

A FLURRY OF LEGISLATIVE ACTIVITY HAS CHANGED THE RULES FOR LLCs, MORTGAGES, AND INSOLVENCY PROCEEDINGS

The 2008 Year-end Legislative Overhaul and Its Implications for the Crisis Economy

By **Grant Williams**, Partner, CMS, Russia

FOR LAWYERS IN Russia, the very end of 2008 saw a major overhaul of a number of key corporate, security and insolvency laws: arguably, for lawyers working in the corporate and commercial arena, some of the most significant changes since the late 1990s. In this article I will outline a very brief description of some of the legal changes, the areas of reform that they promote - particularly in connection with secured lending and direct investment through limited liability companies (LLCs), and also note their place in what might be considered a first wave of legislative reform in the current economic crises.

What Happened?

On December 30, 2008, the Russian President Dmitri Medvedev signed laws amending the way LLCs are regulated (the “LLC Law Amendments”), the way enforcement of Russian security (i.e. pledges and mortgages) may be carried out (the “Security Law Amendments”), and the way insolvency proceedings are implemented and priorities applied on liquidation (the “Insolvency Law Amendments”). Now, I will examine each of these amendments.

The LLC Law Amendments: The key changes under the LLC Law Amendments, which will come into force in July 2009, are as follows (joint stock companies are not affected by these amendments):

- Participants of a LLC may enter into contractual arrangements to regulate their rights as participants (i.e. a shareholders agreement), whereas before there was significant uncertainty regarding the enforceability of such arrangements. The text of the LLC Law Amendments is broad, which offers encouragement that significant rights among participants may be agreed, and specifically agreements may govern the exercise of voting rights, the sale of a participation interest at a pre-defined price (e.g. in connection with pre-emptive rights) and/or upon the occurrence of certain events.
- Information about holdings in LLCs will be contained in the Unified State Register of Legal Entities (the “Unified Register”). Once recorded in the Unified Register this information may be regarded as public and reliable.
- Participants no longer have an unrestricted right to withdraw from the company. Any such

right must now be expressly provided in the company’s charter. Under current law, the ability of a participant to withdraw from a company is viewed as a serious impediment to LLCs being used in on-shore joint ventures.

- The process for transferring participation interest now requires notarization (and in principal in most cases becomes effective upon notarization). This is one of a number of aspects under the legal changes that now involves formalization with a notary.
- Pledges of participation interests created after July 1, 2009 will need to be notarized in order to be valid. The notary will provide the registration authorities and the company with copies of the pledge document, then a record of the pledge will be made at the Unified Register.

The Security Law Amendments:

The key changes under the Security Law Amendments, which came into force on January 11 2009, are as follows.

- Significant changes have been made to the enforcement procedure regarding secured

property (i.e. Russian pledges and mortgages), which (among other things) in theory allow a secured creditor to enforce security against an uncooperative security provider by way of out-of-court enforcement, and allow claims to be satisfied by the transfer of property (rather than just from proceeds of auction). Overall, from a number of aspects, the key changes create a more creditor-friendly environment.

In connection with movable property: it may be possible to realize security by (a) acquisition of the property; (b) direct sale to a third party; (c) sale by way of a commission sale contract; and (d) sale under a private bidding process. Previously, enforcement would ordinarily have been by way of a court-organized public auction.

In connection with immovable property: it is now possible to enforce out of court on the basis of a pre-agreement between the mortgagor and mortgagee. Previously, court enforcement was required (although if the mortgagor is an individual, and in certain other cases, court enforcement is retained).

- A number of safeguards and clarifications are provided: (a) Independent appraisers are required to be engaged for out-of-court enforcements; (b) a cap of 3 percent of proceeds is provided for commission agents fees and certain sale costs; (c) the existing concept of “insignificant default” has been clarified (i.e. as claims of less than 5 percent of pledged assets and default of less than three months); and (d) in a prominent feature of the legal changes, notarized consent is required in connection with out-of-court enforcement.
- Mortgage bonds can now be used as an independent document governing all relations between the mortgagor and mortgagee. Mortgage bonds may now be accounted at a depository, with transference effected through depo accounts, rather than by way of physical endorsement. These amendments, certainly for residential mortgages, will support the practicalities of transfer in securitization.
- Clarification of the position regarding third party creditors. In the bankruptcy proceedings of a security provider that secured (by pledge or mortgage) the obligations of another, its secured creditors will be treated the same as other creditors – irrespective of the identity of the debtor that is secured. Previously there was doubt if insolvency law supported this position.
- A new regime is in force that affects the application of pro-

ceeds from secured assets. During the liquidation stage of insolvency (i.e. winding up), the insolvency law would assure between 70 percent (non-credit agreement obligation) and 80 percent (credit agreement obligation) of the proceeds from the security, with the respective balances paying statutory priorities.

The result, in the right commercial circumstances and given that it is supported by the law, would appear

support the framework of commercial transactions in Russia, and to that extent support investment in the future. However, in many cases, the changes are also likely to generate new issues and questions to resolve. For example, LLCs - with better recognition of shareholder agreements, registration of ownership and security, and the ability to govern exit rights - have been promoted as a more flexible vehicle for direct investment, and which may create stronger protection against non-transparent takeover. Yet the new participation interest transfer processes require notarization, and notaries may be reluctant to act, for example, where transfer pre-conditions are complicated and/or foreign law transfers are involved. Or they may simply not be available to act at required times. Additional transaction costs and attendances may also result under the new processes.

In connection with the enforcement of security (i.e. pledges or mortgages), the legislative changes introduce (as significant developments in the law of Russian security) processes for more clearly recognizing out-of-court enforcement and the possibility of satisfying a creditor’s claims by a transfer of ownership of the secured property to it. Yet in practice, these processes may be held up at the notary stage, disputed, referred to court application for enforcement, and delayed.

One element introduced into a number of the legislative changes discussed in this article is the involvement (and importance) of notaries. Without doubt there will be a range in quality and commercial aptitude of the available notaries, and in certain circumstances (e.g. in connection with discretions on enforcement of security or transfer of participations), it’s not inconceivable that notaries may be subjected to influence to act or not.

What is of less doubt is that 2009 will likely continue to be an interesting year for further legal development and the application of legal process in Russia. ■

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The Insolvency Law Amendments: The Insolvency Law Amendments introduced a wide range of miscellaneous (but important) changes to insolvency law and proceedings, which came into force under laws enacted at the end of 2008 and beginning of 2009. These include the following:

- Re-establishing the insolvent liquidation order of priorities along the lines of: (a) categories of current claims (e.g. insolvency costs, mandatory payment [e.g. taxes] and social payments); (b) first priority claims (e.g. personal injury); (c) second priority claims (e.g. severance benefits, employees); and (d) third priority claims (secured and unsecured claims). Although this is a similar priority basis as under the previous law, the categories have been altered.

ceeds to secured creditors from enforcement of their security in insolvency. During certain restorative measures of the insolvency process (i.e. financial rehabilitation and external administration), secured creditors have the option to enforce (with the courts’ leave), or to waive their rights to do so. If they enforce they have the potential to realize 100 percent of enforcement proceeds, subject to payment of statutory priority claims (see (a), (b) and (c) above in the first bullet point regarding this amendment). However, in commercial reality this may be a better position, depending on the realizable values of the insolvency estate and the exposure to statutory priorities, as the Insolvency Law Amendments guarantee certain thresholds for the

to provide secured creditors with certain protections and a degree of choice.

Crisis Reform? Reaction to These Changes

Overall it would be fair to say that the nature of the above legislative changes and the timing of their implementation have been influenced by the recent negative economic conditions experienced in Russia. A significant number of other laws were introduced at the end of 2008 and, as times of crisis tend to dictate, a significant number of other reforms have been slated for 2009. There is also expected to be a body of ancillary regulations issued to support the effectiveness of a number of the existing changes.

Many of the legislative changes provide rights, remedies, and clarifications that appear to better