

# Modern Russian Secured Transaction Law and Foreign Investors' Rights Thereunder

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## I. INTRODUCTION

Modern Russian commercial law was born in 1985 by *Perestroika*<sup>1</sup> and reached adolescence six years later when the Soviet Union collapsed. The statist, centrally-commanded Soviet economy obviated the need for commercial law or concepts. The explosion of reform gives Russian commercial law teenager-like qualities: it has the energy and desire to develop into *something*, but lacks experience or character, and therefore is crude and unsophisticated.

There are great opportunities for profitable, long-term investing in Russia.<sup>2</sup> The need for capital to strengthen the Russian economy

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1. MIKHAIL S. GORBACHEV, *PERESTROIKA: NEW THINKING FOR OUR COUNTRY AND THE WORLD* (1987). Prior to Mikhail Gorbachev's ascendancy to power and his publication of *Perestroika*, there was no foreign investment in the Soviet Union. That changed during the late 1980s, as Gorbachev began instituting economic reforms in the Soviet Union. *Perestroika* promised more reform than it delivered, but it broke inertia and set reform in motion.

2. Russia's potential for economic growth over the next generation is staggering. It is a nation of 6,592,800 square miles of largely untapped mineral, forestry, and agricultural resources. *WORLD ALMANAC AND BOOK OF FACTS 1993* 693 (Mark S. Hoffman, ed. 1993). However, the most important of its resources is its people. Russia is a nation of 148.5 million people, many of whom are highly educated. The Russian

is unquestioned by the government. For this reason, the Russian leadership has taken many steps to build a legal framework for capitalistic transactions. However, potential investors are inherently fearful of investing money and effort in the unknown. Many foreign investors who are ready and able to invest are not willing. Some are frightened by the political climate in Russia. Boris Yeltsin's power as President is challenged continually, but this analysis proceeds on the belief that his political success to date demonstrates the commitment of the Russian people to economic reform.<sup>3</sup> Hence, an improved understanding of Russian law by Western businesspeople will increase the likelihood of successful investing, regardless of the political leadership.

Perhaps an investor's most basic concern when transacting business is predictability of outcome. It is imperative that a market participant act with confident expectations. Damage control is a major factor when predicting and producing reliable expectations. Therefore, it is vital to know what may happen when damage occurs and the party dealt with defaults or goes bankrupt.

Secured lenders in the United States rely on a solid body of commercial and bankruptcy law to improve the predictability of outcomes. It was judicially developed in the Common Law and is now

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literacy rate is 99 per cent. *Id.* The skill level of the Russian people should enable its economy to grow at a much faster rate than the growth economies of third world nations, and the people's sophistication also should enable Russia to develop a thriving consumer market.

3. As President of the Russian Federation, Boris Yeltsin has outperformed Gorbachev in keeping his reform promises, but not without many fights from the conservative forces that hastened Gorbachev's fall from power. Throughout 1992 Yeltsin issued many decrees affecting business in Russia. In 1993 Yeltsin withstood the greatest challenges to his authority—and the path of reform—when he won a decisive vote of confidence by the general electorate and succeeded in the constitutional coup that disbanded the non-democratic Parliament.

The December 1993 elections resulted in major setbacks to the radical reformers in Russia, but did not signal the peoples's desire to return to Soviet-style government. Since the Soviet era ended, the Russian people have tasted freedom spiritually, economically, and politically. They have more choices available than ever before. If choice is power, it is unlikely that the laws encouraging foreign investment will be reversed, even if Yeltsin were ousted. "The reforms begun in 1992 have enabled us to blunt the crisis. . . . After several years of pointless dispute over words, privatization is going full steam ahead. The rapid growth of the private sector, which already embraces not just trade and finances, but also production, has become a reality of economic life." *Sergey Filatov Marks 1991 Coup Anniversary*, RUSSIA-CIS INTELLIGENCE REPORT, INTERNATIONAL INTELLIGENCE REPORT, Sept. 2, 1993, available in WESTLAW, PTS-NEWS Database.

codified in the Uniform Commercial Code and the Federal Bankruptcy Code.<sup>4</sup> Lenders in Russia do not enjoy the same common law foundation, but the new laws are an attempt to introduce many of these principles to Russian commerce. In addition, due to Russian inexperience with capitalistic commercial law concepts and practice, there is not yet a developed vocabulary in commercial practice. This increases miscommunication and unpredictability. The foreign investor considering lending in Russia must therefore be prepared to grow with her as the economy and law develop.

The purpose of this Comment is to aid the American practitioner and investor in the reduction of risk when lending in Russia by illuminating its nascent secured transaction law and related commercial statutes. Part II focuses on the Law of the Russian Federation "On Mortgage,"<sup>5</sup> as the first Post-Soviet era step at codifying a law of secured transactions. It exposes the rules governing (A) the scope of legal mortgage relations, (B) attachment and rights and duties in mortgage contract, (C) creditor priority and perfection of security interests, and (D) the contracting parties' rights and remedies upon default. The examination compares important provisions of Article 9 of the UCC to the Mortgage Act. Part III addresses the bankruptcy law passed and implemented in 1993. Part IV focuses on the enforceability of cross-border secured interests by looking at other laws significantly impacting a foreign secured party's rights. Part IV.A inquires into foreign investor's rights under Russian property law, and Part IV.B looks into foreign investment law and treaties. Part V briefly describes domestic American resources that aid in securing private Russian debt. In the conclusion, Part VI, some sociological issues likely to confront a foreign investor doing business in Russia are also discussed.

It is important to note that the form of the foreign investment enterprise is important to the decision to extend credit in Russia. This is because citizenship and legal personhood<sup>6</sup> impact the way property rights, and thus security interests, are determined in Russian law. However, this Comment does not purport to be a guide to optimal investment enterprise forms. That decision is individual and involves

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4. UNIFORM COMMERCIAL CODE, (1972) [*hereinafter* UCC]; United States Bankruptcy Code 11 U.S.C. §§ 101-1330, 28 U.S.C. §§ 151-155.

5. Law of the Russian Federation "On Mortgage," Law No. 2872-1 of May 29, 1992, 23 Ved.S'ezda Nar. Dep. R.F. Item 1239 (1992)(*hereinafter* "the Mortgage Act" or "the Act").

6. Legal personhood in Russia means the capacity to possess legal rights and duties. It includes individuals, corporations, and other business associations.

many non-legal factors. Instead, this inquiry maps the legal landscape the investor must travel to protect its credit investment in Russia by securing the debt.

## II. "ON MORTGAGE": THE NEW RUSSIAN LAW OF SECURED TRANSACTIONS

On May 29, 1992, Russia's Parliament passed the Mortgage Act for the purpose that "[m]ortgage shall be a way of creating security for obligation under which the mortgagee (creditor) acquires the right, in the event of non-performance by debtor of the obligation, to receive satisfaction out of the mortgaged property in preference to other creditors, barring statutory exemptions."<sup>7</sup> The word "mortgage" has a broader meaning in Russian than in English, as evidenced by its description of mortgage as a "way of creating security."<sup>8</sup> The term "mortgage" in Russian law refers not only to transactions where an obligation is secured by real property, but to any contract where performance is secured by a property interest.

This sheds light on the most significant distinction between the UCC and the Mortgage Act. The Mortgage Act's purpose and scope is to permit the creation of all types of secured transactions. In contrast, the Code limits the scope of secured transactions it addresses to personal property, both tangible and intangible.<sup>9</sup> Thus, the Russian Mortgage Act reveals both its promise and its weakness: intended as a comprehensive law, it is mainly a relational framework to guide parties through the formation of private contracts securing obligations. Lacking specific definitions of terms and rights, the Mortgage Act does not provide the certainty and protection of the UCC. Rather, the burden is on the parties, especially the lender, to provide certainty and protection in contract.

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7. RF Mortgage Act Art. 1.

8. Two excellent treatments of the Mortgage Act are available. Christopher Osakwe, *Modern Russian Law of Banking and Security Transactions: A Biopsy of Post-Soviet Russian Commercial Law*, 14 WHITTIER L.R. 301 (1993). The author provides a "clinical analysis," *id.*, that examines the Act over the course of its articles and provides the Russian words for key terms. For a more general, practical overview of the Act, see William G. Frenkel, *New Russian Secured Transactions Regime: Analysis of the Law on Pledge*, 4 SURVEY OF EAST EUROPEAN LAW No.2 (Parker School, Columbia University, March 1993). The author does not cite specific provisions of the Act in most of his analysis, but offers a practitioner's perspective that includes references to property relations defined elsewhere in Russian law.

9. U.C.C. § 9-104.

### A. *Scope Of The Russian Mortgage Act*

The baseline features of the mortgagee,<sup>10</sup> mortgagor, and mortgageable property are spelled out in the Act's first section. The Act states that where its terms conflict with those of Russian Federation treaties, treaty rules govern.<sup>11</sup> Hence, the first burden the foreign investor bears is discovery of whether his particular industry or business association is governed by a separate treaty with Russia. The second burden faced is to specify and include the governing law in the contract. The Mortgage Act states that the law of the debtor's domicile will be the governing law unless contracted otherwise.<sup>12</sup> This is different than under the UCC, where there is no right to specify the governing law and the law of debtor's domicile governs.<sup>13</sup>

#### 1. *Statutory Liens*

The Mortgage Act states that a mortgage can be created by contract or operation of law.<sup>14</sup> Even though circumstances where a mortgage will arise by law are narrow, statutory liens are regulated by the Act.<sup>15</sup> The Mortgage Act is silent as to the relationship between statutory liens and other security interests. In contrast, Article 9 does not regulate statutory liens, which generally take priority over perfected security interests in American jurisdictions.<sup>16</sup> The perilous result may be that a well-executed security agreement could be thwarted by local interference and arbitrary applications of law.<sup>17</sup>

10. In this Comment the following terms are interchangeable: debtor and mortgagor; and secured party, creditor, and mortgagee. In Russia, mortgagees are always secured. References to unsecured creditors will be modified by the term "unsecured" or described as ordinary or competitive creditors.

11. RF Mortgage Act Art. 2.

12. *Id.* Art. 10(6).

13. U.C.C. § 9-103(3)(b).

14. RF Mortgage Act Art. 3(1).

15. *Id.* Art. 3(2). "Statute providing for origination of mortgage must contain indication in virtue of which obligation and which specified property must be deemed pledged in mortgage." *Id.* Thus, the circumstances where a mortgage will arise by operation of law relate directly to the property "pledged" and the nature of the transaction. An example of this type of statutory mortgage is the deferral of customs payments for up to thirty days from the date freight clears customs. RF Procedure for Application of RF Interim Import Customs Tariff, s. 3.3-3.4 (RF State Customs Committee Instruction No. 01-20/3243, RF Ministry of Finance No. 46, RF Central Bank No. 5), RF President's Edict No. 630, 14 June, 1992.

16. U.C.C. §§ 9-203(4), 9-310.

17. Local Russian officials, many carrying over from the Soviet era, still wield

## 2. *Owner's Power to Mortgage Property*

Under the Mortgage Act, a mortgagor may be any person who has either full ownership or "full business management"<sup>18</sup> of the collateral. Apparently, only the mortgage of property interests over which the debtor has full control and power of disposal are recognized.<sup>19</sup> This is different from the UCC rule, which allows a debtor to give a security interest in any property interest he owns, subject to encumbrances.<sup>20</sup> The practical effect of the Russian provision narrows the scope of mortgageable relations. Furthermore, it places a heavy burden on the lender to determine that the mortgagor actually has the power to mortgage the subject property. The lender who fails to ascertain this fact assumes a tremendous risk because a contract dispute would probably result in avoiding the agreement.

## 3. *Mortgageable Property*

The range of contracts which may be secured by a mortgage is virtually unlimited under the Mortgage Act. Examples include contracts

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considerable power. Some may be prone to self-interested, arbitrary application of the law. It is therefore imperative that foreign investors have a well-connected and trustworthy Russian representative handling local affairs.

A prime example of political interference in transnational business affairs at the local level, though not secured transaction, is *Financial Matters, Inc. v. Pepsico, Inc.*, 806 F.Supp. 480 (S.D.N.Y. 1992). Monsieur Henri, a subsidiary of Pepsico, held the exclusive license to import *Stolichnaya* vodka into the United States for nearly 20 years. The Russian Federation, in a privatization decree intended to foster exports, stated generally that manufacturing entities now had export rights for their products. Sensing opportunity, a distillery in one of the autonomous republics declared itself the exclusive exporter of *Stolichnaya* vodka.

The distillery entered into "exclusive" import contracts with three American importers. The Deputy Prime Minister of the republic then issued a decree stating that all export and trademark rights belonged to the local distillery. *Id.* at 483. Monsieur Henri succeeded in obtaining a declaratory judgment holding it to be the exclusive owner of the *Stolichnaya* mark in the United States and won an injunction against a competing importer, but not without significant legal costs and headaches. *Id.*

18. "Full business management" is undefined in the Mortgage Act, but a reasonable inference drawn therefrom is that it refers to directorship or management of a business enterprise.

19. RF Mortgage Act Art. 19. The Act permits a lessee to mortgage leasehold rights so long as the mortgage is not prohibited by the contract for lease. *Id.* Art. 19(4).

20. U.C.C. § 1-201(37).

for loans (including bank loans), sales, property leases, carriage of goods, and "other contracts."<sup>21</sup> However, mortgage contracts cannot be for "claims of a personal character," presumably meaning personal servitude, or others statutorily prohibited.<sup>22</sup> Property subject to mortgage includes "chattels, securities, other property and property rights, and future rights."<sup>23</sup> Any property which the owner is free to alienate, subject to Russian Federation legislation, may be mortgaged.<sup>24</sup> The Act covers mortgages where the creditor retains possession of the mortgaged property and mortgages of real property and "[e]nterprises, buildings, structures, flats, transport vehicles, space objects, and other properties specified in Article 6."<sup>25</sup>

The Mortgage Act states that a security interest will attach to the accessories and "usufruct thereof" of mortgaged property unless statutorily or contractually mandated otherwise.<sup>26</sup> However, the "severable fruits thereof" will attach only "within the limits, and in the manner provided for by statute or contract."<sup>27</sup> In effect, this means that some mortgageable property may have the income producing characteristics of a trust for the mortgagor, unless modified by contract. As to after acquired property, a mortgage may attach in situations where the parties provide for attachment in contract.<sup>28</sup>

#### 4. *Hypothecation*

The Mortgage Act utilizes both title and lien theories as the grounds upon which secured transactions are built.<sup>29</sup> Although the Russian Code

21. RF Mortgage Act Art. 4(1).

22. *Id.* Art. 4. An example of a statutorily prohibited mortgage is the hypothecation of jointly owned property where the mortgage is not given with the consent of all owners. *Id.* Art. 7(1).

The RF Mortgage Act does not prohibit many transactions. Therefore, in situations where there is a question about the security interest or the mortgage relationship, the Russian Code of Civil Procedure should be checked for prohibitions, as well as other laws and treaties.

23. *Id.* Art. 19(2). Where full business management of assets have been assigned, the managers or officers shall mortgage the entire enterprise as a "property complex," or mortgage individual buildings and structures, with consent of the owner or by authorized power of agency. *Id.*

24. *Id.* Art. 6.

25. *Id.* Art. 35. The property "specified in Article 6" is "[p]roperty which the mortgagor is free to alienate, under RF legislation." *Id.* Art. 6(1).

26. *Id.* Art. 6(2).

27. *Id.*

28. *Id.* Art. 10(3). *Cf.* U.C.C. § 9-204.

29. Osakwe, *supra* note 8, at 355-56.



of Civil Procedure provides for nine types of security devices, the types of devices intended under the Mortgage Act are hypothecation and pledge.<sup>30</sup> A real property mortgage is referred to as an "hypothecation" (*ipoteka*).<sup>31</sup> All mortgages that touch the land must be hypothecated, and are governed by lien theory. Although most mortgages of personal property utilize title theory, discussed below, some may be hypothecated.<sup>32</sup>

Following lien theory, an hypothecation more closely parallels real property law than the UCC. For example, the Mortgage Act provides the mortgagor the right to retain possession of the mortgaged property after default until all redemptive rights are exhausted.<sup>33</sup> Therefore, though the secured party's rights in the collateral are triggered at default, the secured rights are not enforceable until foreclosure is complete.<sup>34</sup> A creditor's rights may be further limited by other Russian Federation Acts governing property rights in land.<sup>35</sup> However, the debtor's right of redemption where property has been hypoheated does not appear to be for mortgages of land only.

The mortgage of an "enterprise, structure, building, permanent installation or objects directly connected with land, along with the land on which the object stands" also will be considered an hypothecation.<sup>36</sup> In this relationship, special rights accrue to the creditor. The Mortgage Act gives the secured party the right to take affirmative steps to improve the performance of the enterprise, i.e., a right to direct managerial intervention (including replacement), and the power to restrict the disposition of product and other assets of the enterprise.<sup>37</sup> However, it is unclear whether these hypothecation rights are immutable, must be opted into, or may be opted out of the contract. The lender would be wise to specifically delineate its right of intervention in contract.

The notion that an enterprise may be equivalent to its "permanent installation" is unusual and may have severe ramifications. Exercise of the rights of management intervention or asset disposition could

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30. The Civil Code names the nine devices in Articles 192-202. For detailed explanation, see CHRISTOPHER OSAKWE, *SOVIET BUSINESS LAW*, v.1, § 9.19 (1991).

31. *Id.* Art. 41; Frenkel, *supra* note 8, at 12.

32. *See* RF Mortgage Act Art. 48.

33. *Id.* Arts. 41, 42, 45.

34. *Id.* Art. 24.

35. *Id.* Art. 41.

36. *Id.* Art. 42.

37. *Id.* Art. 44(3). The right of managerial intervention is discussed more fully in Part II.D.4, *infra*.

conceivably harm the secured party. Plus, in foreclosure, the enterprise must be sold as an entity.<sup>38</sup> Because the rights to possession and use of real property are necessarily involved in the enterprise, the creditors' right to satisfaction ultimately is not enforceable until all the mortgagee's rights of redemption are foreclosed.<sup>39</sup> The result is a Russian law that is very protective of the debtor's rights in mortgage contracts where the debtor pledges its interest in real property.

### 5. *Goods in the Flow of Commerce*

The mortgage relationship for "goods in the flow of commerce" is akin to a chattel mortgage, and is treated as an hypothecation.<sup>40</sup> The mortgagor retains the right to possession, use, and disposal of the mortgaged property<sup>41</sup> and is permitted to alter the property's form when it is "raw and other materials, semifinished products, finished products, and the like."<sup>42</sup> The mortgagor may reduce the value of mortgaged goods, relative to the value of the obligation partially performed.<sup>43</sup> However, the Mortgage Act makes no references to creditor's rights in this regard other than adding a requirement that when substitute goods are described in detail, then the security interest will attach to the substitute<sup>44</sup>.

### 6. *Pledge, Generally*

Mortgages of personal property, including intangible property and future rights, can be tailored by contract to meet the business and security needs of the parties. The Mortgage Act treats transactions where mortgaged property is physically delivered as a pledge under modern title theory. The articles principally deal with the creditor's duties, and thus are principally aimed at the pawn business.<sup>45</sup> The

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38. *Id.* Art. 44(4). This section of the article stipulates that "[o]n application of foreclosure to enterprise in hypothecation, it shall be sold at auction as a *single complex* in the manner provided for by RF legislation" (emphasis added). As a result, the enterprise cannot be liquidated piecemeal to pay secured creditors. *Id.* However, if an action is brought in bankruptcy, see *infra* Part III, then the enterprise may be liquidated.

39. *Id.* Arts. 41, 42, 45.

40. *Id.* Art. 46; U.C.C. § 9-205.

41. RF Mortgage Act Art. 48.

42. *Id.* Art. 46(1).

43. *Id.*

44. *Id.* Art. 47.

45. *Id.* Art. 50-51.

contractual agreement may vary possessory rights; i.e., whether the property is pledged by physical conveyance to creditor or the debtor retains possession.<sup>46</sup> If the pledgor keeps possession, the mortgaged property must be kept under the pledgee's lock and seal, or the mortgagor must give the collateral "earmarks testifying to pledge."<sup>47</sup> Otherwise, when the pledgee has possession, it has the right to use the pledged object according to the terms of the pledge agreement.<sup>48</sup>

### 7. *Pledge of Rights*

The rules governing the pledge of rights hold great interest for a foreign investor seeking to finance debt by taking a security interest in accounts receivable or other intangible right. Unfortunately, security interests in rights are not addressed in detail. The Act states "[P]ledgor's rights of possession and use, including leaseholder's rights, other rights arising from obligations, and other property rights may be the object of pledge," which should include accounts receivable, options, and other rights.<sup>49</sup> Rights that have no present monetary value (e.g., patents, trademarks, copyrights, or the like) may be pledged at a value set by agreement.<sup>50</sup>

Legitimizing the giving and taking of security interests in rights is a major leap forward for the Russian economy. In this regard, the Mortgage Act now parallels the UCC by virtually eliminating limits on the scope of personal property that may be pledged. The freedom granted by the Mortgage Act to design a contractual relationship that accommodates the needs of modern business practice opens a window of opportunity which never existed before.

### B. *Attachment And The Rights And Duties Of Debtors And Creditors*

#### 1. *Drafting Requirements*

The Mortgage Act has higher drafting requirements than required under the UCC.<sup>51</sup> A contract for mortgage in Russia must be in writing,

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46. *Id.* Art. 49(2).

47. *Id.*

48. *Id.* Art. 51.

49. *Id.* Art. 54(1).

50. *Id.* Art. 54(3).

51. Compare RF Mortgage Act, Art. 10; U.C.C. § 9-203(1). For a security interest to become enforceable and attach, section 9-203(1) requires only that

(a) the collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement which con-

and "must recite the terms providing for type of mortgage, substance of the claim secured by mortgage, its amount, time period for performance of obligation, makeup and value of mortgaged property, and also any other terms on which agreement must be reached, as required by either party."<sup>52</sup> The mortgage contract may be included in the contract for the principal obligation.<sup>53</sup> If it is included in the contract for the principal obligation, then the contract for the principal obligation must conform to rules of the Mortgage Act.<sup>54</sup> The formal requirements of the mortgage contract are governed by the rules of the jurisdiction where it is consummated.<sup>55</sup> However, failure to comply with the particular statutory requirements of a jurisdiction outside of Russia cannot be claimed as a defense to excuse performance when the contract's form complies with Mortgage Act.<sup>56</sup> Hence, to be safe when taking a pledge of Russian property, the secured party should ensure that the mortgage contract complies with Russian law.

## 2. *Notarization*

Notarization in Russia is much different than in the United States. It is a quasi-judicial function that is far more complicated than an American notarization, and may take weeks to accomplish.<sup>57</sup> Under the Mortgage Act, whenever the obligation being secured is notarized,

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tains a description of the collateral and in addition, when the security interest covers crops growing or to be grown or timber to be cut, a description of the land concerned;

- (b) value has been given; and
- (c) the debtor has rights in the collateral.

*Id.* Note that the UCC requirements are for a valid security agreement to attach, not for the financing statement to perfect the security interest against other parties. *Cf.* U.C.C. §§ 9-302, 9-402.

52. RF Mortgage Act, Art. 10(1)-10(2).

53. *Id.* Art. 10(2).

54. *Id.* Art. 10(4).

55. *Id.* Art. 10(5).

56. *Id.* However, all mortgages of buildings, structures, enterprises, land parcels and other objects found on Russian territory, including railroad rolling stock, civilian air, sea and river vessels, and space objects must comply with Russian mortgage contract form, without regard to the requirements of any other jurisdiction. *Id.*

57. John N. Hazard, *Notaries Resume Private Practice*, 4 SURVEY OF EAST EUROPEAN LAW No. 5 (Parker School, Columbia University, June 1993) at 14. In 1993, the State partially privatized the notary function. (Law of Feb. 11, 1993, RF *Vedemosti* (1993) No. 10, item 357).

the mortgage contract must also be notarized.<sup>58</sup> This provision seems to mandate notarization for nearly all mortgages. Because of the requirement to certify by the same agency where the parties notarized their principal contract, it will often be necessary to certify mortgages in multiple locations, especially in the case of hypothecation of property associated with interests in land. Not only does this complicate attachment of the security interest, but multiple notarization also complicates the process of taking notice of prior security interests when deciding to extend credit.

### 3. *Mortgage Registration*

Under the Mortgage Act, state registration is required for all mortgages of corporations and other properties at the agency where the property is registered (e.g., land ownership, mineral and mining operations, etc.).<sup>59</sup> In cases where the mortgage must be registered, the contract will not be deemed concluded and the security interest will not attach until it is properly registered.<sup>60</sup> Failure to accomplish this may have disastrous consequences for the unwitting lender. First, failure to attach the security interest would probably result in the mortgagee being held to possess no rights against the mortgagor on a default. Second, failure to attach the security interest would probably result in the mortgagee holding no rights against third parties. Until the new court system and jurisprudence are entrenched, the wise lender should append to the mortgage contract copies of the rules and attaching and perfecting documents to prove Mortgage Act compliance and protect against misunderstanding and arbitrary judicial conduct.

On the surface, the requirement of registering mortgages of certain classes of property may not appear as confusing as the UCC's filing requirements, which vary by jurisdiction. However, the Mortgage Act does not give uniform direction as to where to register, which the UCC provides.<sup>61</sup> The lack of direction may cause confusion for the foreign

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58. RF Mortgage Act Art. 10(3).

59. *Id.* Art. 11. In these circumstances, where the mortgage contract must be registered pursuant to the property's registration, the security interest will not attach until the mortgage is registered. *Id.*

60. *Id.*

61. The Mortgage Act does not name the appropriate agencies where parties to a mortgage contract must register. This omission contrasts starkly with UCC in two major ways. First, it is not necessary for any registration to be made in order for the security interest to attach. U.C.C. § 9-203(1). Second, the UCC provides the lender, and thus third parties dealing with the debtor, with the proper place to file financing statements in order to perfect or take notice of a security interest. U.C.C. § 9-401.

lender who does not understand Russia's local governmental structure. As a result, the likelihood of improper registration is magnified, with potentially draconian consequences. For protection, the foreign lender must necessarily rely on a representative with sound "local knowledge" and good contacts in order to facilitate mortgage registration and attachment of its security interest.

The Mortgage Act provides that individuals "having an interest" may appeal a denial of registration or a wrongful registration of mortgage in a court in the jurisdiction of the registering agency.<sup>62</sup> The mortgagee, mortgagor, and "other interested persons" have the right to receive from the registering agency, upon request, a certificate and abstract of registration.<sup>63</sup> To protect against abuse by the state registering agency, the agency will be liable for damage caused by breach of the registration rules by its agents.<sup>64</sup> The registering agency also owes a duty to the debtor to register documents confirming either full or partial performance of the secured obligation.<sup>65</sup> There is no analog in the UCC for these provisions, but American lenders have legal protection through established recording systems, state laws on misfiling, and state funds that cover anticipated damages.<sup>66</sup>

#### 4. *Mortgagor's Rights*

The Mortgage Act provides the mortgagor the right of having the security interest insured by the mortgagee when the mortgaged property is in the mortgagee's possession, but allows the parties to opt out of this allocation of risk in the mortgage contract.<sup>67</sup> However, it places

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62. RF Mortgage Act Art. 13. This article is very vague. There is not a definition of parties "having an interest." Consequently, the number of parties who may have standing to challenge acts of the registering agency is quite broad and uncertain.

63. *Id.* Art. 14. However, the land use committee, notary, or other authorized agency is compelled to refuse registration of a mortgage contract where the parties do not demonstrate proof of payment of the state duty. *Id.* Art. 15. The comparable UCC section is U.C.C. § 9-407 ("Information From Filing Officer").

64. RF Mortgage Act Art. 16.

65. *Id.* Art. 17(2); *cf.* U.C.C. § 9-404.

66. U.C.C. § 9-407 is not concerned with the Filing Officer's duties owed to the *debtor* regarding its performance of the obligation, just the Officer's duties to the secured party and third parties.

67. *Id.* Art. 9(1). This provision corresponds to U.C.C. § 9-207.

responsibility on the Russian debtor to insure against its insolvency or acts of the government (*force majeure*) which may impair the security interest.<sup>68</sup>

The mortgagor has the right to demand that the mortgagee issue documents confirming partial and full performance of the secured obligation for entry into the state register where the mortgage is recorded.<sup>69</sup> The closest corresponding section in Article 9 is the "Request for Statement of Account or List of Collateral".<sup>70</sup> The strongest similarities between the provisions are the types of information that must be contained in the accounting or list, which includes the aggregate amount of the mortgagor's indebtedness and identification of the collateral (if applicable), and that the secured party must correct and return it to the debtor within a reasonable time.<sup>71</sup>

There are two major distinctions between the Russian and American accounting statements, however. Under the American provision, the debtor must not only request the information, but must initiate the process by submitting what it believes to be accurate information to the secured party, who must then correct it, or later be estopped from denying its accuracy.<sup>72</sup> Second, there is no obligation to file the accounting with an official agency, whereas the accounting addressed in the Mortgage Act is intended to be filed (registered).<sup>73</sup> As a consequence, the Mortgage Act appears to have a reverse filing requirement: it is filing on demand of the debtor, presumably to protect it against the secured party, rather than as a responsibility of the secured party to protect itself against third parties.

When the mortgagor retains possession of the collateral, it also retains the right to dispose of mortgaged property, unless otherwise agreed.<sup>74</sup> The closest analog in the UCC is section 9-205, which permits the debtor the right to dispose of the mortgaged property without accounting to the secured party.<sup>75</sup> However, the focus in section 9-205

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68. RF Mortgage Act Art. 9(2).

69. *Id.* Art. 17(1).

70. U.C.C. § 9-208.

71. *Id.*

72. *Id.* § 9-208(2). The secured party bears the risk of liability for inaccuracies not only to the debtor, but to third parties who are misled by his reply. *Id.*

73. RF Mortgage Act Art. 17(1).

74. *Id.* Arts. 37, 20.

75. U.C.C. § 9-205. U.C.C. § 9-205 is as follows:

A security interest is not invalid or fraudulent against creditors by reason

is on the validity of the security interest as to third parties when the debtor has the power to use or dispose of the collateral in the operation of its business, principally in cases where the security interest is in accounts receivable or inventory.<sup>76</sup> In contrast, the focus of the Mortgage Act appears to be on the debtor's right to sell mortgaged property to a third party who assumes the mortgage.<sup>77</sup>

Under the Mortgage Act, the mortgagor's exercise of its right to transfer the collateral does not extinguish the mortgagor's original obligation unless it is also transferred.<sup>78</sup> The mortgagor may subsequently mortgage the collateral, subject to the terms of the mortgage contract.<sup>79</sup> In any case, the original security interest in the collateral remains in force where there is a transfer by the mortgagor of the original obligation or debt to a third party.<sup>80</sup>

The mortgagor also has limited, but statutorily protected, rights in cases of foreclosure.<sup>81</sup> Where the mortgagor has performed its obligation prior to sale of the collateral in foreclosure, the mortgagor has the right of terminating the foreclosure.<sup>82</sup> The language is unclear as to whether this means a duty to perform the obligation completely, or just to bring it up to date. The lack of statutory clarity may create problems when there is contractual ambiguity, thereby emphasizing the need for thorough drafting. After foreclosure, the mortgagor has the right to any surplus proceeds received from the sale of the collateral.<sup>83</sup>

##### 5. *Mortgagee's rights*

The Mortgage Act states that mortgaged property may be substituted only with the consent of the mortgagee.<sup>84</sup> The mortgagee, on

of liberty in the debtor to use, commingle or dispose of all or part of the collateral (including returned or repossessed goods) or to collect or compromise accounts or chattel paper, or to accept the return of goods or make repossessions, or to use, commingle or dispose of proceeds, or by reason of the failure of the secured party to require the debtor to account for proceeds or replace collateral.

*Id.*

76. *Id.* § 9-205 Official Comments.

77. RF Mortgage Act Art. 20.

78. *Id.* Transfer of the original obligation to a third party must be consented to by secured party. *Id.*

79. *Id.* Art. 21.

80. *Id.* Art. 33.

81. Default rights are discussed in detail in Part II.D *infra*.

82. *Id.* Art. 31(1).

83. *Id.* Art. 30.

84. *Id.* Art. 8.



the other hand, has the right to sell or assign to third parties its interest in the pledged property without terminating the mortgage, thereby permitting trade in secured notes.<sup>85</sup>

In cases where the collateral remains in the mortgagor's possession, the mortgagee has the right of having it insured "to its full value" by the mortgagor.<sup>86</sup> The mortgagee is also entitled to have the collateral preserved and maintained while in the debtor's possession.<sup>87</sup> In addition, the mortgagee is entitled to verification of the condition and value of the collateral, notice of leases of the collateral, and replacement of it when there is accidental loss of the collateral.<sup>88</sup> Failure of the mortgagor to honor these rights may result in the mortgagee acquiring the right to accelerate performance of the secured obligation.<sup>89</sup>

As to a pledge of intangible rights, the mortgagee has additional rights under the Mortgage Act. Unless modified by contract, the mortgagee holding a security interest in intangible rights is entitled to have the debtor protect its interest by the statutory requirement (1) to perform required acts to secure the right, (2) not to assign the pledged right, (3) not to do any act that will reduce the value or terminate the pledged right, (4) to protect the right against infringement by third persons, and (5) to give the secured party notice of alterations, infringement by third persons, or claims against the pledged right.<sup>90</sup> If the mortgagor of intangible rights fails to perform these duties, then the mortgagee has the right (1) to claim transfer of the pledged right to himself, irrespective of the maturity of the secured obligation, (2) to intervene in any lawsuit in which the pledged right is in issue, and (3) to take independent action to protect the pledged right against infringement by third parties.<sup>91</sup>

## 6. *Proceeds*

When the debtor has performed its obligation prior to the maturity of the obligation, the proceeds received in satisfaction become the object

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85. *Id.* Art. 32, 33.

86. *Id.* Art. 38(1).

87. *Id.* Art. 38(2).

88. *Id.* Arts. 36, 38.

89. *Id.* Arts 36, 39. However, the failure to give the mortgagee notice of a lease of the collateral (Art. 38(3)) is an exception to the rule, and will not result in the mortgagee acquiring the right to accelerate performance of the mortgage obligation. *Id.* Art. 39.

90. *Id.* Art. 56.

91. *Id.* Art. 57.

of pledge and notice of receipt must be given to the mortgagee without delay.<sup>92</sup> Proceeds received “by way of redemption (of the collateral)” require the mortgagor to remit to the creditor on demand.<sup>93</sup> This seems to parallel the UCC Rule that a specific reference in the security agreement to proceeds from the sale of the collateral is not necessary for the security interest to attach.<sup>94</sup> However, it is not the same.

Under the UCC, the substitution of proceeds for the original security interest is a baseline rule, but under the Mortgage Act the mortgagor owes affirmative duties to the mortgagee upon the receipt of proceeds. These duties may effectively convert proceeds received to a pledge of personalty. If this is an accurate interpretation, then the debtor may bear the burden of keeping the proceeds in escrow until disposition is directed by the creditor. Such conduct may be mandatory insofar as it would comport with the pledgor’s statutory duty “to preserve and maintain” the security interest and “to take measures required for protection of pledged right against infringement by third persons.”<sup>95</sup>

Furthermore, the word “required” is not defined with specificity in the Mortgage Act.<sup>96</sup> “Required” could be interpreted to impose a statutory duty on the pledgor, or it could mean “required by the terms of the contract.” Hence, it is necessary to explicitly stipulate in contract the pledgor’s duties to notify and remit in order to avoid disputes.

The contractual requirements place a very high burden on the lender to ensure attachment of a security interest in proceeds. Although substitution of the mortgaged property is permissible only with the consent of the mortgagee, substitution procedure mandates that the object of substitution be described in detail.<sup>97</sup> It may be wise, when taking a security interest in property or rights likely to be converted

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92. *Id.* Art. 58(1).

93. *Id.* Art. 58(2).

94. U.C.C. § 9-203(3).

95. RF Mortgage Act Arts. 38(2), 56(4). It is important to note the language requiring immediate notification to the pledgee of the receipt of proceeds. *Id.* Art. 58(1). It appears as though notification of the mortgagee is mandatory (“shall”) because there is no opt-out language, whereas Article 58(2) is less forceful in its language as to remittance of proceeds (“unless contract of pledge provides otherwise”). The lack of clarity underscores the Mortgage Act’s weakness by not providing key gap-filling provisions to allocate risks in the event contract drafting fails.

96. *Id.* Art. 58(1)-58(2).

97. *Id.* Art. 47. This article specifies what must be defined in the contract: “type and other generic features of mortgaged goods, total value of object of object place where it is located, and also the types of goods which could be substituted for object of mortgage.” *Id.*

into proceeds, to specify in contract the currency and rate of exchange of the anticipated proceeds as a matter of course. An extremely weighty burden is on the lender's shoulders if such specificity is necessary for a security interest to attach. While there may be a hint of statutory protection for the mortgagee in some Mortgage Act language,<sup>98</sup> the only safe conclusion is that all risk of non-attachment is borne by the lender.

### C. *Priority and Perfection of Security Interests*

#### 1. *Creditor priority*

Priority of lien in the Mortgage Act apparently is established by first-in-time.<sup>99</sup> This is simpler than the regime established in the UCC, although the core doctrines are the same.<sup>100</sup> The principal difference is that the Russian Act focuses on the time of attachment, whereas the UCC determines priority by the time of perfection.

"Priority satisfaction" is granted to the secured party from insurance compensation paid on claims for damage to the mortgaged property.<sup>101</sup> Second and subsequent mortgages shall be satisfied from the remaining value in pledged property after the first mortgage is satisfied.<sup>102</sup> All such "junior" mortgagees have the right to receive notice from the mortgagor of any existing liens and the value of the obligations secured.<sup>103</sup> The mortgagor must indemnify junior mortgagees for injuries resulting from the mortgagor's failure to perform these duties.<sup>104</sup>

#### 2. *Perfection, Generally*

The difference in focus between American secured transaction law and the new Russian law reveals itself in many ways. Perhaps the most

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98. *See id.* Art. 46(1).

99. RF Mortgage Act Art. 22.

100. U.C.C. §§ 9-312. Specifically, § 9-312(5) codifies the first-in-time rule, but there are many other influencing factors. These are not included in the Russian rule.

101. RF Mortgage Act Art. 9(3). *Cf.* U.C.C. § 9-306(1). The UCC treats insurance monies as ordinary proceeds, "except to the extent that it is payable to a person other than a party to the security agreement." *Id.* Because of the parties' duty to insure the collateral, depending on who possesses it (RF Mortgage Act, Arts. 9, 38), the likelihood of some other party being the beneficiary of the insurance proceeds should be extremely low and the security interest would probably attach to the proceeds.

102. RF Mortgage Act Art. 22(1).

103. *Id.* Art. 22(2).

104. *Id.*

glaring shortfall of the Mortgage Act is its scant provision for perfection of security interests.<sup>105</sup> Both laws address the secured party's rights *vis a vis* the debtor, but American law is directed toward the parties' rights in relation to third parties who may impair the security interest. As a result, Article 9 specifies the steps that both the secured party and the debtor must take to perfect and protect the security interest. Article 9 also provides procedural structure for cases where remedial action is needed after secured rights are triggered. In contrast, the Mortgage Act provides fundamental debtor-creditor rights, but is distinguished by the fact that fundamental rights are all it provides.

### 3. Notice

The Mortgage Act devotes little attention to protecting the mortgagor's rights against third party claims over the collateral. In contrast, the UCC "primarily sets out rules defining rights of a secured party against persons dealing with the debtor."<sup>106</sup> Whereas the UCC is built on a solid foundation of state agencies and recording procedures, the Mortgage Act has no such foundation and thus lacks firm guidelines for communicating the existence of secured rights to third parties.<sup>107</sup> Even though the Act requires registration of some types of mortgage,<sup>108</sup> registration affects attachment. Instead, the Mortgage Act takes a general approach that relies on the parties to record alterations and notify potential buyers via a mortgage book.<sup>109</sup>

It is impossible to physically convey intangible rights or give them earmarks of ownership, so, in the absence of a recording system to give third parties notice of existing security interests, it appears as though the mortgagee necessarily foregoes this important purpose of perfection. By not providing the lender with guidelines for notifying and perfecting its security interest against third parties, the Mortgage

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105. This is the view held by most commentators who have addressed the Act. See Osakwe, *supra* note 8; see also Frenkel, *supra* note 8, at 1.

106. U.C.C. § 9-102.

107. The UCC provides detailed guidelines for perfecting security interests when the goods are consumer goods, fixtures, accounts, farm equipment, investment securities, pledge, or proceeds. U.C.C. §§ 9-302—9-306.

108. RF Mortgage Act Art. 17. The Russian law makes no provision for registering a formal financing statement as a means of perfecting a security interest, only to attach it. However, the mortgage contract itself may be used at registration or notarization as a form of financing statement and thus serve the purpose of notifying third parties of the existing security interest.

109. *Id.* Art. 18.

Act requires the lender to rely on the debtor. This places a heavy burden on the lending party to monitor the mortgagor's performance, especially when the security interest is in intangible rights.

#### 4. *The Mortgage Book*

The mortgagor must protect the mortgagee, and any potential subsequent mortgagees, by keeping a book of mortgage records.<sup>110</sup> The mortgage book is the only device named in the Act which serves as a universal perfecting device. It is intended to protect both the mortgagee and third parties dealing with the mortgagor by giving notice of prior interests in the subject property, and it must be available for inspection by any interested person.<sup>111</sup> The mortgagor is required under the Act to update the book within ten days of all new obligations secured by mortgage.<sup>112</sup>

The duty to keep a book of mortgage records is unclear in the Mortgage Act. There is no description of the actual mortgage book in the Act, including the important questions of whether the book is issued officially by the government, must conform to certain specifications, or where it must be kept. Nor does the Act specify if an enterprise must keep only one mortgage book, in which all secured obligations are recorded, or whether a book must be kept for each mortgage individually. These omissions are problematic because the law trusts the debtor to insure the accuracy and maintenance of the book's recordation.<sup>113</sup> Despite the mortgagor's statutory liability for maintaining both the availability of the mortgage book and the accuracy and timeliness of its entries, the opportunity for forgery, fraud, or accidental loss creates a tremendous, unnecessary risk that could be avoided if there existed a neutral, central recording system.

Furthermore, in the case of the pledge of rights, it is even more important that the mortgagor maintain a detailed, up-to-date mortgage book. The issues raised are more acute because intangible property cannot be marked to give third parties notice, and even the most diligent monitoring still relies on the debtor's trustworthiness. Consid-

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110. *Id.*

111. *Id.* Art. 18(1).

112. *Id.* This provision applies to legal persons and natural persons registered as businesses. The information that must be entered into the book of mortgage records includes the type and object of the mortgage, and the extent to which the obligation is secured by the mortgage. *Id.*

113. *Id.* Art. 18(2).

ering the opportunity for a debtor's fraud or negligence, or, in contrast, whether a mortgagee's inspection is an unwarranted intervention, the mortgage book is likely to be the focal point of much dispute.

Ultimately, reliance on the mortgage book places too much responsibility on the debtor to police itself and protect the security interest of the lender. The Mortgage Act is too new and complex to be implemented without growing pains. For the foreign lender who has the resources to monitor the debtor and thus protect its security interest, the use of a mortgage book to perfect its security interest may not be an unsurmountable hurdle. For many other investors, though, reliance on the debtor to monitor itself through the book may be too great a leap of faith.

#### *D. Default Rights of the Creditor and Debtor*

##### *1. Triggering Default Rights*

Mortgage rights are derivative of the non-performance of the secured obligation.<sup>114</sup> If the secured obligation is satisfied, then the mortgage is terminated and rights will not be triggered. A mortgage terminates in five enumerated circumstances: (1) termination of the secured obligation, (2) destruction of the mortgaged property, (3) expiration of the right in cases where the secured interest is a right, (4) transfer of right in the security interest to the mortgagee, and (5) other cases specified by law.<sup>115</sup> The named circumstances are types that ordinarily are defined in an American security agreement. Thus, the Mortgage Act is not substantively different from American secured transaction practice in this respect.

There are probably two reasons for listing terminating conditions in the Mortgage Act. The first is that this type of detail is typical of European civil codes, and thus a carryover from earlier Russian and Soviet Civil Codes. Second, due to Russian inexperience in secured transactions, the Mortgage Act must necessarily provide vocabulary and rules to aid the debtor and creditor in both the formation and termination of a secured obligation contract.

##### *2. Remedial Rights*

The Mortgage Act appears to provide a vastly different bundle of remedial rights than American law. The UCC provides secured parties

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114. *Id.* Arts. 23, 24. This is essentially the same rule as U.C.C. § 9-501(1).

115. RF Mortgage Act Art. 34.

with a wide array of legal tools,<sup>116</sup> including rights to judicial remedy, self-help, and simultaneous actions in multiple fora. Under the Mortgage Act, however, remedies are more limited.

In event of default on a mortgage of intangible rights, the mortgagee has the right in an Arbitration Court to claim transfer of the pledged right when the debtor has failed to perform its statutory duties.<sup>117</sup> The secured party may intervene in lawsuits concerning the pledged right, and may also take independent action to protect the pledged right against infringement by third persons when the debtor has failed to perform its duty.<sup>118</sup> These are default rights the secured party may opt to waive its rights in the security agreement.<sup>119</sup>

The mortgagee has the right to complete satisfaction of the secured obligation out of the collateral.<sup>120</sup> Partial performance of an obligation will not partially extinguish the obligation without an agreement to that effect.<sup>121</sup> In cases where the secured interest is in several things or rights, the mortgagee retains the right to seek satisfaction out of either the entirety of collateral or the particular components thereof.<sup>122</sup> In choosing the latter course, the mortgagee does not waive its interest in the remaining property.<sup>123</sup>

A right analogous to the common law doctrine of subrogation is provided in circumstances where a third party satisfies the obligation.<sup>124</sup> In such a case, the mortgagee's security interest and his right of claim transfer to the third party.<sup>125</sup>

### 3. *Self-help*

The Mortgage Act prohibits self-help remedies for defaults on an hypothecation, but is silent regarding pledges. Under true title theory,

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116. U.C.C. §§ 9-501—9-505.

117. RF Mortgage Act Art. 57.

118. *Id.*

119. *Id.*

120. *Id.* Art. 23. This right is determined by the "time of actual satisfaction, including interest, losses caused by delayed performance, and penalty, in the cases specified by statute or contract; [and] necessary costs in maintenance of mortgaged property and costs incidental to satisfaction of mortgage-secured claim shall also be subject to indemnification." *Id.*

121. *Id.* Art. 25.

122. *Id.* Art. 26. Like most rights granted in the Mortgage Act, this right can also be modified by contract.

123. *Id.*

124. *Id.* Art. 27.

125. *Id.*

self-help (e.g., the sale of the pledged object) would be permissible on the ground that title passed to the pledgee on the pledgor's giving a security interest. However, in light of the pervasive governmental control of property during the Soviet Era, the seizure and sale of assets may be considered as virtually criminal acts when the pledged object is valuable. As a result, it is unclear whether seizure of certain assets will be distinguished from others, or whether the act of seizure would be distinguished from other self-help remedies under Russian law.

#### 4. *Secured Party's Right to Managerial Intervention*

Nowhere in the UCC is there language permitting managerial takeover of a defaulting debtor.<sup>126</sup> The Mortgage Act's provision of this right opens the door to many problematic issues with respect to lender liability. If a mortgagee exercised its right to intervene in the management of the debtor-enterprise and then failed to satisfy the principal obligation (or at least make it current), it is conceivable that it might be estopped from exercising its statutory rights to attach other property or seek a judicial solution. The debtor's theory would essentially assert that the mortgagee's assumption of control equates to a voluntary assumption of risk. As a result, the mortgagee may be held to have waived other rights by exercising this one.

The secured party's remedial rights when lending to an enterprise and taking a security interest in enterprise property are unclear under the Russian law, especially with regard to this novel remedy. The lack of clarity is one of the Mortgage Act's most glaring weaknesses because it effectively raises the cost, and thus slows, foreign lending to Russian enterprises. In addition, the risk potentially imposed on the secured party by intervention in the management of the debtor-enterprise may vitiate the protection it offers.

#### 5. *Foreclosure*

Russian law, like Anglo-American law, views foreclosure as the extinguishment of the mortgagor's rights to possession or ownership of the collateral. Foreclosure may be declared by a court of law, arbitration court, or mediation court, unless otherwise provided by law.<sup>127</sup> The

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126. It is not contended that parties to a secured transaction in the United States could not contract for management intervention—they could. However, management intervention would then be triggered by the occurrence of a condition, and not a statutory remedy.

127. *Id.* Art. 28(1). This clause adds that some foreclosures "shall be made in



right to foreclose vests once the agreed date for "redemption of the mortgage-secured obligation" is reached.<sup>128</sup> This is somewhat different from Article 9, which states that the secured party's rights are cumulative.<sup>129</sup> In this context, "cumulative" means that the secured party has the right to exercise any recognized remedy when the debtor defaults, which includes pursuing alternate remedies simultaneously. The Mortgage Act, however, takes a more "linear" approach that seeks to ensure that the defaulting debtor will not be dispossessed of his property until all other legal avenues are exhausted. Under Russian law, the rights of the mortgagor in the mortgaged property are jealously guarded.

In cases where the proceeds from the sale of pledged property are insufficient to satisfy the mortgagee's claims, the mortgagee shall have the right to attach other property of the debtor.<sup>130</sup> If the opposite should occur, and a sale of the collateral brings more value than necessary to satisfy the obligation, the mortgagor is entitled to the excess.<sup>131</sup>

#### 6. *Mortgagor's Redemptive Rights*

The Mortgage Act provides a right of redemption, mandating that the debtor may at any time perform the obligation and terminate the foreclosure.<sup>132</sup> However, this is not the same right expressed in U.C.C. § 9-506, where the debtor is provided a redemptive right to extinguish in full (accelerate) the secured obligation and to pay any expenses incurred by the lender.<sup>133</sup> The right of redemption also extends to

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no-recourse procedure, on the basis of notarized execution clauses." *Id.* Presumably, this applies to pledges where the mortgaged property is in the possession of the mortgagee already, and the notarization clause acts as a quitclaim of the mortgagor's interest in the collateral.

128. *Id.* Art. 24.

129. U.C.C. § 9-501(1).

130. RF Mortgage Act Art. 29. This right may be waived in contract and is subject to statutory limitation. It seems unusual that this article does not mention auction or foreclosure. The inference should follow that the broad language was intended to cut a wide swath, vesting the secured party with remedial rights even in cases where the collateral is sold without judicial intervention.

131. *Id.* Art. 30. *Cf.* U.C.C. § 9-504 ("Secured Party's Right to Dispose of Collateral After Default; Effect of Disposition").

132. RF Mortgage Act Art. 31(1). Under the Mortgage Act, the date for redemption may be affected by other Russian Federation statutes. *Id.* Art. 24. *See also id.* Art. 41 (providing statutory deference to Russian land laws).

133. U.C.C. § 9-506 reads as follows:

At any time before the secured party has disposed of collateral or entered

agreements where the obligation is performed in installments by allowing the defaulting mortgagor to bring the obligation up to date and terminate the foreclosure.<sup>134</sup> No such right exists under the UCC, lest the debtor have no motive to pay on time.

It is possible for the contracting parties to opt out of some Russian foreclosure procedures.<sup>135</sup> However, the Mortgage Act forbids contractually opting out of (1) the mortgagor's statutory rights to redeem the mortgaged property prior to the completion of foreclosure or (2) the mortgagor's right to make current its performance when performance is due in installments.<sup>136</sup> The Act states that any agreement restricting the mortgagor's redemptive rights is void.<sup>137</sup> This conflicts with the article allowing the parties to opt out of Russian foreclosure procedures, at least insofar as absence of such procedures restricts the mortgagee's redemptive rights. Effectively, then, the power to opt out of foreclosure procedures may be illusory.

### 7. *Judicial Enforceability*

The ultimate remedial issue is the judicial enforceability of the secured obligation. The legal devices of mortgage, foreclosure, and bankruptcy are newly created. There is very little published material available in translation pertaining to the application of these laws. Whether the Arbitration Courts<sup>138</sup> will follow a common or civil law model in deciding commercial cases is not clear.

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into a contract for its disposition under Section 9-504 or before the obligation has been discharged under Section 9-505(2) the debtor or any other secured party may unless otherwise agreed in writing after default redeem the collateral by tendering fulfillment of *all obligations* secured by the collateral *as well as the expenses reasonably incurred* by the secured party in retaking, holding and preparing the collateral for disposition, in arranging for the sale, and to the extent provided in the agreement and not prohibited by law, his reasonable attorney's fees and legal expenses.

*Id.* (emphasis added).

134. RF Mortgage Act Art. 31(2).

135. *Id.* Art. 28(2).

136. *Id.* Art. 31(3).

137. *Id.*

138. A brief explication of the changing Russian legal system may be helpful to the American investor lending to a Russian enterprise. Prior to the passage of the new constitution, plans were made to draft 2000 new judges for the Arbitration Courts, but it is not clear whether these were implemented. Carey Goldberg, *As legal System Blossoms, Russians Belly Up to the Bar; Law: After Decades of a Totalitarian System, Fledgling Attorneys are Capitalizing on Confusing New Statutes*, L.A. TIMES, Jan. 10, 1993, at A1.

Under the new Constitution, economic disputes are settled in the Arbitration

It is important to note that much of the Mortgage Act's language tracks the Code of Civil Procedure closely. Although an oversimplification, generally, civil law judges are not bound by precedent. In contrast, Anglo-American businesspeople rely on Common Law precedents to give certainty to their business decisions. The Common Law provides certainty because precedents give contracting parties notice of their rights and duties under the law. In Russia, uncertainty is magnified because many judges are not experienced at making commercial law decisions.<sup>139</sup> Additionally, the law may still be in the hands of conservative judges, so the Mortgage Act's progressiveness cannot be assumed. Until the Act is interpreted and applied uniformly, the uncertainty with which it is cloaked will constitute a significant impediment to American investment in the Russian economy. To be safe, before a Russian commercial jurisprudence is developed, foreign lenders probably should stipulate a law and forum other than Russia to govern their contract.

#### *E. Brief Conclusion On the Russian Mortgage Act*

There are many distinctions between the Mortgage Act and the UCC. The most important point to remember, though, is that the Russian law was enacted to facilitate the flow of capital into the economy by providing legal rights legitimizing the debtor-creditor relationship. As a result, the Mortgage Act recognizes the devices of hypothecation and pledge as legal means of creating enforceable secured transactions.

The Mortgage Act's generalized treatment of many complex transactions imposes a heavier burden on the contracting parties than if they could rely on gap-filling default rules in a Common Law codification, such as the UCC. The net result is that the responsibility of creating an enforceable agreement is squarely on the shoulders of the creditor. Contract formation requires intense specificity to provide what the law does not, and it must remove any vestiges of doubt regarding the contract's meaning.

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Courts. KONSTITUTSIYA RF Chap. 7, Art. 127 (1993). The Superior Court of Arbitration is the highest Arbitration Court. *Id.* at Chap.3, Art. 71(n). A literal reading of this subsection mandates that the entire judicial system is federal, although the power to appoint judges is the joint jurisdiction of the Russian Federation and the local "components of the Russian Federation." *Id.* at Chap. 3, Art 72(k). However, the Constitution is not specific about the organization of lower Arbitration Courts. Whether every jurisdiction will have an Arbitration Court is a decision left to the new legislature.

139. Many Russians complain that their judges have a highly formalistic view of law, implementing it stiffly, rather than in its spirit. VALENTIN STEPANKOV, PUBLIC PROSECUTOR OF THE RUSSIAN FEDERATION, INTERVIEW DURING OFFICIAL KREMLIN INTERNATIONAL NEWS BROADCAST, February 11, 1993 (Federal Information Systems Corp.), available in LEXIS, News library, Omni File.

### III. RUSSIAN BANKRUPTCY LAW

#### A. *Background*

The introduction of free market reforms in the former Soviet Union created a need for new laws, the kinds of which the Russian people had never known. Although the vital role of bankruptcy law in a market economy is not necessary for discussion here, an overview of the first Russian bankruptcy law is important for the foreign lender to see the whole picture of secured transaction law.

Russian enterprises are emerging from a history of governmental monopoly and subsidy. State banks routinely issued new credits to cover old debts. Repeated issuance of new credits created many problems for Russia's economy. Among these are hyper-inflation, inefficiency, poor product quality, and corruption. To promote economic growth, many old and inefficient State-run enterprises must close or reorganize under new management rather than sustained on the life support of government credits. The Supreme Soviet, which had staunchly resisted letting State institutions collapse, finally relented and passed the Law on Bankruptcy in late 1992.<sup>140</sup>

#### B. *Security Interests and the Bankruptcy Estate*

Secured obligations enjoy special protection under the Bankruptcy Law. Secured parties are assured priority at bankruptcy because the Bankruptcy Law mandates that the bankruptcy estate, named the "competitive mass," excludes property subject to a lien.<sup>141</sup> The competitive mass does not include property over which the debtor is not an owner with complete disposal rights.<sup>142</sup> Therefore, the competitive mass should exclude hypothecated property because the mortgagor has less than full disposal power of encumbered property. It should follow that pledged property also cannot be attached under this definition as well.

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140. RF Law on Insolvency (Bankruptcy) of Enterprises, Supreme Soviet, Nov. 19, 1992, VSND&VS RF No. 1 (1993), item 6; ROSS. GAZETA, Dec. 30, 1992; RF Decree on Implementation of the Law on Bankruptcy, Supreme Soviet, Nov. 19, 1992, No. 3930-1, ROSS. GAZETA, Dec. 30, 1992.

It is important to note that, as the title suggests, this law only applies to enterprises. Personal bankruptcies are not yet available in Russia, and it is unknown what preference, if any, would be given to secured lenders in that situation.

141. *Id.* Art. 26(4). The definition of "competitive mass" is not found within an article of the Law, but in a definitional section preceding Article 1.

142. *Id.* Art. 26(5).

The Bankruptcy Law further states that the debtor's obligations secured by liens will be repaid from the debtor's property outside the "competitive proceedings."<sup>143</sup> The rule that appears to result is that competitive creditors<sup>144</sup> cannot reach mortgaged property to satisfy their unsecured claims. This is different than American bankruptcy jurisprudence, which permits the seizure and sale of mortgaged property so that general creditors can seek satisfaction from a bankruptcy estate that includes the debtor's equity.<sup>145</sup> As a consequence, under the Russian Bankruptcy Law, secured creditors may be unaffected by a mortgagor's bankruptcy.

Many potential problems exist for secured parties when their mortgagor is in bankruptcy, however. It is unlikely that a mortgagor's bankruptcy would leave its mortgagee uninjured, especially if the debtor-enterprise is liquidated. First, after liquidation an enterprise would no longer exist to generate cash to pay the secured obligation. Second, in the case that the mortgaged property is an intangible right, e.g., accounts receivable, the mortgagee's problem is magnified because there will not be hard assets remaining to attach or seize if the proceeds are insufficient. Thus, if the right is no longer worth enough to satisfy the obligation, or the cost of collection is prohibitive, the loss could pass to the secured lender without recourse.

### C. *Creditor Priority at Bankruptcy*

The Bankruptcy Law is not as detailed as the United States Bankruptcy Code when outlining creditor priority, but additional detail probably is not necessary at this early point in its jurisprudential development.<sup>146</sup> First-in-line at the bankruptcy window are tort victims: "citizens to whom the debtor is responsible for causing harm to their life and health."<sup>147</sup> Next are workers' wages, pension funds, and "au-

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143. *Id.* Art. 29. "Competitive proceedings" are defined as "a procedure aimed at compulsory or voluntary liquidation of an insolvent enterprise, as a result of which the competitive mass is distributed among the creditors." *Id.* at definitions (*hereinafter* "competition").

144. "Competitive creditor" is the name given to general creditor under the Bankruptcy Law, and is defined as "a natural person of legal entity with property claims against the debtor who does not have a lien." *Id.* at definitions.

145. 11 U.S.C. § 541(a)(1). "Such estate is comprised of all the following property, wherever located and by whomever held: (1) . . . all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case." *Id.*

146. 11 U.S.C. § 507.

147. RF Bankruptcy Law Art. 30(2).

thorial and licensing obligations.”<sup>148</sup> Third are on-budget and non-budget “obligatory payments,” the language of which appears to indicate that the obligatory payment is directed toward the government.<sup>149</sup> Competitive (ordinary) creditors are fourth on the list and not privileged.<sup>150</sup>

If a foreclosure proceeding does not satisfy a secured obligation, it is conceivable that a secured party holding a judgment may become an ordinary creditor, and thus join the competition for its share of the mass. The Bankruptcy Law is silent on this point. It declares only the three types of creditors to be privileged, and does not mention judgment creditor in the list of privileged creditors. If the judgment is held to put a lien on property of the debtor, then the lien should be held to be a claim outside the competition, as though it were an hypothecation. However, there is no rule stating that this would happen.

If a money judgment does not put a lien on the debtor’s property, however, then it is arguable that a judgment based on a secured obligation should still enjoy privilege over competitive claims. The basis for this argument is that a court-rendered judgment is given by a body of the government in the administration of its governmental duty. Public policy should dictate that the court’s judgment for satisfaction of a secured claim is a privileged, obligatory payment on the grounds that the Bankruptcy Law recognizes the sanctity of the mortgage contract as a matter of law by protecting mortgaged property from the bankruptcy competition. In addition, failure to provide secured lenders preferential treatment at this point would discourage lending to Russian enterprises by depriving lenders of the knowledge that their security interest in the collateral is still protected even though the debtor is bankrupt.

#### *D. Automatic Stay*

One of the most important features of American bankruptcy law is the automatic stay of legal proceedings against either the debtor or property of the bankruptcy estate.<sup>151</sup> The automatic stay protects the creditors from judgments in collateral proceedings which could impair the fair distribution of the estate property, and it protects the debtor

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148. *Id.*

149. *Id.*

150. *Id.*

151. 11 U.S.C. § 362.

from multiple litigation. There is no provision in the Russian Bankruptcy Law that provides an equivalent level of protection for any of the parties.

In cases where the debtor-enterprise is to be liquidated, the Russian law states:

From the time the debtor is declared insolvent (bankrupt) and a decision is made to initiate competitive proceedings:

it is prohibited to transfer or otherwise alienate the property of the debtor (except in cases when the decision for alienation is given by the meeting of the creditors)... .

From that time on all property claims may be submitted to the debtor only within the framework of the competitive proceedings.<sup>152</sup>

The last sentence of this rule may be interpreted to mean that once a debtor-enterprise is declared bankrupt, initiation of other claims against it must be in the competitive proceedings only, or else they are void. If this true, then there is a sort of stay attaching at the point of insolvency.

However, this interpretation does not answer the question regarding the status of claims initiated earlier, but not yet decided. Perhaps if a creditor initiates a separate legal proceeding to “conceal” or shield certain property from the competitive mass in anticipation of the debtor’s bankruptcy, it may violate the Bankruptcy Law.<sup>153</sup> Not only may its claim then be stayed from adjudication, but the creditor may also be liable under other Russian laws.<sup>154</sup> If the creditor who made the prior claim was not acting fraudulently, then the claim should be submitted to the competition and the prior litigation dropped, effectively “staying” the prior litigation. Nevertheless, whether there is an effective “stay” in Russian Bankruptcy jurisprudence is unclear at this point in time.

### *E. Initiation of Bankruptcy Proceedings*

It is conceivable that a secured party could wind up in the position of general creditor if foreclosure proceedings do not satisfy the mortgage obligation and the balance of the debtor-enterprise’s property is in the competitive mass. Hence, it is important to understand the procedure for initiating bankruptcy proceedings. There are two ways that a bank-

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152. RF Bankruptcy Law Art. 18.

153. *Id.* Art. 47.

154. *Id.* Art. 48.

ruptcy will come to exist: (1) by a decree of insolvency by an arbitration court, if an involuntary bankruptcy action, or (2) by the official declaration of the debtor, if voluntary.<sup>155</sup> Bankruptcy cases are heard in essentially two fora: the Supreme Arbitration Court of the Russian Federation or the local Arbitration Court where the founding documents of the enterprise are located.<sup>156</sup> All bankruptcy cases are heard by a panel of three judges.<sup>157</sup> The sum of the claims presented to the arbitration court must exceed 500 times the Russian minimum wage for the court to hear the case.<sup>158</sup>

Bankruptcy proceedings may be instituted by three parties, each under different circumstances: the debtor, creditor, and the procurator (Russia's "attorney general").<sup>159</sup> Under the Bankruptcy Law, secured parties are not general creditors.<sup>160</sup> Facts giving rise to a perceived bankruptcy are, first, nonpayment of public or private obligations for three months and, second, the enterprise does not provide for, or is incapable of, meeting the demands of creditors.<sup>161</sup> For creditors to initiate bankruptcy proceedings, the debtor must have refused to pay its obligations without excuse (either by law or agreement) for more than three months.<sup>162</sup>

155. *Id.* Art. 1.

156. *Id.* Art. 3(1). The local arbitration courts recognized are those of the jurisdiction where the enterprise was formed.

157. *Id.* Art. 9.

158. *Id.* Art. 3(3).

159. *Id.* Arts. 4-8. The debtor may institute proceedings when application is made by either the owner of the enterprise or its authorized agents thereof. The debtor may apply for bankruptcy protection if it anticipates insolvency, but its application is irrevocable. *Id.* Arts. 5(2), 5(6).

The procurator may apply for bankruptcy proceedings to be taken against an enterprise it suspects of deliberate or fraudulent bankruptcy. *Id.* Art. 7(1). The procurator's application is revocable up to the time that the arbitration court begins proceedings. *Id.* Art. 7(2).

160. *Id.* at Definitions. "Competitive creditor - a natural person or legal entity with property claims against the debtor who does not have a lien." *Id.*

161. *Id.*

162. The creditor must send, via certified mail, (1) a notice to the debtor of its intention to apply to the Arbitration Court for institution of bankruptcy proceedings and (2) a demand for fulfillment of the obligation within one week of receipt of the notice. *Id.* Art. 6(1). After receiving confirmation of delivery of the notice and demand, but not before the deadline specified therein, the creditor may apply to the Arbitration Court to begin the bankruptcy proceedings. *Id.* The application may also contain a petition for institution of receivership. Requirements for properly completing the application to the arbitration court are in Article 6(2). These include appendices confirming claims against the debtor that were not certified during the three month "grace period",



### F. *Reorganization and Bailout*

If the debtor seeks reorganization under an outside administrator, it must petition the arbitration court in conjunction with a creditor, and the petition must contain (1) justification for the need and expediency of reorganization and (2) nomination of a suggested administrator.<sup>163</sup> An arrangement (bailout) may be sought by the debtor, owner of the debtor, or the creditor of the enterprise.<sup>164</sup> Unlike reorganization, an arrangement does not require agreement between both creditor and debtor.<sup>165</sup> Parties given preferential rights to participate in an arrangement are the owner of the enterprise, the creditors, and the members of the work collective.<sup>166</sup> Foreign legal persons may also participate in an arrangement.<sup>167</sup> Both reorganization and arrangement have 18 month periods to return the bankrupt enterprise to solvency.<sup>168</sup>

### G. *Brief Conclusion on the Russian Bankruptcy Law*

There are many more details in the Bankruptcy Law, but their explication here is not necessary. It is sufficient to say that even though the Law is incomplete by American standards, it is a good first step at creating a legal structure for an important legal, economic, and social issue. Though there are few bankruptcy cases in the Arbitration

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certification of delivery of the notice to the debtor, and certification of sending copies of the application and appendices to the debtor. The creditor may withdraw its application at any time prior to the arbitration court's commencement of proceedings. *Id.* Art. 6(4).

163. *Id.* Art. 12(1). The debtor and creditor have until a decision is issued by the Arbitration Court to petition for outside reorganization. Justification for reorganization is defined as the "existence of a real possibility of restoring the solvency of the debtor enterprise in order for it to continue its activity by selling some of its property or conducting other organizational and economic measures." *Id.* 12(2). The administrator to be suggested to the Court must be either an "economist or jurist" *Id.* 12(4). The finer points of reorganization are found in the balance of Article 12.

164. *Id.* Art. 13(1).

165. *Id.* Art. 13, para. 1, 2. The time for petitioning for arrangement extends up to the point where a decision is issued by the Arbitration Court. The petition for arrangement is not very different than the petition for reorganization in that it must show justification for the arrangement on the basis of "real possibility of restoring the solvency of the debtor enterprise for continuing its activity" and a nominate list of consenting participants.

166. *Id.*

167. *Id.* Art. 13, para. 4. This section also details the parties' rights in auctioning the enterprise among the parties who have consented to participate in the competition.

168. *Id.* Art. 12(2); Art. 13(9). In addition, a subsequent arrangement may not be sought within 36 months of a prior arrangement. *Id.* Art. 13(3).

Courts, in 1993 the Ministers of Finance and Privatization took steps for "launching bankruptcies."<sup>169</sup> The primary concerns for the foreign secured lender are the knowledge that the law is now in place, the Russian government is actively promoting its implementation, and it protects secured parties, even though there are scenarios in which secured parties may be exposed to unintended risk.

The secured creditor would be wise to include in the mortgage contract specific definitions of events comprising default well before insolvency. In the least, a clause should be included in the mortgage contract stating that (1) the mortgagee's solvency is a condition of the obligation and (2) the institution of bankruptcy proceedings, whether voluntary or involuntary, is an automatic default. This should provide a mortgagee with enough protection to keep it in front of unsecured creditors. Additional conditions requiring regular financial statements according to an agreed accounting norm or periodic audits should also help the mortgagee keep its priority interest by monitoring the mortgagor's performance.

#### IV. OTHER LAWS OF THE RUSSIAN FEDERATION IMPACTING THE ENFORCEABILITY OF TRANSNATIONAL SECURED TRANSACTIONS

Merely understanding the Mortgage Act will not provide enough of a legal basis for achieving financial security when transacting business in Russia. Russian property and foreign investment laws and treaties, factor into the enforceability of the secured lending contract. These laws impact questions that must be answered before the contracting phase. The major laws substantially affecting foreign secured transactions, (A) property law and (B) foreign investment law, are discussed in this section.

##### *A. Property Law Issues Affecting Secured Transactions*

###### *1. Law on Ownership of Property*

The first major steps away from state ownership of property under the Communist regime were taken in December 1990 when the "Law

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169. Russia Express-Perestroika: Executive Briefing, June 7, 1993, No. 103, International Industrial Information, Ltd. (Westlaw, Copr. 1991 Predicasts, Inc.) See also YURI TYUNKOV, ED. IN CHIEF, THE FIRST BANKRUPTCIES: A QUIET SENSATION?, VESTIK VYSSHEVO ARBITRAZHNOVO SUDA ROSSIISKOI FEDERATSII [JOURNAL OF THE RUSSIAN FEDERATION HIGHER COURT OF ARBITRATION], ROSSIISKIYE VESTI, Sept. 3, 1993 (CURRENT DIGEST OF THE SOVIET PRESS, Sept. 29, 1993, available in LEXIS, News Library, Omni File).

on Ownership in the RSFSR" was adopted.<sup>170</sup> The Ownership Act guarantees citizens the right of property ownership, granting the right to "possess, use, and dispose of the property which belongs to him," including real and personal property.<sup>171</sup> The State retained ownership of many types of property, including most natural resources, cultural and historical artifacts, state banks, and necessary means of production.<sup>172</sup> The Ownership Act also guaranteed that the State would not appropriate property without just compensation.<sup>173</sup> It shields private citizens from attachment of their property for obligations created by juridical persons in which the property owner is a participant.<sup>174</sup> Joint ventures that have foreign participants are permitted to own property "necessary for the effectuation of the activity provided by the constitutive documents."<sup>175</sup> However, foreign juridical persons are excluded from direct ownership of land.<sup>176</sup>

## 2. *Law on Ownership of Land*

Nearly three years later, on October 27, 1993, President Yeltsin issued a decree "[O]n the Regulation of Land Relations and the Development of Agrarian Reform in Russia"<sup>177</sup> which promised free alienation and ownership of land by all Russian citizens. Mainly intended to impact agricultural land and collectivized farms, the Decree grants to all citizens the right to freely own, use, and transfer land.<sup>178</sup>

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170. "Law on Ownership in the RSFSR", Adopted by the RSFSR Supreme Soviet, Dec. 24, 1990, *Ekonomika i zhizn'*, No. 3, (1991) (*hereinafter* "Ownership Act").

171. *Id.* at Art. 2(2).

172. *Id.* at Art. 21.

173. *Id.* at Art. 31.

174. *Id.* Art. 8(2), (3). Juridical persons are corporations, collectives, partnerships, enterprises and other like entities created as owners of property. The property of a juridical person could be levied against for obligations it created. *Id.*

175. *Id.* Art. 26.

176. *Id.* Art. 28. Foreign citizens and juridical persons can own "industrial and other enterprises, buildings, installations, and other property [for its business purpose]," *id.*, but apparently not the land under it. The exclusion of land in this article, which is devoted expressly to foreign parties' rights, leads to the conclusion that direct foreign land ownership is not permitted under Russian law.

177. "Decree By the President of the Russian Federation on the Regulation of Land Relations and the Development of Agrarian Reform in Russia," Decree No. 1767 of Oct. 27, 1993, The British Broadcasting Corporation, Summary of World Broadcasts, ITAR-TASS News Agency (World Service), available in LEXIS, News Library, Omni file).

178. *Id.* Art. 2. "[C]itizens and legal persons who are landowners have the right to sell, bequeath, gift, mortgage, rent out and exchange land, and also transfer land or part of it as an investment in the capital funds of joint-stock companies, associations and cooperatives, including ones which have foreign investments." *Id.*

However, it is silent as to whether foreign individuals or juridical persons could own land apart from joint stock companies. The failure to include foreign citizens and legal persons on the list of legitimate landowners probably means that they are not entitled to own land.<sup>179</sup> The result is that the issue is at best unsettled.<sup>180</sup>

### 3. *Impact of Property Laws on Security Interests*

Property laws silent as to foreign ownership of land effectively remove real estate from the range of securable property for a foreign lender. If land cannot be taken in mortgage by a foreign lender, then the lender's risk increases. This is unfortunate because security interests in land put a foreign lender in a stronger position at foreclosure; it could sell the enterprise more easily if there were a larger pool of potential buyers and the transfer would not be hampered by the potential interference of the landowner-debtor. Other options that could be available to the lender include retaining land ownership and leasing the enterprise to a new management team or installing its own management and then mortgaging the land to acquire additional capital. A change in Russian property law giving foreign investors the right to take title, and thus security interests, in real property would reduce risk and transaction costs in cross-border lending, with the likely effect of increasing the flow of foreign capital into the Russian economy.

## B. *Foreign Investment Law And Treaties*

### 1. *Foreign Investment Law*

A foreign investment law in the Russian Federation was first adopted in 1991, while still part of the USSR.<sup>181</sup> Even though it was

179. This interpretation was bolstered in recent remarks by the Chief Legal Expert at Russia's Committee for Land Tenure and Land Resources, Vladimir F. Mogusev. Mogusev explained Russia's hesitation about letting foreigners own land, saying "Rich foreigners could buy up all of Russia, while priority should be given to Russian citizens. The interests of Russia should come first." "Yeltsin Decree Will Let Joint Venturers, Legal Entities, Citizens Own Russian Land," *INT'L BUS. & FIN. DAILY (BNA)*, November 1, 1993.

180. See "Yeltsin's Speech to American Business Circles," *THE BRITISH BROADCASTING CORPORATION, SUMMARY OF WORLD BROADCASTS*, June 19, 1992, available in LEXIS, News Library, Omni File. The law is unsettled mainly because of the conflicting signals sent by the Russian leadership. On one hand, the new law appears not to sanction the ownership of land by foreign investors. On the other, President Yeltsin told a conference of Russian and American businessmen, "I signed a decree on the sale of plots of land to foreign private investors as private property during the privatization of state enterprises. . . . In this way rights to real estate are being transferred to the new private owners of privatized enterprises or enterprises under construction, and it is unimportant whether they are foreign citizens or our own." *Id.*

181. RF Law on Foreign Investment in the Russian Federation, July 4, 1991.

passed under the prior regime, it is still good law in Russia. The Foreign Investment Law is primarily directed toward equity investing, but its provisions impact all forms of foreign investments in Russia. In some areas it is not clear, and in others appears to conflict with the Bilateral Investment Treaty with the United States.<sup>182</sup> In this light, the Foreign Investment Law and BIT require general explication before analyzing their combined impact on secured transactions.

The Foreign Investment Law recognized four classes of foreign investors: (1) foreign juridical persons (corporations), (2) foreign citizens and persons without citizenship, (3) foreign states, and (4) international organizations.<sup>183</sup> Foreign investors were given the right to participate in partnership with other Russian juridical persons and citizens, to create new, wholly foreign-owned enterprises (including branch offices), to purchase permits for the right to use land and natural resources, and to purchase other property and property rights.<sup>184</sup> A foreign investment enterprise ("FIE") also has the right to give mortgages secured by property and other property rights.<sup>185</sup>

The Foreign Investment Law mandates that the State guarantee protection and compensation to foreign investors for harmful government actions.<sup>186</sup> Fora for the settlement of conflicts are the Supreme Court of the Russian Federation, the Supreme Arbitration Tribunal, or another forum permitted by treaty.<sup>187</sup> Under the Foreign Investment Law, the Ministry of Finances regulates FIEs.<sup>188</sup> Other authorized departments of the Federation may also have jurisdiction over the transaction.<sup>189</sup> In Free Enterprise Zones, FIEs enjoy the same rights and privileges accorded Russian citizens.<sup>190</sup> Most importantly, after paying taxes and duties, FIEs have the right to repatriate profits.<sup>191</sup>

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182. The Bilateral Investment Treaty, also known as the Most Favored Nation Trade agreement went into effect on September 1, 1992 (*hereinafter* BIT).

183. RF Foreign Investment Law, *supra* note 181 Art. 1.

184. *Id.* at Art. 3.

185. *Id.* at Art. 31.

186. *Id.* at Arts. 7-8.

187. *Id.* Art. 9. For cross-border disputes, BIT expands the list to include the International Centre for the Settlement of Investment Disputes, the Additional Facility of the Centre, an arbitral tribunal established under UNCITRAL rules, or a mutually agreed upon arbitral facility. BIT, *supra* note 182 Art. IV § 3(a).

188. RF Foreign Investment Law, *supra* note 181 Arts. 15-18. Article 16 details the State registration requirements for the foreign investment enterprise. *Id.*

189. *Id.*

190. *Id.* Art. 42.

191. *Id.* Art. 10. Article 10 reads as follows:

Foreign investors, after paying taxes and duties, are guaranteed the right

However, this right is not unfettered.<sup>192</sup> Essentially, profits to be repatriated must be covered either by accumulating hard currency profits or by keeping hard currency on deposit in Russia.<sup>193</sup>

## 2. *Bilateral Investment Treaty*

The provision that profits may be repatriated pursuant to certain requirements conflicts with BIT in a particularly important aspect. Article IV of BIT mandates that "[e]ach Party [nation] shall permit all transfers related to an investment to be made freely and without delay into and out of its territory."<sup>194</sup> However, BIT language following

to freely remit payments connected with their investments, if these payments are received in foreign currency, and including:

- revenues for investments received as profits, share of profits, dividends, interest, license and brokerage payments, technical assistance and service payments and others;
- sums paid on the basis of money demands and demands to meet one's agreement commitments that have economic value;
- sums received in connection with partial or complete liquidation or sale of investments;
- compensations provided in Article 8 of this law [compensation and reimbursement of losses to foreign investors for nationalized or requisitioned investments].

*Id.*

192. *Id.* at Art. 26. Article 26 reads as follows:

All hard currency expenses connected with different kinds of economic activities of FIEs on the territory of the RSFSR, including remittance of the foreign investor's share of profits abroad, must be covered by hard currency profits for these activities and from other sources of foreign currency allowed by the law. FIEs must conduct foreign currency operations in the order provided by the current legislation of the RSFSR.

*Id.*

193. *Id.*

194. BIT, *supra* note 182. Art. IV, § 1 is as follows:

Each Party shall permit all transfers related to an investment to be made freely and without delay into and out of its territory. Such transfers include:

- (a) returns;
- (b) compensation pursuant to [expropriation or nationalization];
- (c) payments arising out of an investment dispute (as defined in Article VI);
- (d) payments made under a contract, including amortization of principal and accrued interest payments made pursuant to a loan agreement;
- (e) proceeds from the sale or liquidation of all or any part of an investment; and
- (f) additional contributions to capital for the maintenance or development of an existing investment. Companies or nationals of each Party shall be

shortly thereafter seems to give supremacy to the domestic laws and regulations of the nations in the "equitable, nondiscriminatory and good faith application of its law."<sup>195</sup> As a result, the Russian requirement that "hard currency expenses . . . including remittance of the foreign investor's share of profits," including interest, be covered by hard currency probably does not contravene the treaty.<sup>196</sup> The net effect is that BIT probably does not offer American lenders all the protection it promises, and thus lowers return on investment because of the apparent requirement of keeping additional capital in Russia over the life of the transaction.

### 3. *Foreign Lender's Profits Earned from Interest*

The fact that profits earned as interest are covered by the Foreign Investment Law increases the foreign lender's risk in two significant ways. First, failure to maintain requisite deposits in Russia could possibly be argued in defense of a debtor's default.<sup>197</sup> Conceivably, it could be held against the creditor that (1) the debtor had no place to remit the interest and (2) the creditor had no right to the interest earned until it complied with Russian law. If the Russian enterprise was formerly state run, and its managers former party functionaries, acceptance of these arguments may not be surprising.

The second major risk flowing from the inclusion of interest in the list of covered profits is that upon default the foreign secured party may not be able to effectuate foreclosure proceedings against the debtor without first covering the expected profit and/or anticipated legal expenses with hard currency. This interpretation comes from language in the Foreign Investment Law.<sup>198</sup> The added burden this requirement would put on the secured party is extremely heavy. Not only might the foreign lender need to cover the full value of the loan, despite the likelihood of a loss, the lender may need to cover the legal and ad-

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permitted to convert such transfers into the freely convertible currency of their choice.

*Id.*

195. *Id.* Art. IV, § 3(b).

196. RF Foreign Investment Law, *supra* note 181 Art. 26.

197. The probable reason a lender needs to keep additional foreign currency deposits covering the expected profit on account in a Russian bank is to guarantee payment of taxes and duties. Non-compliance may be interpreted as an intent to evade taxes, weakening the foreign claimant's position in court.

198. RF Foreign Investment Law, *supra* note 181 Art. 26. Article 26 is vague in not defining what "expenses connected with different kinds of economic activities

ministrative costs before entering court. Hence, a foreign secured party could tie up huge sums of money just to get out of a bad deal, let alone earn profit from it.

Through negotiation a lender possibly could gain the right to substitute the secured property itself for the required hard currency coverage. The agreement would need to be creative and thorough, so as not to run afoul of other Russian laws. One possible solution is that the secured party could give a subsequent mortgage of its secured interest to a Russian bank in return for the hard currency necessary to cover the interest, expenses, and taxes. Then it could keep the funds in escrow during the life of the transaction, identifying them as the coverage for the payments and interest repatriated from Russia. Of course, this arrangement necessitates additional transactions, which raises costs and lower returns.

## V. ALTERNATIVE SECURITY DEVICES FOR THE FOREIGN CREDITOR

American investors looking to lend to Russian enterprises need not explore the field on their own. The Overseas Private Insurance Corporation ("OPIC"), and the Export-Import Bank ("EXIM-BANK") are American agencies dedicated to providing financing, guarantees, and insurance to Americans investing in developmental Russian projects. Although securing financing debt through this type of organization technically is outside the scope of this discussion, these organizations are trailblazers in the field and information about them is valuable to investors and practitioners alike.

### A. *Overseas Private Insurance Corporation*

OPIC was created by federal statute in 1969.<sup>199</sup> It provides pre-investment services, risk insurance, and project financing for investment projects in developing nations around the world.<sup>200</sup> OPIC "both promotes economic growth in developing countries by encouraging U.S. private investment in those countries, and simultaneously build[s] U.S.

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of FIEs on the territory of the RSFSR." *Id.* It can be easily argued that legal expenses incurred in pursuit of a debt are connected with economic activity. The "connection" is arguably tenuous, but, insofar as the government may want deposits on account to insure payment of legal and administrative costs, such deposits could be required.

199. 1969, Pub. L. 87-195, Pt. I, § 231, 83 Stat. 231 (codified as amended at 22 U.S.C.A. §§ 2191-2200a (West Supp. 1992)).

200. "New Interagency Group Meeting Weekly on Export Promotion, EX-IMBANK Chief Says", (*quoting* Ruth Harkin, President and Chief Executive Officer of OPIC), *Int'l Trade Rep. (BNA)*, August 11, 1993.



economic strength by promoting U.S. exports and jobs.'<sup>201</sup> Pioneering the field, OPIC has already registered 400 companies for insurance coverage on investment projects in the former Soviet Union.<sup>202</sup> Due to the difficulty in perfecting traditional security interests in Russia, OPIC has developed many alternative forms of security, including stock pledges, assignment of contract rights and licenses, contractual liens, direct payment agreements, and offshore escrow accounts.<sup>203</sup> OPIC is aggressively targeting environmental development in Russia and the other CIS states, having established an Environmental Investment Fund among its innovative projects.<sup>204</sup>

### B. *Export-Import Bank*

EXIMBANK is a federal agency created by Congress<sup>205</sup> for the purpose of providing financing and guarantees in deals for the exchange of American goods with developing countries.<sup>206</sup> Unlike OPIC, EXIMBANK generally accepts only foreign obligors who hold sovereign guarantees as security.<sup>207</sup> EXIMBANK also takes irrevocable letters of credit, which are secured by offshore escrow deposits of hard currency or direct assignment of hard currency profits.<sup>208</sup> EXIMBANK not only secures other private transactions, but finances its own.<sup>209</sup> Recently, EXIMBANK has set up a limited recourse project financing program that is geared for projects exceeding US\$50m, and is heavily involved

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201. James D. Berg, Acting President and Chief Executive Officer, OPIC, statement before the Senate Committee on Armed Services, March 3, 1993, FEDERAL NEWS SERVICE, FEDERAL INFORMATION SYSTEMS CORP., available in WESTLAW, PTS-NEWS Database.

202. Merryl Burpoe, Regional Manager, OPIC, remarks to U.S.-CIS Business Leadership Strategy meeting, August 23, 1993 (Chicago), "U.S. Programs to Help Investment in CIS are Poorly Understood, Officials Say", Int'l Trade Rep. (BNA), August 25, 1993.

203. Berg, *supra* note 201.

204. Harkin, *supra* note 200.

205. The Export-Import Bank is codified as amended at 12 U.S.C.A. § 635 (West Supp. 1992).

206. Export-Import Bank, Newly Independent States (NIS) Fact Sheet as of Aug. 18, 1993. (On file at EXIMBANK branches. EXIMBANK has branch offices in Washington, Chicago, Houston, Los Angeles, Miami, and New York)(*hereinafter* "Fact Sheet").

207. *Id.*

208. *Id.*

209. *Id.*

in oil and gas projects.<sup>210</sup> Other areas in EXIMBANK's focus are consumable goods, raw materials, commodities, spare parts, and components.<sup>211</sup>

## VI. CONCLUSION

A "meeting of the minds" between the foreign lender and the debtor will be the key to success when lending in Russia because understanding and communication will probably provide more protection than the law in its early development. Communication is extremely important because many Russian entrepreneurs are unfamiliar with the language of credit or secured transactions. This is true for the simple reason that during the Communist regime there was no need to develop a vocabulary. As a result, an investor may find it more difficult to make a contract understandable to a Russian counterpart than to understand Russian law. The explication of concepts and terms taken for granted in Anglo-American commercial law will be an essential part of a successful deal.

The burden of teaching is inescapably borne by the experienced lender in this relationship. Making sure to use internationally recognized commercial language will raise the level of understanding between parties.<sup>212</sup> Furthermore, it is imperative that the lender learn about the thought processes and expectations of his Russian borrower/debtor.

Mistrustfulness is deeply imbedded in the Russian psyche.<sup>213</sup> Commercially, Russians are mistrustful of entrepreneurs mainly for two reasons. The first is that paranoia was part of the mentality of Soviet communism and it still survives.<sup>214</sup> The second is that during and since the Soviet regime, many Russians who have accumulated money are

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210. "EXIMBANK establishes guarantee/lending scheme for Soviet Republics", INTERNATIONAL TRADE FINANCE, July 7, 1993 (FINANCIAL TIMES BUSINESS INFORMATION, LTD.), available in WESTLAW, PTS-NEWS Database.

211. Fact Sheet, *supra* note 206 at 1.

212. Harvey Jay Cohen, Dinsmore & Shohl, remarks to the Midwest Conference on International Law, sponsored by the American Society of International Law and the American Bar Association Section of International Law and Practice, (October 8, 1993). *Incoterms* (International Chamber of Commerce Publication 1990) are an invaluable aid in improving understanding. *Incoterms* are internationally recognized and their use will reduce confusion, especially if a dispute arises. Cohen suggested appending a copy of *Incoterms* to the contract and citing to it to reduce the margin of error. *Id.*

213. ROY D. LAIRD, THE SOVIET LEGACY (1993).

214. *Id.* at 4. "Many of the leaders now contending for power, and most of the people, express distrust of pluralist, open, democratic institutions and practices."

dealers in the underground market.<sup>215</sup> This attitude is changing, but it will take time for Western free market ideas to become the norm.<sup>216</sup>

Though it may be difficult to gain the trust of a Russian partner, that hurdle will be small compared to gaining the trust of a Russian judge. Faced with a long, detailed contract containing foreign terms and concepts, an inexperienced Arbitration Court judge will be hard-pressed to deliver swift justice. As an outsider to the transaction, coupled with inexperience in commercial matters, the judge will have little understanding of the parties' expectations or the adequacy of remedies. Without the foundation of a strong common law, going to court in Russia will be a gamble. Soviet Civil Law notions may still color the perception of judges in the new courts.<sup>217</sup> It is therefore critical that the parties reach such a high level of understanding that any inferences of fraud, unfair advantage, or motive contrary to public policy are removed from the transaction.

Taking advantage of the newly created commercial rights in Russia is not easy. Though changes in the law enable foreign investors to take security interests in Russian property like never before, the transaction costs for creating a transnational deal are staggering. As important as clarity of understanding is to any deal generally, it is even more important to make expectations, rights, and duties clear to all parties from the beginning of this cross-border relationship.

The best solution for the lending party is to include as much law as necessary in the contract. Unlike a UCC jurisdiction, where the Code's default rules fill a contract's gaps, Russian laws lack this level of sophistication. The lender bears the burden of drafting an airtight contract that defines the terms, anticipates contingencies, provides an exit strategy, protects against default, and is easily understandable. The lender also must make sure that the contract complies with the requirements of the Mortgage Act and is registered in the right agencies. Then, to succeed, the foreign lender needs the contacts and "local

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215. Anne Imse, "A Housing Boom Remakes the Russian Landscape", N.Y. TIMES, section 3, p. 5, August 29, 1993. Ms. Imse quoted a 64 year old Russian retiree who exemplified this attitude "They're swindlers. Building such a huge house requires millions. People who work can't earn that much!"

216. Fred Kaplan, "Russia: The New Edition; School Texts Revise Children's Look at History, Economics", BOSTON GLOBE, section: National/Foreign, p. 1. Earnest attempts to plant free market ideas in the Russian psyche are being made through the introduction of new history books of the 20th Century in the Russian public schools. An intriguing children's book, CROCODILE GENA'S BUSINESS, is now being used to teach free market concepts to children in their tender years. *Id.*

217. W.E. BUTLER, SOVIET LAW 178 (2d ed. 1988).

knowledge'' of a reliable Russian partner who may need to be taught about sophisticated financing norms. Failure to educate the debtor to the lender's expectations, penalties for default, and governing law could doom an otherwise well planned debt contract.

Finally, the lender must monitor the performance and condition of the debtor throughout the life of the agreement. In the absence of an established body of law of secured transactions, monitoring takes on greater importance. Even though the Act requires notarization and registration of certain contracts and guarantees, these are not perfecting devices. The current want of a Russian commercial jurisprudence demands additional lender monitoring until the law's dependability is established.

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