

# Important changes to the Federal Law on pledge of movable property

February 2009

Toward the end of December 2008 Russian legislators passed a number of laws that have significantly changed the regime regarding enforcement of pledges over movable property, payment priorities on insolvency, as well as making a number of related clarifications. The principal changes, which amend a number of Russian laws, are set out in Federal Law No. 306-FZ dated 30 December 2008 "On amendments to certain legislative acts of the Russian Federation for the purpose of improving procedures for levying execution on pledged property" (the "**new law**").<sup>1</sup> The new law came into effect on 11 January 2009. An overview of its key provisions follows.

## Major Focus Points

### 1. Enforcement procedure

Before the new law, the enforcement of a pledge could generally only be carried out through a public auction. Although an out-of-court auction process was available, this would require the co-operation of pledgees at enforcement, and without this a court enforced public auction was assumed to be the most likely route. In any event the pledgor would only be entitled to proceeds from the sale of the pledged property.

The new law allows the parties to a pledge agreement to agree (in the pledge agreement or by way of separate documentation) to certain methods of enforcement. The methods of enforcement and principal features are described as follows.

- *Acquisition of title:* If the pledge is between legal entities or individual entrepreneurs and is in connection with business activities, the parties can agree that upon default, title to the pledged property may pass to the pledgee or to a third party (privately or by way of a commission agency agreement);
- *Private auction:* If the parties have agreed that an out-of-court settlement should apply, this may be carried out under auction organised by the pledgee, the process for which may be specified in the pledge (or other) agreement. If publicly traded securities are pledged, then their sale must be across the relevant exchange;
- *Public auction:* If enforcement of a pledge is carried out through court process, the new law clarifies that this is to be carried out by public auction (i.e. a sale organised by the Federal Bailiff Service). Previously in connection with court enforced auction, the court had the ability at the request of the pledgor to delay process for up to one year (without clear reasons). Under the new law valid reasons should be presented for any requested delay, and a court should not postpone enforcement if there is a risk of damage or devaluation to the property, or if the pledgee's financial position may deteriorate; and

---

<sup>1</sup> This article pledges over movable property. In connection with the law changes related to immovable property see – "CMS – Important changes made to the Federal Law "On mortgages (pledges of immovable property)", February 2009

- *Other features and clarifications:* Some other notable features and clarifications under the new law are:
  - (a) Independent appraisers are required to be engaged for out of court enforcements;
  - (b) A cap of 3% 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% of pledged assets and default of less than 3 months);
  - (d) Parties may determine an enforcement timetable, which must have a minimum 11 days from the date of enforcement notice; and
  - (e) In what is a prominent feature of the enforcement methods under the new law, a notarised pledgor's consent is required in connection with out of court enforcement. To this extent, if the pledgor does not consent to the enforcement, it's likely that enforcement would be routed through the court process.

## 2. Secured claims in Insolvency

The new law affects the application of proceeds to secured creditors from enforcement of their security in insolvency.<sup>2</sup>

During certain restorative measures of insolvency process (i.e. financial rehabilitation and external administration), pledgees (i.e. secured creditors) have the option to enforce their pledge (with the courts' leave), or to waive their rights to do so. If they enforce they have the potential to realise 100% of enforcement proceeds, subject to payment of statutory priority claims. If they waive their rights (or the court declines an application) they may participate in the restorative insolvency processes with full voting rights.

In addition, if the insolvency process deteriorates to liquidation (i.e. winding up of the entity), the insolvency law would assure between 70% (in relation to non-credit agreement obligations) and 80% (in relation to credit agreement obligations) of the realised proceeds from the enforcement of a pledge, with the respective balances paying statutory priorities. In commercial reality, this may result in a better insolvency result for a pledgee - depending on the realisable values of the insolvency estate and the exposure to statutory priorities.

By way of background – the statutory priorities run along the lines of:

- *Current claims* (e.g. insolvency costs, mandatory payment (e.g. taxes) and social payments);
- *First priority claims* (e.g. personal injury);
- *Second priority claims* (e.g. severance benefits, employees); and
- *Third priority claims* (secured and unsecured claims) – i.e. into which falls the application of proceeds arising from the enforcement of pledges.

<sup>2</sup> In connection with the legal regime related to insolvency see: "CMS – Corporate Insolvency and related proceedings in the Russian Federation, February 2009" and "CMS – Insolvency law in relation to credit organisations in the Russian Federation, February 2009".

### 3. Reaction to the new law

In principle, from the perspective of secured creditors, the new law is an improvement from the previous legal regime – under which the pledge (and enforcement process) was often regarded as defensive, rather than as an instrument and process that might readily support enforcement for the benefit of secured creditors.

In this respect, the ideas of a recognised extra-judicial enforcement process and being able to appropriate title under enforcement are significant steps forward. However in practice, if the pledgor is uncooperative, it's likely that a notary would not act to the detriment of a pledgee without court intervention, and the likely necessity of court enforcement may remain a reality. Leaving aside the requirement for notarisation of enforcement consent, the ability of being able to take title to an asset (rather than just enforce through a public auction) would appear to have useful application in connection with pledges over contracts, and the possible receipt of a third party payment flow.

Depending on the wording of pledge agreements currently entered into, and application of further assurance wording, it may be beneficial for secured parties to consider amending existing pledges to better contemplate enforcement through the new law. Care in this respect should be exercised regarding activating any new hardening periods.

#### CMS, Russia

#### Contact details:

**Grant Williams**  
E +7 495 786 30 78  
E grant.williams@cmslegal.ru

**Karen Young**  
T +7 495 786 30 80  
E karen.young@cmslegal.ru

**CMS**  
Gogolevsky Blvd, 11  
119019 Moscow  
Russia  
Tel +7 495 786 4000  
Fax +7 495 786 4001  
[www.cmslegal.ru](http://www.cmslegal.ru)

This commentary is not a full review of the topics it covers and does not purport to give legal advice. If you would like to receive specific legal advice, please contact your usual CMS attorney. All liability for damages arising from the information provided is explicitly excluded.