

# Special Update on Clarifications of the Supreme Commercial Court on Pledges and Mortgages

18 March 2011



This Update is a summary of long-awaited clarifications of the Supreme Commercial Court, mainly related to the levy of execution on secured property.

The structure of this summary generally follows the structure used in the Court's resolution.

**On 17 February 2011 the Plenum of the Supreme Commercial Court adopted Resolution No. 10 "On Certain Issues Relating to Application of Legislation on Pledge (Mortgage)."**

## GENERAL ISSUES RELATING TO PLEDGES AND MORTGAGES

**General (contents and form of security agreements, changes in secured debt)**

- *Absence of provisions on interest rate.* If a pledge (mortgage) agreement fails to specify the amount of and/or procedure for payment of loan interest, then the secured claim is deemed limited to the principal debt.
- *When notarization is not needed.* Pledge (mortgage) agreements with respect to aircraft, sea and river vessels, rolling stock and spacecraft do not need to be notarized.
- *Changes in the secured obligation.* Changes in the amount or term of a secured obligation as described in a pledge (mortgage) agreement (e.g. change of the interest rate or the loan maturity date) shall not entail termination of security. For example, if the amount of a secured principal debt is increased, the pledge shall secure the debt in the amount which existed prior to such increase, unless the parties have previously agreed that the secured debt could be increased by a specified amount.

## Mortgage specific issues

- *Division or merger of a land plot.* In case of a division, merger or allotment from a mortgaged land plot(s) the mortgage will remain in effect with respect to newly formed land plots unless the parties agree otherwise. State registration of mortgage with respect to newly formed land plots shall be performed by the registrar on its own and the filing of a separate application for registration is not needed.
- *When mortgage of a land plot or rights thereto is not needed.* The law provides that a building may be mortgaged only together with the underlying land plot or lease rights thereto. According to the clarifications, this rule does not apply in case of i) mortgage of non-residential premises rather than the whole building (upon enforcement the purchaser will acquire the mortgagor's right to share in the common title to the relevant building), and ii) mortgage of a building located on a land plot which may not be mortgaged due to certain statutory restrictions (the purchaser of such building will acquire the same right to use the land plot as was

## In this issue

General issues relating to pledges and mortgages .....	1
Levy of execution on pledged (mortgaged) property .....	3
Realization of pledged (mortgaged) property .....	4

## Key Contacts

**Igor Ostapets**  
[iostapets@whitecase.com](mailto:iostapets@whitecase.com)

**Irina Nesvetova**  
[inesvetova@whitecase.com](mailto:inesvetova@whitecase.com)

**White & Case LLC**  
 Tel +7 495 787 3000  
 Fax +7 495 787 3001

[www.whitecase.ru](http://www.whitecase.ru)  
[www.whitecase.com](http://www.whitecase.com)

# Special Update on Clarifications of the Supreme Commercial Court on Pledges and Mortgages

18 March 2011

enjoyed by the mortgagor of the building).

- *Assignment of a secured claim.* If a creditor assigns its claims secured by a mortgage to a third party, the new creditor may only claim mortgage enforcement after the transfer of the mortgage rights to it is registered.

## **Issues related to out-of-court enforcement**

- *When extra-judicial enforcement is not allowed.* Russian law provides that where a pledge or mortgage was granted by an individual and the conclusion of a security agreement required a third party's consent, such security may only be enforced through a judicial procedure. The Court clarified that an out-of-court enforcement ("OE") option is therefore not available for: i) a pledge of property in common ownership granted by an individual, including an individual entrepreneur (e.g. property in common ownership of spouses); ii) a pledge of a participation interest granted by an individual participant to a non-participant (because such pledge requires the other participants' consent); and iii) a pledge (mortgage) of land lease rights by an individual if it required the the landlord's consent (rather than just notification) and there are no buildings on the land plot.
- *Form and registration of an agreement on OE.* If an agreement on OE is concluded as a separate document (rather than included in a security agreement), it should be in the same form as the security agreement and should be registered if the latter is itself subject to state registration. In particular, an agreement on OE of a mortgage executed as a separate document is subject to state registration.
- *Unlawful levy of execution.* If a pledgeholder levies execution unlawfully (e.g. if an agreement on OE is invalid), the pledgor (mortgagor) may either i) recover the secured property from the purchaser or the pledgeholder who kept it (and in this case the pledgeholder will also need to compensate the pledgor's (mortgagor's) expenses related to the "restoration of the right infringed upon"), or ii) claim the full amount of damages from the pledgeholder, including the value of the secured property.
- *Pledgor's consent for OE.* Russian law differentiates between the "pledgor's consent for OE" and an "agreement on OE." A notarized consent to the OE, which is required by law for pledges if the pledgor is an individual and for all mortgages, i) may be granted either before or after a security agreement is made; ii) does not need to be notarized if a relevant agreement on OE is notarized; and iii) may not be revoked by the pledgor (mortgagor) and may not be challenged separately from the agreement on OE.
- *Resort to court despite the existence of an agreement on OE.* If a pledgeholder goes to court to enforce security despite the existence of an agreement on OE then, irrespective of the outcome of the case, the pledgeholder shall bear all the relevant court expenses. This will not be the case if i) the pledgholder proves that OE appeared to be unsuccessful or is impossible, or ii) the parties have agreed upon the possibility of both judicial and extra-judicial enforcement. In addition, the pledgeholder who goes to court despite an agreement on OE may ask the court either that the pledged property be i) realized according to the procedure established for judicial enforcement, or ii) transferred to it for further realization in

*An agreement on out-of-court enforcement of mortgage executed as a separate document is subject to state registration*

# Special Update on Clarifications of the Supreme Commercial Court on Pledges and Mortgages

18 March 2011

accordance with the agreement on OE.

- *Old security agreement and new agreement on OE.* The parties may conclude an agreement on OE even if the pledge (mortgage) agreement was made before Federal Law No. 306-FZ, dated 30 December 2008, entered into force.

## LEVY OF EXECUTION ON PLEDGED (MORTGAGED) PROPERTY

### *Enforcement if the pledgor disposes of the secured property (sells it, grants a subsequent pledge, etc.)*

- *When pledged movable property is sold.* If a pledgor disposes of pledged movable property (e.g. sells it) without the pledgeholder's consent, the pledgeholder may not challenge the disposal, rather it may accelerate the secured debt and levy execution on the pledged property.
- *When mortgaged immovable property is sold.* The above approach applies to mortgages of immovable property save for cases when a mortgagor alienates mortgaged property without the mortgageholder's consent or grants a subsequent mortgage in breach of a prohibition established in the prior one. In these cases the mortgageholder is entitled to challenge the disposal.
- *Simultaneous levy of execution by a prior and a subsequent pledgeholder.* If a prior and a subsequent pledgeholder wish to levy execution on the pledged (mortgaged) property in an extra-judicial procedure simultaneously, they are to send a joint enforcement notice to the pledgor (mortgagor).
- *Bona fide purchaser of pledged movable property and enforcement.* A pledgeholder may not levy execution on pledged movable property if it was sold by the pledgor to a third party who did not know and could not have known that the property was subject to pledge.

### *Specific terms of pledge (mortgage) agreements affecting enforcement*

- *Security for claims to restitution when secured obligation is invalid.* The parties may agree that the pledge (mortgage) secures not only claims arising out of an agreement (e.g. on loan repayment and payment of interest), but also claims to restitution if the agreement turns out to be invalid.
- *Levy of execution on part of secured property.* If a pledge (mortgage) agreement indicates the total value of several pledged (mortgaged) items and does not indicate the values of those separate items, then execution shall be levied on all the secured property and it shall only be realized as a whole. Partial levy of execution will only be possible if the i) the pledgor (mortgagor) proves that the partial sale proceeds will suffice to satisfy the secured debt in full, and ii) there are documents confirming the market price of the relevant separate items of secured property. In addition, if the auction for the sale of the pledged property as a whole fails because only one participant showed up or no one increased the starting sale price, the pledgor or the pledgeholder may apply to the court and ask that the pledged property be sold in parts.

*A pledgeholder may not levy execution if the pledged property was sold to a third party who did not know and could not have known that the property was subject to pledge*

# Special Update on Clarifications of the Supreme Commercial Court on Pledges and Mortgages

18 March 2011

## REALIZATION OF PLEDGED (MORTGAGED) PROPERTY

### *Methods of realization of mortgaged immovable property*

- *Methods of realization when immovable property is mortgaged.* The Court pointed out that the methods of realization of the mortgaged property in case of OE are as follows: i) sale at an open or closed auction; and ii) acquisition of the mortgaged property by the mortgageholder for itself or for a third party.
- *Only one realization method in an agreement on OE of mortgage.* An agreement on OE of mortgage may indicate only one of these methods. If no such method is indicated or several methods are indicated, then the agreement on OE is deemed "non-concluded" and thus the mortgage may be enforced through a judicial procedure only.
- *Acquisition of mortgaged property by the mortgageholder.* The law does not allow the mortgageholder to acquire the mortgaged property if the mortgaged property consists of a land plot. The Court clarified that this restriction does not apply to mortgage of a land plot (land lease rights) occupied with a building mortgaged to the same mortgageholder.

### *Methods of realization of pledged movable property*

- *Extra-judicial enforcement of pledges of movable property.* The law provides that in case of OE, the pledged property is to be realized through an auction or sale under a commission agreement concluded by the pledgeholder. If a pledge agreement is concluded among legal entities and/or individual entrepreneurs, they may agree that the property will be acquired by the pledgeholder or sold, including by a commission agent, without an auction.
- *Involvement of a commission agent and sale at an auction.* The Court pointed out that in the former case the involvement of a commission agent means that the pledged property shall be sold by the commission agent at an auction, whereas in the latter case (i.e. where the pledge agreement is among legal entities and/or individual entrepreneurs), the pledged property shall be sold by the commission agent without an auction.
- *Methods of realization when movable property is pledged.* The Court further summed up that the methods of realization of pledged movable property in case of OE are therefore as follows: i) sale by the pledgeholder at an open or closed auction; ii) sale at an open or closed auction organized by a commission agent; iii) sale of traded securities on a stock exchange; iv) acquisition of the pledged property by the pledgeholder; v) sale by the pledgeholder without an auction; and vi) sale by the commission agent without an auction.
- *Several realization methods in an agreement on OE of pledge of movable property.* As opposed to an agreement on OE of a mortgage, an agreement on OE of a pledge of movable property may contain several methods of realization, and in that case it is the pledgor (rather than the pledgeholder) who will be able to choose a particular method at its discretion, unless agreed otherwise. If no such method is indicated, then the pledged property shall be sold by the pledgeholder at an open auction (which may be organized by a commission agent), or on a stock

*An agreement on out-of-court enforcement of mortgage may contain only one realization method, whereas an agreement with respect to the pledge of movable property may contain several realization options*

# Special Update on Clarifications of the Supreme Commercial Court on Pledges and Mortgages

18 March 2011

exchange if traded securities are pledged.

## ***Term of realization, pledgeholder's authority***

- *Pledgor's rights when realization is delayed.* The law provides that pledged movable property shall be realized within the term agreed upon by the parties or, if none is agreed, within a reasonable term. The Court clarified that if pledged property is realized after the expiry of the term for its realization, the pledgor may claim, from the pledgeholder, damages incurred due to the late realization (e.g. the amount of interest accrued after the term expired and withheld by the pledgeholder from the sale proceeds). This approach shall also apply to a mortgage if the parties agreed upon a certain term for realization in an agreement on OE.
- *Pledgeholder's authority to make transactions in its own name.* The statutory rule allowing the pledgeholder to conclude all the transactions required for realization of pledged property in its own name shall apply to OE realization with any of the methods mentioned above.

## ***Transfer of title to secured property***

- *The need for possession of pledged movable property.* The acquisition of pledged movable property by the pledgeholder or its sale to a third party without an auction is only possible if the pledgeholder possesses the pledged property. Thus, the pledgeholder or the purchaser, as applicable, shall only obtain title to the pledged property provided it obtains possession of such property.
- *Transfer of title to mortgaged property.* If a mortgageholder wishes to acquire mortgaged property for itself or for a third party, it does not need to conclude a separate sale-purchase contract with the mortgagor. To register the transfer to title to the mortgaged property the mortgageholder shall submit to the registrar an application for state registration (no mortgagor's application is needed) together with i) documents evidencing the lawfulness of enforcement (e.g. a mortgage agreement with a notary's executive endorsement on it); ii) enforcement notice; iii) a declaration (notice) on acquisition of the mortgaged property for itself or for a third party (and such declaration shall indicate the price at which the property is acquired), as well as iv) evidence that the mortgagor has received these documents. If mortgaged property is acquired by the mortgageholder for a third party, the application for state registration of the transfer of title shall be submitted both by the mortgagor and by that third party acquiring title.
- *Transfer of title to pledged rights.* If the pledgeholder acquires pledged rights, such rights shall be transferred to the pledgeholder at the moment of receipt by the pledgor of the pledgeholder's declaration (notice) on retaining such rights for itself, provided the prior enforcement notice was properly sent to the pledgor.

## ***Price of secured property***

- *OE without an auction to be done at the market value determined by an appraiser.* Pledged property shall be acquired by the pledgeholder or sold to a third party without an auction at its market price to be determined by an independent appraiser.

White & Case Moscow's Special Updates appear in the Legislative Update section of our website. You may also choose to receive our free Special Updates and Weekly Updates by e-mail. To subscribe, simply complete the form on our website: [www.whitecase.ru](http://www.whitecase.ru).

# Special Update on Clarifications of the Supreme Commercial Court on Pledges and Mortgages

18 March 2011

- *Challenging of enforcement in case of breaches.* If the rules on appraisal of the pledged (mortgaged) property are violated in the course of its OE realization without an auction, the realization may be challenged by an interested person. Such transaction shall be found invalid if it is proved that the purchaser knew or should have known that the rules on appraisal were breached. In addition, the pledgor (mortgagor) is entitled to claim damages from the pledgeholder irrespective of whether the realization transaction is challenged or not.
- *Starting sale price at an auction – no less than 80% of the price determined by appraiser.* Where the law requires engagement of an independent appraiser for OE realization, the starting sale price of the pledged property at the auction may not be less than 80% of the market price determined by an independent appraiser.
- *Realization of receivables.* In case of extra-judicial realization of pledged receivables, they are subject to independent appraisal both in case of sale at an auction and acquisition by the pledgeholder or sale without an auction.
- *When the auction fails.* If an auction for the sale of pledged property fails because only one participant showed up or no one increased the starting sale price, the pledgor or the pledgeholder may apply to a court and ask that the starting price be reduced. In this case the claimant must prove that the market price of the pledged property significantly decreased after the entry into force of the decision on the levy of execution.

**The Resolution is mandatory for lower commercial courts when considering similar issues.**

This update is a general summary of recent legislative developments and should not be treated as legal advice. Readers should seek the advice of legal counsel on any specific question. All translations of terminology in this update are unofficial.

© 2011 White & Case LLC.