills are laid before the Duma, some work is carried out by Duma's committees and various other institutions (*e.g.*, for bills that require any expenditure from the state budget, the Government's official opinion must be received, and for amendments to the Criminal Code – the opinion of the Supreme Court).

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<sup>771</sup> The Resolution of the State Duma of the Federal Assembly No.2134-II GD, "On Regulations of the State Duma of the Federal Assembly of the Russian Federation", dated 22 January 1998.

As a rule, a bill passes through three readings in the Duma (Article 115 of the Duma Regulations).

Once the bill is adopted by the State Duma, its approval by the upper chamber of the Russian parliament – by the Federation Council – may also be required. Some bills must be approved by the Federation Council, including those relating to: federal budget; federal taxes; financial, foreign exchange, credit and customs regulations; emission of money, *etc.* (Article 106 of the Constitution 1993). As a rule a simple majority of votes of *all* members of the Federation Council is required; federal constitutional laws require three quarters of the votes in the Federation Council (Articles 105 and 108 of the Constitution 1993). A veto of the Federation Council on a bill can be overcome by a subsequent supermajority (two-thirds) vote of the Duma.

Once adopted by the Federal Assembly, the bill is laid before the President, who has to sign it within fourteen days. If the President uses the right of veto, it can be overcome by subsequent super-majority (two-thirds) votes in the Duma and Federation Council (Article 107 of the Constitution 1993).

One of the most controversial issues in Russian legal theory is the status of the higher courts' decisions. The commonly held perception is that one of the major distinguishing characteristics of common law from civil law systems is the nature of higher courts' judgments: in common law a judgment's *ratio* is one of the source of law and, generally, must be applied in subsequent cases; in civil law a higher court's decision is not a source of law and is not mandatory for subsequent cases. However, throughout this work references are made to courts' decisions and other documents issued by higher courts, *e.g.*, Informational Letters of the Presidium of the Supreme Arbitrazh Court and Resolutions of the Plenum of Supreme Court. Do such documents matter in cases other than those they were directly concerned with?

The discussion below will focus on the Supreme Arbitrazh Court, since its jurisdiction is more relevant for the purposes of this work; however, similar considerations also apply to the documents of the Supreme Court.

The Constitution 1993 provides that the Supreme Arbitrazh Court "*issues clarifications on issues of court practice*" (Article 127). This provision may be contrasted with that on the Constitutional Court, which is empowered to "*interpret*" the Constitution (Article 125).<sup>772</sup>

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<sup>772</sup> On "interpretations" by the Constitutional Court, see also p.225 below.

Therefore, the effect of the views of the Supreme Arbitrazh Court and Constitutional Court on a provision of law is different.

The position of the Supreme Arbitrazh Court is further regulated by the Federal Constitutional Law No.1-FKZ “On Arbitrazh Courts in the Russian Federation”, dated 28 April 1995 (the “**Law on Arbitrazh Courts**”). According to Article 10 of the law:

*“[The Supreme Arbitrazh Court] studies and summarizes the arbitrazh courts’ practice of application of laws and other normative acts, which regulate relationships in the area of entrepreneurial and other economic activity, and issues clarifications on the issues of court practice”.*

According to Article 7 of the same law:

*“Judicial acts of the arbitrazh courts – decisions, resolutions, which entered into force, are mandatory for all state bodies, local authorities, other bodies, organizations, officials and citizens and must be carried out throughout the Russian Federation”.*

And according to Article 13:

*“On issues under its competence, the Plenum of the Supreme Arbitrazh Court ... adopts resolutions, which are mandatory for arbitrazh courts in the Russian Federation.”*

Turning to the statute that sets forth the procedural rules for the proceedings in the arbitrazh courts – the Arbitrazh Procedural Code No.95-FZ, dated 24 July 2002, it provides that:

*“Legality in proceedings in arbitrazh courts is ensured via the correct application of laws and other normative acts ...” (Article 6).*

Furthermore, Article 170 the Arbitrazh Procedural Code, which is dedicated to the contents of an arbitrazh court’s decision, expressly allows to refer to resolutions of the Plenum of the Supreme Arbitrazh Court in arbitrazh courts’ judgments (more specifically, its reasoning part).

The above provisions can be summarized as follows. The Supreme Arbitrazh Court:

- issues clarifications of laws;
- studies court practice in order to issue clarifications;
- generally issues documents that are mandatory in Russia; and

- when acting in Plenum, issues resolutions, which are mandatory for all arbitrazh courts.

Furthermore: arbitrazh courts may refer to Plenum’s resolutions in judgments and legality is ensured by the correct application of law. It is easy to understand what the outcome is in practice: the Plenum “clarifies” in its resolutions what the law is, and, if a lower court fails to follow such a clarification, the respective judgment of the lower court must be treated as unlawful (since the law was not applied correctly).

A technical point must also be made: the statutes expressly refer only to the resolutions of the *Plenum* of the Supreme Arbitrazh Court as documents mandatory for arbitrazh courts. At the same time, the *Presidium* of the Supreme Arbitrazh Court regularly issues informational letters, where it also “clarifies” the law. In hierarchy such letters are below the resolutions of the Plenum. However, the Presidium is the court of the final instance for cases in the arbitrazh system. Thus, if a case is appealed<sup>773</sup> to the Presidium, the Presidium is very likely to adopt the position it expressed in its own informational letter. If a lower court failed to follow such a position, the Presidium would normally overturn the lower court’s decision.

The status of specific judgments of the Presidium is less clear: they can hardly be compared with the resolutions of the Plenum containing clarifications of law. However, the judgments of the Presidium (as of any other court) must contain the reasoning section, where the Presidium often expresses its view on a provision of law. Consider again the case where a lower court’s decision contradicts the view of the Presidium (as expressed in a specific judgment). If such a lower court’s decision is “appealed” to the Presidium, it is likely to be overturned, too.<sup>774</sup>

From the practical point of view, the Plenum’s resolutions with clarifications are close to being “precedents”; and the letters of the Presidium and its specific decisions have at least a persuasive influence on any subsequent cases in arbitrazh courts.

Russian commentators express different views with respect to the treatment of court decisions as sources of law. For example, it was suggested that the decisions of the higher courts – the Supreme Court and Supreme Arbitrazh Courts – could be viewed as “*precedents in fact*”.<sup>775</sup> On the other hand, some authors adopt a more cautious approach with respect

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<sup>773</sup> Technically, the procedure by which a case ends up in the Presidium is not an appeal. It is an extraordinary procedure, which depends on the discretion of the court – *nadzornoye proizvodstvo*.

<sup>774</sup> See footnote 776 on p.224 below.

<sup>775</sup> M.Rozhkova, “Judicial Precedent and Court Practice” in M.Rozhkova (ed.), *Claims and Court Decision: a Collection of Articles*, Statut, 2009. The article argues that the separation of powers in Russian into legislative, executive and judicial does not preclude the courts from “creating” laws (similar, for example, to the Russian

to the informational letters of the Presidium.<sup>776</sup> Whichever theoretical position is adopted, regard must be given in practice to all decisions by the higher courts. An additional difficulty for a Russian lawyer, in comparison with a common law lawyer, is that there is no official expression of a *stare decisis* principle: there is nothing in law to preclude a court insisting that its earlier decision need not be applied in a new case.

## E. Courts

Judges are declared independent and are obliged to “obey” only the Constitution 1993 and federal law.<sup>777</sup> Court proceedings are adversarial and, as a rule, are open to public (Article 123).

According to the letter of the law, Russian system of courts is uniform;<sup>778</sup> however, it is not homogenous and, depending on the litigated dispute/issue and parties involved, a specific avenue must be chosen. In principle, Russian court system consists of the Constitutional Court, General Jurisdiction Courts and Arbitrazh Courts.<sup>779</sup>

From another perspective, courts can be divided in accordance with their position in the hierarchy and territorial jurisdiction. In the terms of federative hierarchy courts can be either federal or local.<sup>780</sup> The following courts are organized at the federal level:

- the Constitutional Court;
- the Supreme Court, supreme courts of the republics, regional courts, district courts, etc. (all of them – general jurisdiction courts); and
- the Supreme Arbitrazh Court, regional federal arbitrazh courts (cassation courts), arbitrazh appellate courts, arbitrazh courts of the constituent entities of Russia (arbitrazh courts).

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executive branch, which has express powers to adopt normative acts – see on this *Executive and Legislative Powers* on p.212 above). The article also offers an interesting international view on the doctrine of precedent as it may be found in continental systems of law.

<sup>776</sup> A.Efimov, *Supervision Proceedings in Arbitrazh Proceedings*, Wolters Kluwer, 2007, where the author refers to an early letter of the Supreme Arbitrazh Court of the Russian Federation No.OU-30/1-533, “On Informational Letters of the Presidium of VAS RF”, dated 4 October 1996. The letter stated that Informational Letters of the Presidium: “... do not have mandatory character for arbitrazh courts and other state bodies of the Russian Federation”.

<sup>777</sup> See *Federative Organization* on p.210 above.

<sup>778</sup> Article 3 of the Federal Constitutional Law No.1-FKZ, “On Court System of the Russian Federation”, dated 31 December 1996.

<sup>779</sup> This classification is not exhaustive and is provided here for the purpose of convenience, rather than comprehensive review. For example, military courts also exist – the Federal Constitutional Law No.1-FKZ “On Military Courts in the Russian Federation”, dated 23 June 1999.

<sup>780</sup> Article 4 of the Federal Constitutional Law No.1-FKZ, “On Court System of the Russian Federation”, dated 31 December 1996.



Local courts include justices of the peace (part of the general jurisdiction system) and constitutional (charter) courts of the constituent entities of Russia. For the purposes of this work, local courts have lesser relevance than federal courts and are not considered further.

**(i) Constitutional Court**

The Constitutional Court is a stand-alone institution in the sense that it is not divided into any regional court divisions and includes only nineteen judges (Article 125). The Constitutional Court was originally located in Moscow; however, it was moved to Saint-Petersburg in 2008.<sup>781</sup>

In general, the Constitutional Court adjudicates on disputes/issues involving the interpretation of the Constitution 1993. Examples of the Courts' jurisdiction include the following:

- conformity of laws and secondary legislation with the Constitution 1993;<sup>782</sup>
- disputes between authorities related to their respective competence; and
- petitions on infringement of “citizens”<sup>783</sup> constitutional rights.

Generally, the Constitutional Court cannot exercise its jurisdiction on its own volition; for example, in order to consider issues in (i) above, a request from the President, Government, or Parliament, *etc.*, must be received by the Court.<sup>784</sup>

The Constitutional Court is empowered to issue “*interpretations*” of the Constitution 1993; and if the Constitutional Court decides that a particular document or provision contradicts the Constitution, such a document or provision, as the case may be, “*loses its force*” and must not be applied. No other Russian court has such dramatic powers: to officially interpret

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<sup>781</sup> The Federal Constitutional Law No.2-FKZ “On Introducing Amendments to the Federal Constitutional Law “On Constitutional Court of the Russian Federation””, dated 5 February 2007. There was some controversy related to the relocation of the court. A representative office of the court is still located in Moscow.

<sup>782</sup> The majority of laws and secondary legislation fall within the jurisdiction of the Constitutional Court. However, issues that fall within the (exclusive) competence of local (as opposed to federal or joint federal and local) authorities, are outside the jurisdiction of the court. See Article 125 of the Constitution 1993.

<sup>783</sup> The wording of the respective provision left doubts as to whether juridical persons, *e.g.*, stock companies could file petitions with the Constitutional Court; indeed, the position remained unclear for some time. However, in 1996, the Constitutional Court adopted a wide interpretation of the provision so as to extend the right to a petition to juridical persons: see the Resolution of the Constitutional Court of the Russian Federation, No.17-P “On Case on Review of Constitutionality of part one of Article 2 of the Federal Law [...]”, dated 24 October 1996 and the discussion in V.Kuznetsov, “Constitution and the Rights of Juridical Persons”, *Russian Justitziya*, No.4, 1997.

<sup>784</sup> This provision could have been introduced following the the Constitutional Court declaring unconstitutional the Presidential Decree No.1400, “On Staged Constitutional Reform in the Russian Federation”, dated 21 September 1993. The Decree was adopted in response to a political crisis between the President and the parliament: according to that decree “*the carrying out of the legislative, administrative and controlling functions [of the parliament] were terminated*”.

statutes and, essentially, repeal them. In Russian legal tradition,<sup>785</sup> the power to enact laws lies with the legislature<sup>786</sup> and the courts' function is to apply laws as they were enacted; the position of the Constitutional Court is a striking exception to this rule. There is no agreement between Russian commentators whether the decisions of the Constitutional Court are technically sources of law;<sup>787</sup> nevertheless, it is obvious that for practical purposes such decisions are as close as possible, at least, to being a source of law.

Though the Constitutional Court is not the most likely avenue for litigation, in a cross-border financing transaction, it is not irrelevant. A new law or application of a law by the courts/authorities may cause a party to a financing transaction bring a claim in the Constitutional Court; purely commercial disputes are not likely to end in its chambers.

### **(ii) Courts of General Jurisdiction**

Court proceedings in courts of general jurisdiction are governed by the Civil Procedural Code of the Russian Federation No.138-FZ, dated 14 November 2002 (the "**Civil Procedural Code**"). The jurisdiction of these courts is indeed "general" and it covers, *inter alia*, claims:

*"... with the participation of citizens, organizations, state and local authorities related to the protection of violated or disputed rights, freedoms and lawful interest, on disputes arising out of: civil, family, labor, housing, land, ecological and other relationships"* (Article 22 of the Civil Procedural Code).

The system of courts of general jurisdiction is hierarchical. At the top of the hierarchy is the Supreme Court – the highest judicial authority on civil, criminal, administrative and other cases that are within the jurisdiction of the "courts of general jurisdiction". The Supreme Court also carries out the function of judicial control and issues "*clarifications*" on questions of judicial practice (Article 126 of the Constitution 1993).<sup>788</sup>

At the bottom of the hierarchy are justices of the peace, who consider less complex or less valuable issues: *e.g.*, claims valued less than 50,000 Rubles and some family law matters. Unless a claim must be submitted to a justice of the peace, district courts consider all (other) claims as the court of first instance. District courts also act as appellate courts for the decision of the justices of the peace (Chapter 39 of the Civil Procedural Code).

<sup>785</sup> Russian law is "continental" (as opposed to common law systems). In continental law, courts decisions are not recognized as a source of law.

<sup>786</sup> The President, the Government, *etc.*, also have powers to adopt acts of legislative nature ("normative acts"), but these must comply with laws.

<sup>787</sup> See, *e.g.*, N.Kurova, "Resolutions of the Constitutional Court of RF in the System of Sources of Law", *Advocat*, No.9, 2009.

<sup>788</sup> On the status of "clarifications", see *Sources of Law* on p.219 above.

An application to review any judgment of a court of general jurisdiction in a higher court may be made. The respective procedure and proceedings are referred to as “cassation” and “cassation proceedings”, respectively, in Russian. The exception are the decisions of the justices of the peace, which are appealed to the district courts. Cassation of the district courts’ decisions lies to the supreme court of the respective republic or regional court, *etc* (Article 337 of the Civil Procedural Code). The choice of the cassation instance court depends on the location and position in hierarchy of the first instance court.

District courts’ judgments are considered on cassation by supreme courts of the respective republic, regional courts, courts of federal cities, *etc*; first instance judgments of supreme courts of republics, regional courts and courts of federal cities – in the Supreme Court. The highest cassation instance is the Cassation Chamber<sup>789</sup> of the Supreme Court.

Cassation proceedings can be initiated only with respect to judgments that have not entered into full force: a decision enters into force once the period for the appeal or cassation, as the case may be, lapses (Article 209 of the Civil Procedural Code). The respective period is ten days from the delivery of the final judgment of the first instance (Article 321 and 338). After a judgment is in full force, the aggrieved party may attempt to initiate extraordinary proceedings in a higher instance court – review proceedings.<sup>790</sup> Review proceedings are extraordinary in the sense that review proceedings commence only if the designated officials of the review court on initial inspection of the application decide that there may be grounds for review (Article 381). Review proceedings are started in a higher court than that, which judgment is reviewed. The highest review instance court is the Presidium of the Supreme Court (Article 377).<sup>791</sup>

### **(iii) Arbitrazh Courts**

Proceedings in arbitrazh courts are governed by the Arbitrazh Procedural Code of the Russian Federation No.95-FZ, dated 24 June 2002 (the “**Arbitrazh Procedural Code**”).

Generally, arbitrazh courts are concerned with justice in “*entrepreneurial or other economic activity*” (Article 1 of the Arbitrazh Procedural Code).

In fact, the competence of arbitrazh courts includes the cases on economic disputes and other cases, connected with the “*carrying out of entrepreneurial and other economic activity*” (Article 27 of the Arbitrazh Procedural Code).

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<sup>789</sup> *Kassatsionnaya kollegiya* in Russian.

<sup>790</sup> *Nadzornoye proizvodstvo* in Russian.

<sup>791</sup> According to the Civil Procedural Code, the judgments of Cassation Chamber of the Supreme Court may be reviewed by the Presidium if such judgments “*violate the uniformity of court practice*” (Article 377).

Generally, the competence of the arbitrazh courts includes:

*“... economic disputes with the participation of juridical persons [or] citizens with the status of an individual entrepreneur when carrying out entrepreneurial activity ...”*

(Article 27).

In prescribed circumstances, arbitrazh courts also decide on disputes involving state bodies.

Thus, the competence of arbitrazh courts is invoked when two sets of circumstances exist: (i) the dispute is economic in nature; and (ii) the participating persons have specified legal status.

The competence of arbitrazh courts has two prongs: civil law competence and administrative law competence. Administrative law competence generally relates to disputes arising out of administrative law,<sup>792</sup> but which are economic in nature (Article 29). This competence is less important for the purposes of this work and is not considered here further.

Other statutes also may designate arbitrazh courts as competent courts. An important example is the Law on Insolvency 2002: according to its Article 6, arbitrazh courts consider all insolvency claims.

An important amendment has been made to the Arbitral Procedural Code in July 2009.<sup>793</sup> One of the reasons for the adoption of the amendment was to decrease the risk of corporate raids.<sup>794</sup> Arbitrazh courts now have the competence on “*corporate disputes*”, which includes disputes related to the incorporation of a juridical person and governance or participation in a juridical person, which is a commercial organization (or a non-commercial organization which joins commercial organizations). Importantly, corporate disputes also include disputes related to ownership of shares or participation interest and appointment of corporate governing bodies.<sup>795</sup> Another important novelty is that all corporate disputes must now be considered at first instance in one designated court: arbitrazh court where the respective company is located (Article 38).

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<sup>792</sup> See *Branches of Law* on p.218 above.

<sup>793</sup> The Federal Law No.205-FZ, “On Introduction of Amendments to Selected Legislative Acts of the Russian Federation”, dated 19 July 2009.

<sup>794</sup> See, e.g., T.Uvakina “Antiraider Law – New for Joint Stock Companies”, *Ezh-Jurist*, No.29, 2009. Corporate raids in Russia often involve “forcible” takeover of property via the use of illegal judgments, enforcement actions, etc.

<sup>795</sup> Full list of corporate disputes is provided in new Article 225.1 of the Arbitrazh Procedural Code.

Arbitrazh courts are also hierarchical. At the first instance, cases are considered by arbitrazh courts of republics, regions, federal cities, *etc.*<sup>796</sup> Thus, first instance arbitrazh courts are “higher” up the ladder when compared to the first instance general jurisdiction courts (which are justices of the peace or district courts, as the case may be). A judgment of the court of the first instance may be appealed to a higher-standing court; as a rule, the period within which a judgment can be appealed (and is not in force) is one month from the day when it was delivered (Article 257-9). On appeal new claims cannot be made and new evidence can be advanced only in limited circumstances (*e.g.*, if it was not available during first instance hearing); appellate court can review both the questions of fact and law. A decision of the court of the first instance or an appellate decision can be further challenged in cassation proceedings in a higher court. Generally, cassation proceedings must be initiated within two months from the day when the respective judgment entered into force (Article 276). In cassation proceedings, the court generally reviews questions of law and not of fact (Article 286). Similarly to courts of general jurisdiction, arbitrazh courts have extraordinary review proceedings (Chapter 36).

Review proceedings must be initiated in the Supreme Arbitrazh Court within three months from the day of the delivery of reviewed judgment (Article 292). The court where the proceedings will actually take place (if on initial consideration the Supreme Arbitrazh Court decided that there may be merits in conducting the review) is the Presidium of the Supreme Arbitrazh Court. The grounds for granting a review to a judgment are more limited than those for appeal and cassation: a judgment may be reviewed if it violates uniformity of interpretation and application of rules of law by arbitrazh courts; violates human rights as they are commonly recognized by the principles and rules of the international law;<sup>797</sup> violates rights and lawful interests of an unspecified set of persons or other public interests (Article 304).

A judgment of an arbitrazh court may also be set aside by the same court (if several courts considered a case – the highest of them) if there are “*new circumstances available*” (Article 309-10). At a basic level, the petitioner must have not and should have not known of such

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<sup>796</sup> Article 34 of the Arbitrazh Procedural Code. Certain categories of cases are considered by the Supreme Arbitrazh Court at the first instance.

<sup>797</sup> This ground for review was arguably introduced so as to make claimants “pass through” the Presidium before they would acquire the right to petition the European Court of Human Rights. See A.Luk’yantzev and A.Burov “On the System of Review of Judicial Acts of Arbitrazh Courts in the Order of Review”, *Legislation and Economics*, No.2, 2009.

circumstances at the time when the initial judgment was delivered. However, the rules on the grounds for review are complex, and their review is beyond the scope of this work.<sup>798</sup>

Throughout their history,<sup>799</sup> arbitrazh courts in the Soviet Union and Russia were adjudicating on more complex issues, often involving high value claims and large business entities. The judges of the arbitrazh courts were spared, for example, from the wearing, and often unsettling, divorce proceedings or proceedings related to inheritance. Furthermore, claimants and defendants in arbitrazh courts were, as a rule, represented by law professionals (unlike in the courts of general jurisdiction). Perhaps, due to all these factors, judges in arbitrazh courts were, and still are, considered to be more capable and familiar with complex issues of law and fact. In the context of this work if a dispute must be adjudicated in Russia, it is likely to be in the competence of arbitrazh courts: the parties are likely to be juridical persons and the dispute is likely to be economic.

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<sup>798</sup> See, *e.g.*, T.Zhukova and M.Kozlov, "On Grounds for Review of a Case on New Available Circumstances", *Zakon*, No.12, 2006.

<sup>799</sup> See p.23 above.

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#### **C.2. International Agreements and Declarations**

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#### **C.4. Laws and Normative Acts of Similar Nature**

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Law of the U.S.S.R. No. 8998-XI "On Cooperatives", dated 26 May 1988

Law of the U.S.S.R. No.2278-I "On Main Foundations of De-statization and Privatization of Enterprises", dated 1 July 1991

Law of the U.S.S.R. No.810-I "On Foundations of Legislation of the U.S.S.R. on Lease", dated 23 November 1989

Resolution of the II<sup>nd</sup> Meeting of the Soviets of the Union of the Soviet Socialist Republics "On Approval of the Foundation Law (Constitution) of the Union of the Soviet Socialist Republics", dated 31 January 1924

Resolution of the Supreme Soviet of Russian Federation No.3301-I "On Regulation of Civil Legal Relationships during Economic Reform", dated 14 July 1992



Resolution of the Supreme Soviet of the R.S.F.S.R. "On the Order of Entry into Force of the Law of R.S.F.S.R. "On Privatization of State and Municipal Enterprises in the R.S.F.S.R."", dated 3 July 1991

Resolution of the Supreme Soviet of the R.S.F.S.R. No. 446-I "On Order of Entry into Force of Law of the R.S.F.S.R. "On Enterprises and Entrepreneurship"", dated 25 December 1990

Resolution of the Supreme Soviet of the Russian Federation No.2980-I "On State Program of Privatization of State and Municipal Enterprises in the Russian Federation for year 1992", dated 11 June 1992,

Resolution of the Supreme Soviet of the Russian Federation No.3930-1 "On Order of Entry into Force of Law of Russian Federation "On Insolvency (Bankruptcy) of Enterprises", dated 19 November 1992

Resolution of the Supreme Soviet of the U.S.S.R. No. 1530-1 "On the Order of Entry into Force of the Law of the U.S.S.R. "On Enterprises in the U.S.S.R."", dated 4 June 1990

Resolution of the Supreme Soviet of the U.S.S.R. No. 2212-I "On Entry into Force of Foundations of Civil Legislation of the Union of SSR and Republics", dated 31 May 1991

Resolution of the Supreme Soviet of the U.S.S.R. No. 6051-XI, dated 19 November 1986

Resolution of the Supreme Soviet of the U.S.S.R. No. 7285-XI "On the Order of Entry into Force of the Law of the U.S.S.R. "On State Enterprise"", dated 30 June 1987

Resolution of the Supreme Soviet of the U.S.S.R. No.2279-I "On Entry into Force of the Law of the U.S.S.R. "On Main Foundations of De-statization and Privatization of Enterprises"", dated 1 July 1991

Resolution of the Supreme Soviet of the U.S.S.R. No.811-I "On the Order of Entry into Force of the Foundations of the Legislation of the Union of S.S.R. and Republics on Lease", dated 23 November 1989

Resolution of the Supreme Soviet of U.S.S.R. No. 1530-I "On Order of Entry into Force of Law "On Enterprises in the U.S.S.R."

## **C.5. Normative Acts of the Executive ("Secondary Legislation") and Documents of Similar Nature**

Decree "On Confiscation of Share Capitals of Former Private Banks", dated 26 January 1918, adopted by the Council of People's Commissars,

Decree of the All-Russian Central Executive Committee "On Courts" (No.2), dated 7 March 1918

Decree of the Central Executive Committee and the Council of People's Commissars "On Workers' Control", dated 14 November 1917

Decree of the Council of People's Commissars "On Courts" (No.1), dated 24 November 1917.

Decree of the President of the Russian Federation No. 2284 "On State Program of Privatization of State and Municipal Enterprises in the Russian Federation", dated 24 December 1994

Decree of the President of the Russian Federation No.1400, "On Staged Constitutional Reform in the Russian Federation", dated 21 September 1993

Decree of the President of the Russian Federation No.1535 "On Main Provisions of the State Program of Privatization of State and Municipal Enterprises in the Russian Federation after 1 July 1994", dated 22 July 1994

Decree of the President of the Russian Federation No.2264 "On Measures on Realization of Legislative Acts on Insolvency (Bankruptcy)", dated 22 December 1993

Decree of the President of the Russian Federation No.914 "On Entry into Force of the System of Privatization Checks in the Russian Federation", dated 14 August 1992

Regulation on Stock Companies, approved by the Resolution of the Council of Ministers of the R.S.F.S.R. No.601, dated 25 December 1990

Resolution "On the Peculiarities of Recording in the System of Maintenance of the Register of Pledge of Registered Issuance Securities and the Making of Changes into the System Related to the Transfer of Rights on Pledged Registered Issuance Securities" No.13/ps, dated 22 April 2002

Resolution No.2134-II GD, "On Regulations of the State Duma of the Federal Assembly of the Russian Federation", dated 22 January 1998

Resolution of Central Executive Committee of U.S.S.R. and Council of Ministers of the U.S.S.R., dated 17 August 1927

Resolution of the All-Russian Central Executive Committee "On Entry into Force of the Civil Code of R.S.F.S.R.", dated 11 November 1922

Resolution of the All-Russian Central Executive Committee "On Entry into Force of the Civil Procedural Code of the R.S.F.S.R.", dated 10 July 1923

Resolution of the All-Russian Executive Committee “Regulation on Judicial System”, dated 11 November 1922

Resolution of the All-Russian Executive Committee and the Council of People’s Commissars, dated 21 September 1922

Resolution of the Central Committee of the CPSU and Council of Ministers No. 729, dated 4 October 1965

Resolution of the Central Executive Committee of the R.S.F.S.R. “On Entry into Force of Labor Code of the R.S.F.S.R., edition 1922”, dated 9 November 1922

Resolution of the City of Moscow No.788 “On Introduction on the Territory of Moscow of Uniform System of State Registration of Pledge and Uniform Register of Contracts of Pledge”, dated 20 September 1994

Resolution of the Council of Ministers No.1134 “On Transition to Application of Contractual Retail Prices on Certain Types of Consumer Goods”, dated 12 November 1990

Resolution of the Council of Ministers of the U.S.S.R. No.1195 “On Issuance of Securities by Enterprises and Organizations”, dated 15 October 1988

Resolution of the Council of Ministers of the U.S.S.R. No.280 “On the Order of Transfer of Union Enterprises (Associations) and Their Assets into Leases”, dated 20 March 1990

Resolution of the Federal Commission on the Securities Markets ““On Approval of the Resolution on the Maintenance of the Register of Owners of Registered Securities”” No.27, dated 2 October 1997

Resolution of the Government of the Russian Federation No.1049-g, dated 21 July 2008

Resolution of the Government of the Russian Federation No.476 “On Measures on the Increase of the Efficiency of the Application of the Procedure of Bankruptcy”, dated 22 May 1998

Resolution of the Government of the Russian Federation No.498 “On Some Measures on Realization of Legislation on Insolvency (Bankruptcy) of Enterprises”, dated 20 May 1994

Resolution of the President of the Russian Federation No.85-rp, dated 5 February 1993

## **C.6. Court Cases**

Resolution of the Supreme Arbitrazh Court of the Russian Federation No.13952/05, dated 25 April 2006

Decision of the Supreme Arbitrazh Court of the Russian Federation No. 13294/08, dated 17 October, 2008

Resolution of Plenary Session of the Supreme Arbitrazh Court of the Russian Federation No.4 “On some Questions, Related to the Entry into Force of the Federal Law “On Insolvency (Bankruptcy)”, dated 8 August 2003

Resolution of the Arbitrazh Court of Moscow region No.KG-A40/5294-06, dated 23 June 2006, on case No.A40-65945/05-58-526

Resolution of the Constitutional Court of the Russian Federation No.4-P, dated 12 March 2001

Resolution of the Constitutional Court of the Russian Federation No.250-O “On Request of State Assembly – *Kurultai* of the Republic of Bashkortostan on the Interpretation of a Line of Provisions of Articles 5, 11, 71, 72, 73, 76, 77 and 78 of the Constitution of the Russian Federation”, dated 6 December 2001

Resolution of the Constitutional Court of the Russian Federation No.11-P, dated 30 April 1996

Resolution of the Constitutional Court of the Russian Federation, No.17-P “On Case on Review of Constitutionality of part one of Article 2 of the Federal Law [...]”, dated 24 October 1996

Resolution of the Federal Arbitrazh Court of East-Siberian region on case A19-11125/04-10-F02-6374/05-C2, dated 16 January 2006

Resolution of the Federal Arbitrazh Court of Moscow region No. KG-A40/3248-04, dated 12 May 2004

Resolution of the Federal Arbitrazh Court of Moscow region No. KG-A40/7139-04, dated 18 August 2004 Resolution of the Federal Arbitrazh Court of Moscow region No. KG-A40/5457-05, dated 21 June 2005

Resolution of the Federal Arbitrazh Court of Moscow region No.KG-A40/8205-09, dated 22 September 2009

Resolution of the Federal Arbitrazh Court of North-Caucasian region No. F08-507/99, dated 7 April 1999, on case A-53/10964/98-C2-10

Resolution of the Federal Arbitrazh Court of North-Caucasian region No. F08-2003/99, dated 29 October 1999, on case A-53/10964/98-C2-10

Resolution of the Federal Arbitrazh Court of the Central region on case No.A64-1588/06-9, dated 10 November 2006

Resolution of the Federal Arbitrazh Court of the Central region on case No.A64-1587/06-8, dated 18 December 2006

Resolution of the Federal Arbitrazh Court of the Moscow region No.KG-A40/2072-08, dated 18 June 2008, on case No.A40-48398/07-21-357

Resolution of the Federal Arbitrazh Court of the Moscow region No.KG-A40/4930-04, dated 23 June 2006, on case No.A40-2245/04-9-17

Resolution of the Federal Arbitrazh Court of the Moscow region No.KG-A40/4347-06, dated 29 May 2006

Resolution of the Federal Arbitrazh Court of the Moscow region No.KG-A40/10293-05, dated 27 October 200

Resolution of the Federal Arbitrazh Court of the Moscow region on case KG-A40/6015-01, dated 25 October 2001

Resolution of the Federal Arbitrazh Court of the North-West region No.A56-20181/98, dated 15 March 1999

Resolution of the Federal Arbitrazh Court of the North-West region No.A56-6381/04, dated 12 January 2005

Resolution of the Federal Arbitrazh Court of the Ural region No.F09-5986/09-C1, dated 20 August 2009

Resolution of the Federal Arbitrazh Court of the Volgo-Vyatsk region on case No.A28-190/2009-3/9, dated 3 August 2009

Resolution of the Federal Arbitrazh Court of the West-Siberian region on case No.F04-5032/2009(13103-A27-13), dated 24 September 2009

Resolution of the Federal Arbitrazh Court of Volgo-Vyatsk region on case No.A79-9875/2006, dated 14 November 2007

Resolution of the Plenum of Supreme Arbitrazh Court of the Russian Federation No.25 "On Some Questions Connected with Qualification and Determination of Claims on Mandatory Payments and Penalties for Public Violations in Bankruptcy Cases", dated 22 June 2006

Resolution of the Plenum of Supreme Court of the Russian Federation No.13 and Plenum of the Supreme Arbitrazh Court of the Russian Federation No.14 “On Practice of Application of Provisions of the Civil Code of the Russian Federation on Interest on Use of Others’ Funds”, dated 8 October 1998 (as amended on 4 December 2000)

Resolution of the Plenum of the Supreme Arbitrazh Court of the Russian Federation No.40 “On some Questions of Practice of Application of Provision of Legislation on Interested Party Transactions”, dated 20 June 2007

Resolution of the Plenum of the Supreme Court of the Russian Federation No.2 “On Some Questions in Connection with the Adoption and Introduction into Force of the Civil Procedure Code of the Russian Federation”, dated 20 January 2003

Resolution of the Presidium of the Supreme Arbitrazh Court No.1617/96, dated 10 September 1996

Resolution of the Presidium of the Supreme Arbitrazh Court No.2577/99, dated 7 December 1999

Resolution of the Presidium of the Supreme Arbitrazh Court No.3863/98, dated 20 April 1999

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.2860/02, dated 17 September 2002

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No. 7965/95, dated 2 July 1996

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation in case No. 6202/97, dated 6 October 1998

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.4735/98, dated 17 November 1998

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.1136/96, dated 29 October 1996

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.584/97, dated 27 May 1997

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.6925/98, dated 30 March 1999, on case No.A40-11008/98-83-136

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.4215/00, dated 9 September 2001, on case No.7074/99-16

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.11079/04, dated 14 December 2004

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.8955/00, dated 18 December 2001

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.8065/95, dated 25 November 1997

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.5710/96, dated 11 March 1997

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No. 3521/97, dated 13 January 1998

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.6110/98, dated 23 February 1999

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation, No.1020/99, dated 15 June 1999

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.58 “On Some Questions, Related to the Satisfaction of Demands of the Pledgee in Bankruptcy of the Pledgor”, dated 23 June 2009

Resolution of the Presidium of the Supreme Arbitrazh Court of the Russian Federation No.6110/98, dated 23 February 1999

Resolution of the Presidium of the Supreme Court of the Russian Federation No.5951/99, dated 28 March 2000

Resolution of the Presidium of the Supreme Court of the Russian Federation No.5951/99, dated 28 March 2000

Resolution of the Supreme Arbitrazh Court of the Russian Federation No.2327/02 on case No.A40-19687/01-57-220, dated 18 June 2002

Resolution of the Supreme Arbitrazh Court of the Russian Federation No.17762/07, dated 27 February 2008

Resolution of the Supreme Arbitrazh Court of the Russian Federation No. 10768/08, on case No. A56-3211/20073482/2005c9, dated 8 April 2009

Resolution of the Supreme Court of the Russian Federation No.5243/06, dated 19 September 2006, on case No.A40-64205/05-30-394

Resolution of the Plenary Session of the Supreme Arbitrazh Court of the Russian Federation No.29 “On Some Questions of the Practice of Application of the Federal Law “On Insolvency (Bankruptcy)””, dated 15 December 2004

### **C.7. Letters and Declarations**

Declaration “On Main Directions for Stabilization of People’s Economy and Transition to Market Economy”, adopted by the Supreme Soviet of the U.S.S.R. on 19 October 1990

Letter of the Association of Russian Banks No. A-01/5-535, dated 17 October 2001

Letter of the State Tax Service No.NP-6-11/104 “On Procedure for Petitioning Arbitrazh Courts on Liquidation of Enterprises”, dated 16 February 1996

Letter of the Supreme Arbitrazh Court No. S-13/OP-167, “On Particular Recommendations, Adopted at Meetings on Court-Arbitrazh Practice”, dated 20 May 1993

Letter of the Supreme Arbitrazh Court No.S1-7/OP-237, dated 25 April 1995

Letter of the Supreme Arbitrazh Court of the Russian Federation No.SZ-8/up-929, dated 6 September 2001

Letter of the Supreme Arbitrazh Court of the Russian Federation No.OU-30/1-533, “On Informational Letters of the Presidium of VAS RF”, dated 4 October 1996

Letter of the Supreme Arbitrazh Court, No.OP-13/4, dated 15 May 1995

## **D. Other Non-Russian Sources**

### **D.1. Cases (UK)**

*Ashborder v Green Gas Power Ltd* [2004] EWHC 1517 (Ch)

*Barbados Trust Co v Bank of Zambia* [2007] EWCA Civ 148

*Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 56

*Barclays Bank v Estates & Commercial* [1997] 1 WLR 415

*China and South Sea Bank Ltd v Tan Soon Gin (alias George Tan)* [1990] 1 AC 536



*Clydebank Engineering and Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6

*Cosslett (Contractors) Ltd, Re* [1997] 4 All E.R. 115

*Dearle v Hall* (1823) 3 Russ 1

*Devaynes v Noble, Clayton's case* (1816) 1 Mer 529.

*DKG Contractors Limited* [1990] B.C.C. 903

*Don King Productions Inc v Warren and others* [1999] 2 All ER 218

*Dunlop Pneumatic Tyre Co Ltd v Selfridge & Co Ltd* [1915] AC 847

*Great Eastern Rly Co v Lord's Trustee* [1909] AC 109

*Hewett v Court* (1983) 149 CLR 639

*Hill v Spread Trustee Company & another* [2006] EWCA Civ 542

*Holroyd v Marshall* (1862) 10 HL Cas 191

*Illingworth v Houldsworth* [1904] AC 355 at 357

*In re Overnight Ltd; Goldfarb v Higgins and others* [2009] WLR (D) 49

*In the matter of Parkside International Limited (in administration)* [2008] EWHC 3654 (Ch)

*Industrials Finance Syndicate, Limited v. Lind (In Re Lind)* [1915] 2 Ch. 345

*Jones v Humphreys* [1902] 1 KB 10

*Maxwell Communications Corporation plc (No.2)* [1994] 1 All ER 737

*MS Fashions Ltd v Bank of Credit and Commerce International SA (in liquidation) (No 2)* [1993] Ch 425

*Nash v Eads* (1880) 25 Sol Jo 95, CA

*National Westminster Bank plc v Spectrum Plus Limited & Others* [2005] UKHL 41

*NV Slavenburg's Bank v Intercontinental Natural Resources Ltd and others* [1980] 1 All ER 955)

*Phillips (Liquidator of AJ Bekhor & Co) v Brewin Dolphin Bell Lawrie Ltd (formerly Brewin Dolphin & Co Ltd)* [2001] UKHL 2

*Phillips (Liquidator of AJ Bekhor & Co) v Brewin Dolphin Bell Lawrie Ltd (formerly Brewin Dolphin & Co Ltd)* [2001] UKHL 2

*Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214

*Re Brumark* [2001] UKPC 28

*Re Charge Card Services Limited* [1986] 3 All ER 289

*Re Conley* [1938] 2 All ER 127

*Re Crompton & Co Ltd* [1914] Ch 954

*Re MC Bacon Limited* [1990] BCC 78

*Re Paramount Airways Ltd* [1990] B.C.C. 130

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*Re Potters Oil Ltd (No.2)* [1986] 1 All ER 890

*Re Sonatacus Ltd* [2007] EWCA Civ 31

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*Re Williams, Williams v Ball* [1917] 1 Ch 1

*Ricketts v Ad Valorem Limited* [2003] EWCA Civ 1706

*Rolled Steel Products Limited v BSC* [1985] 3 All ER 52

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*Taunton v Sheriff of Warwickshire* [1895] 2 Ch 319

*Trident International Ltd v Barlow* [1999] 2 BCLC 506

*West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250

## **D.2. Other**

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– 1136(2)

Company Directors Disqualification Act 1986 [UK]

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Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 On Settlement Finality in Payment and Securities Settlement Systems [EU]

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- 1A;
- 40;
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- 176A;
- 214;
- 216;
- 233;
- 238;
- 245; and
- 386; and

Schedules:

- A1;
- B1 (para 3(1), 42 and 43); and
- 6

Insolvency Rules 1986/1925, rule 4.90 [UK]

Land Registration Act 2002, section 49 [UK]

Late Payment of Commercial Debts (Interest) Act 1998 [UK]

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- 85;
- 87;
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- 136(1)

Overseas Companies (Execution of Documents and Registration of Charges) Regulations  
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U.S. Uniform Commercial Code, Article 9, Part 3, §9-310(a) [US]