INTERNATIONAL CONFERENCE
ON SECURED COMMERCIAL LENDING
IN THE COMMONWEALTH OF INDEPENDENT STATES

4-5 November 1994
Moscow, RF

Conference Proceedings
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Preface

The International Conference on Secured Commercial Lending in the Commonwealth of Independent States took place in Moscow at the Russian Supreme Arbitration Court in November 1994. During the Conference, jurists, parliamentarians, bankers and entrepreneurs from Russia and the other member countries of the CIS discussed issues of secured commercial lending with leading experts in law and banking from the United States and Europe. The Conference was timely, taking place shortly before the enactment of Part I of the new Russian Civil Code, containing provisions on secured transactions.

The Conference grew out of work that the European Bank and IRIS Center assisting in the creation and protection of security interests and other property rights in the Russian Federation and across the CIS. Such protection is essential if lenders are to extend credit to the newly emerging private sector.

The Conference began by outlining institutional and legal impediments to secured lending by leading jurists, judges, practising lawyers and bankers from Russia and the CIS. Afterwards, prominent Western experts described the elements required for the protection of security interests in the U.S. and Europe. Experts from the region and the West also examined related issues, such as enforcement, insolvency and registration.

On the second day of the Conference, participants applied this framework to a hypothetical business situation. This case study produced intense debate among the CIS participants about the appropriate framework for secured lending in their countries and provided an opportunity to apply to a concrete case the discussion from day one of the Conference.

The proceedings from the conference are reproduced in English and Russian. This publication contains all remarks from the first day of the Conference, as well as substantial parts of the case study discussion on the second day. The co-sponsors hope that their publication will promote greater understanding of the issues involved and stimulate further debate about the means of building an effective secured commercial lending regime in the countries of the CIS.

Andre Newburg
General Counsel
European Bank for Reconstruction and Development

Charles Cadwell
Director
Center for Institutional Reform and the Informal Sector
University of Maryland

May 1995
Sponsoring Organisations

Inter-Parliamentary Assembly of Member Nations of the Commonwealth of Independent States.

The Inter-Parliamentary Assembly of Member Nations of the Commonwealth of Independent States was created in Almaty in March 1992. The IPA, acting as the legislative arm of the CIS, provides a forum in which the countries can discuss issues of mutual concern and develop joint activities, in co-ordination with national legislatures. The Assembly, which is located in the historic Tavrichesky Palace in St. Petersburg, also sponsors conferences and seminars on common problems facing the CIS.

Supreme Arbitration Court of the Russian Federation

The Russian Constitution creates a branch of courts, the Arbitration (or Arbitrazh) Court, that deals exclusively with economic disputes. The system includes the Supreme Arbitration Court and eighty one regional arbitration courts at the republic, kray and oblast level. The Arbitration Court is one of three sub-branches of the Russian judicial system, which also includes the Constitutional Court and courts of general jurisdiction that handle criminal and civil proceedings.

The Supreme Arbitration Court of the Russian Federation, located in Moscow, is, according to Russia's Constitution, the highest judicial authority on economic matters and the Court of final appeal on disputes arising from commercial transactions.


The restoration of economic ties and the rebuilding of trade relations within the CIS requires co-ordination and some standardisation in the development of civil legislation. With this objective in mind, the leaders of the member nations of the Commonwealth of Independent States established the Scientific Consulting Center for Private Law of the CIS in April 1994 to draft model legislation. The center has produced a model civil code, which was adopted by the Inter-Parliamentary Assembly of the CIS in October 1994, and is working on model laws on joint stock companies, mortgages, condominiums and registration of immovable property. This collaborative process is an important vehicle for harmonising commercial law within the CIS, which is itself a critical step in the economic reforms of these transition economies. This CIS institute is modelled after the Research Center for Private Law under the President of the Russian Federation, which has been responsible for drafting Russia's Civil Code.

The European Bank for Reconstruction and Development

Purpose and role

In 1991, the European Bank for Reconstruction and Development (EBRD) was established to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the central and eastern European countries committed to and applying the fundamental principles of multi-party democracy, pluralism and market economics.
The Bank aims to help its countries of operations to implement structural and sectoral economic reforms, including demonopolisation, decentralisation and privatisation, taking into account the particular needs of countries at different stages of transition. Its activities include the promotion of private sector activity, the strengthening of financial institutions and legal systems, and the development of the infrastructure needed to support the private sector.

The EBRD encourages co-financing and foreign direct investment from the private and public sectors, helps to mobilise domestic capital, and provides technical co-operation in relevant areas. It works in close co-operation with international financial institutions and other international organisations. The Bank promotes environmentally sound and sustainable development in all of its activities.

Membership and capital

The EBRD has 59 members (57 countries and the EC and EIB), including 25 countries from central and eastern Europe and the former Soviet Union.
The initial subscribed capital is ECU 10 billion, of which 30 per cent is paid in. The Bank also borrows in various currencies on world capital markets.

Organisation

The powers of the EBRD are vested in a Board of Governors, to which each member appoints a Governor and an Alternate. The Board of Governors has delegated powers to a Board of Directors with 23 members, who are elected by Governors for a three-year term. The Board of Directors is responsible for the direction of the general operations of the Bank, including establishing policies, taking decisions concerning projects and approving the budget. The President is elected by the Board of Governors for a four-year term. Vice Presidents are appointed by the Board of Directors on the recommendation of the President.

Financing

One of the EBRD’s strengths is that it can operate in both the private and public sectors. It merges the principles and practices of merchant and development banking, providing funding for private or privatisable enterprises and for physical and financial infrastructure projects to support the private sector.

The EBRD aims to be flexible by using a broad range of financing instruments, tailored to specific projects. The kinds of finance it offers include loans, equity investments and guarantees. In all of its operations, the Bank applies sound banking and investment principles. The terms of the EBRD’s funding are designed to enable it to cooperate both with other international financial institutions and with public and private financial institutions through co-financing arrangements.

By the end of August 1994, the Bank had approved 217 projects for a total of ECU 4.6 billion. Of these, 169 had been signed.

Project-related technical co-operation is a major feature of the EBRD’s activities. By the end of August 1994, 32 co-operation fund agreements with bilateral donors, totalling over ECU 210
million, had been made with the Bank for this purpose; 670 projects, with a total estimated cost of over ECU 152 million, had been committed.

**Operations**

The EBRD’s operations are carried out through its Banking Department, which is composed of teams combining the Bank's private sector and public sector specialists. Country teams ensure consistent implementation of the Bank's country strategies; these are backed up by the specialist expertise of sector teams and operations support units.

The other Bank departments are as follows: Finance, Personnel and Administration, Project Evaluation, Secretary General, General Counsel, Chief Economist, Internal Audit and Communications.

The EBRD's headquarters are in London, with Resident Offices in 12 countries of operations.

**THE IRIS CENTER**

The center for Institutional Reform and the Informal Sector (IRIS), an affiliate of the University of Maryland at College Park, was launched in 1990 with funding from the United States Agency for International Development (USAID). The purpose of the project is to foster reform of legal, political, and economic institutions in countries making the transition from centrally planned to market economies. IRIS pursues this objective by developing and disseminating knowledge about institutions and by assisting select governmental and private sector organisations and individuals who are studying and improving institutions in their own countries. IRIS is engaged in institutional reform throughout the world - in the new countries of the former Soviet Union, in Central and Eastern Europe, in Asia, and in Africa.

The IRIS center is composed of lawyers and economists who specialise in the reform of institutions central to market democracies. IRIS is based on the concept that the quality of a country's legal and political institutions principally determines its economic performance. Governments may permit capital markets to emerge within their borders, but those markets will not thrive unless legal institutions secure individual property rights and provide for the impartial enforcement of contracts. Thus, while IRIS recognises the importance of other factors - such as natural resource endowment or level of capital - its premise is that institutional reform is a requirement for economic development, whether in Russia and the other former Soviet Republics, Eastern Europe, or the Third World.

The IRIS center's current overseas projects include the development and implementation of a collateral law system in Poland, land and antitrust laws in Mongolia, company and contract laws in Nepal, business registration and customs fraud prevention programmes in Chad, anti-monopoly regulation in Ukraine, economic policy research and analysis in Armenia, and commercial law, economic research, and natural monopoly regulation in Russia. In all of these activities, local experts and officials play a paramount role. For its part, IRIS, which has placed long-term resident advisors in each of these countries, provides expertise in both the legal and economic aspects of the reform process.

**IRIS-RUSSIA PROJECT**
From its Moscow field office, the IRIS-Russia Project is involved in a range of economic and legal reform activities through three distinct USAID-sponsored projects: Commercial Law Reform, Economics and Institutions, and Market Environment Reform.

**Commercial Law**

The objective of the Commercial Law Reform Initiative is to assist and train Russian law makers, judges, and legal practitioners at the Federation level as they develop the components of a commercial law regime essential for Russia's transition to a market economy. Among other activities, IRIS is advising the presidential commission drafting the new Civil Code, the body of law that will form the legal basis for all commercial transactions in Russia.

**Economics and Institutions**

IRIS and the Russian Institute for the Economy in Transition are co-operating on an Economics and Institutions project with Russian economists and policy makers in areas related to the transition. Through this programme, IRIS supports Russian researchers studying the economic policy issues and legal problems associated with the transition, organises seminars and conferences for policy makers in economics, collective choice, and the legal institutions of a market economy, and assists young economists interested in examining the transitional period.

**Market Environment**

IRIS is the prime contractor under a USAID contract to support market environment reforms across the Newly Independent States of the former USSR. The contract has two major components - creation of a legal and regulatory environment, and economic education.

In Russia, IRIS has established a programme on Natural Monopolies with the participation of the Working center for Economic Reform under the Government of Russia and the Ministry of Economy. The programme's main purpose is to assist the Russian Government in the development and evaluation of alternatives for the economic regulation of natural monopoly industries and in the implementation of reforms in these industries.

**USAID**

The United States Agency for International Development (USAID) was created in 1963 and is funded through the United States federal budget to respond to countries requesting American technical assistance. Today USAID is active in approximately 70 countries and provides various kinds of assistance in a variety of areas. These areas include agriculture, business development, health, energy, the environment and education.

When Russia began its historic reforms in the late 1980s, a series of summit meetings were conducted between Russian and American leaders. These meetings have resulted in a number of efforts whereby the two countries co-operate to address issues arising out of the reform effort in Russia. Today USAID is co-operating with the Government of Russia in such areas as environmental policy and technology, health care improvement, private sector development, housing reform, economic restructuring, legal reform, training and energy development. In each of these sectors USAID has activities which have been designed in co-operation with the Government of Russia to address specific needs.
Like the United States, Russia is a large and diverse country. As it goes through its reforms the Russian will become stronger. American assistance is not directed only at Moscow but is evident throughout the country (including the Russian far east). However, US assistance concentrates activities in regions which have shown the most reform progress and are making the greatest reform efforts.

USAID is proud of its relationship with the Government of Russia and the achievements which have evolved as a result of the co-operation between Washington and Moscow.
1. Welcoming Remarks

Andre Newburg,
General Counsel, European Bank for Reconstruction and Development, London

Ladies and gentlemen,

Allow me to welcome you on behalf of the organisers to this international conference on secured commercial lending in the CIS countries. One of the reasons for this conference is the European Bank's draft of a model law on secured transactions. The role of the European Bank is to provide support to the countries of central and Eastern Europe and the Commonwealth of Independent States in the process of transition to a market economy. Secured transactions are especially important for financing of projects in market economies.

Allow me to introduce the conference organisers: The Inter-Parliamentary Assembly of CIS Member Countries, the Supreme Arbitration Court of the Russian Federation, the Russian Federation President's Research center for Private Law, the IRIS center, the US Agency for International Development, and the European Bank for Reconstruction and Development. I would like to thank Olek Vitalyevich Boikov for his involvement in our work and for the opportunity to hold this seminar in this wonderful building. Our conference will last two days each of which will have different agendas. The first day will be organised in the style traditional for such forums and will take the form of several seminars. The second day will be devoted to the study of a concrete case, with financial and legal analysis of a secured lending transaction. This case will be presented to you for consideration today during an upcoming session.

Let me say a few words about the sessions that we will have today. We begin this morning with a look at the law and practice of secured lending in Russia and the CIS. This will be followed by a broader look at the law and practice of secured lending in other countries. This afternoon we hear about various elements of secured transactions: property that may be subject to charges, the realisation of charges, the effects of insolvency, and registration systems. Then there will be some words on developments in secured lending in the CIS, including the Russian Law on Pledge of 1992 and the pledge provisions of the draft Civil Code which have been followed in a number of the other countries of the CIS.

Significant progress has been made but implementation still needs to take place and practice still need to be developed. We hope that the legislatures will be able to draw some support from the EBRD's model law which envisages a comprehensive system of charges and registration. The law has already stimulated proposals in other countries such as Hungary, as well as the UNIDROIT proposal of a draft model law on secured transactions. The EBRD model law has been translated into Russian and is included in the materials that you have that have been distributed to you. It has also been translated into Romanian and Latvian. The proceedings of this conference are to be published in Russian and English and we hope the discussion of the next two days will provide stimulus to work on this very important matter of
securing business credits in the transition economies. Thank you very much and I wish us all a successful conference.

Charles Cadwell,
Director IRIS-Center, University of Maryland

It is my pleasure to join Andre Newburg in welcoming you to this two-day conference. Across history and regardless of geography, those countries which have experienced economic growth and provided broad-based well-being for their people have been those which provided secure property rights and the impartial enforcement of contracts. And so it is a particularly relevant pleasure to be opening today's conference which focuses on ideas central to the establishment of property rights and to have the conference held in a building dedicated to the impartial enforcement of commercial arrangements. The center for Institutional Reform in the Informal Sector, which is located in the economics department of the University of Maryland, has its activities unified by this idea: the idea that the arrangements, the institutions as economists call them, by which society organises its commercial activity are central to growth. This idea unifies our work not only in Russia, but in Ukraine, Poland, Mongolia, India, Nepal, and other places around the world. Our interests are not only in the adoption of laws, of course, but also in their implementation. As difficult as it is to agree and to adopt a law through a legislature, experience is replete with examples of adopted but unimplemented laws - laws that don't work. Today's programme brings together both legal drafters and practitioners, so we look forward to an interesting and also important two days of discussion. I think it is particularly important that there are experts in the room from all of the CIS countries, from Lithuania, from Poland, from Norway, Germany, the United Kingdom and the United States. I must say it is a particular personal pleasure that we have with us as well two of the leading scholars on commercial law from the United States: James White and Allan Farnsworth. Their work and their teaching is something that all of us who have trained in the United States have benefited from significantly. I want also to take the opportunity at the beginning of today's proceedings to thank both the US Agency for International Development, whose financial support makes our work in Russia possible, as well as this conference, and the EBRD for its support. But most importantly, I want to thank the Supreme Arbitration Court for its generous hospitality in hosting today's conference and also this evening's reception to which I want to make sure everyone is aware that you are invited. Having said that, let me introduce our host: Mr. Olek Boikov, the Deputy Chairman of the Supreme Arbitration Court.

Olek Boikov,
Deputy Chairman of the Supreme Arbitration Court of the Russian Federation, Moscow

We have a situation here in which the hosts are being introduced by the guests. But I do not think that this matters a great deal. Allow me, on behalf of the Supreme Arbitration Court, to congratulate you on the opening of the conference and to wish it success. Unfortunately, the Chairman of the Supreme Arbitration Court is travelling on business and could not do this personally. And so he instructed me to congratulate the conference participants on his behalf.

Under the Russian Constitution, the Supreme Arbitration Court, whose building you are in, is the supreme judicial body for the settlement of economic disputes. And this, as you can understand, accounts for our interest in the problem of secured commercial lending and our participation as conference organisers. As you noticed from the previous presentations, everyone praised others for their active involvement in preparing the conference but, naturally, not themselves. It seems that I too should carry out this mission and point out that a major
contribution to the preparation of this conference, as conference organisers and sponsors, was made by the European Bank for Reconstruction and Development, the center for Institutional Reform and the Informal Sector, and the US Agency for International Development.

As I said, our subject matter is extremely relevant. It is indeed relevant from the standpoint of the state of the Russian economy. We know that at the current time our country is experiencing a difficult economic period. During this period a considerable role is being played by commercial lending, as one of the levers that might be capable of bringing the economy out of this difficult situation. Of course, there are economic factors, above all, inflation. But there are also legal factors that, nonetheless, are hindering the use of this means in the economy. As a judicial body, we have especially keen first-hand experience with these negative legal factors. I am referring primarily to the fact that our legislation in this field is extremely imperfect. And in saying so, I am not following a fashion, for it is fashionable in our country today to criticise legislation, especially when you have nothing else to say. I am simply stating the fact, since in this particular case we are enforcers of the law and can speak of this matter as a genuine fact.

Our legislation, as you know, has arisen in different time periods. It is internally contradictory, and there also are a great deal of discrepancies and contradictions at the level of enactment. We, the Supreme Arbitration Court, and the other arbitration courts are often asked to settle disputes relating to these discrepancies and contradictions. Some feel that parties turn to us too often, which attests to the disorderly state of legal relations in this country. Others, on the contrary, believe that parties turn to us too rarely, which would indicate that we do not yet have an appropriate legal status in this country. Our view is that parties turn to us exactly as often as necessary, depending on our legislative situation, legal status and legal culture. I would like to point out once more that you will be discussing this subject for two days, and that there are indeed some highly complex issues here that have not been resolved by law. We encounter them every day. A search is under way, including a search for legal enforcement practices, and foreign experience will also be useful.

For we sometimes have to deal with rather odd forms of protecting commercial credits. I am referring to attempts, and they are very widespread, to protect such credits through so-called "insuring of liability by the borrower himself." We think that this conference will not only be of great importance for enforcement of the law, but that it will be of even greater significance for the development of legislation. In this hall, and we are very much aware of this, are people who are directly engaged in drafting the texts of new laws, especially the Civil Code and its second section, as well as banking legislation, and also people who are responsible for making decisions based on these laws. I, therefore, think that there are good prospects that the recommendations of our conference will be implemented. Allow me once more, on behalf of the Supreme Arbitration Court, to wish you success in your work. Thank you for your attention.

2. The Law of Secured Lending in Russia and the CIS

Professor Alexander Makovsky,
Vice-Chairman of the Research Center for Private Law under the President of the Russian Federation, Moscow

Dear Chairman and dear ladies and gentlemen,
I see my task, and I spoke about this with the conference organisers, as attempting to say a few words about the new elements that are now appearing in the future Civil Code with the aim of bringing about more effective secured lending.

When discussing the importance of the law on commercial lending, people usually speak of a chain. Economic development is impossible without investment, investment is impossible without lending, lending is impossible without security, and security is impossible without good legislation. And for this reason, no doubt, at the very outset of Russia's transition to a market economy, efforts got under way to draft a Mortgage Law. This law arose, as you know, rather quickly and, unfortunately, it must be said bluntly that it has not accomplished the tasks it was intended to accomplish, nor has it realised the hopes that had been pinned to it. Is this a consequence of shortcomings of the law alone? Yes, the law has many shortcomings. I will speak of several of them, which we have tried to avoid in the Civil Code. But the law's shortcomings are by no means the only problem. The problem, of course, lies primarily in the state of our economy. Such forms of secured lending as pledges, above all pledges of real property and mortgages, as well as such forms of security as bank guarantees and other sureties, are unfortunately not going to develop sufficiently given the inflationary economic state that we currently have. The second point that must be made in speaking of the insufficient effectiveness of the Mortgage Law is that it has not and could not accomplish two tasks that were beyond its scope altogether. At the time, perhaps, we did not understand this very well.

The first task that lies beyond the scope of the Mortgage Law and which, I must say, lies even beyond the scope of civil legislation in general, is the task of creating in the country a normal, smoothly operating system of registration of real property and of transactions involving real property. Until such a system is created, and creating it is a complex and rather costly affair, mortgages will not be a normal and effective means of securing obligations, because the creditor will always have doubts that he may be in danger of being deceived or swindled in accepting a mortgage on a given property. The second circumstance that lies outside the scope of the Mortgage Law and outside the scope of the Civil Code, but which is related, naturally, to legislation, and which we also failed to take into sufficient account in drafting the Mortgage Law is the creation of a sufficiently effective system for selling property and recovering property pledged as security. This is something that we are still working on today, above all in the Civil Procedural Code, which had undergone no changes in this respect, and whose regulations in this area in no way take into account Russia's transition to a market economy. In effect, if you try to apply these regulations on recovering property to private property, the only thing in them that is more or less suitable with respect to the subsequent sale of such property, the only thing that is more or less relevant today, is the sale of a residential building belonging to a citizen. Strictly speaking, applying these regulations to the sale of other property would doubtless be impossible. In drafting the Civil Code and drafting the regulations on securing obligations, including on securing lending agreements, those who worked on this draft naturally tried, insofar as possible, to make these regulations effective. And here the drafters found themselves between Scilla and Charybdis, so to speak, between two dangers that had to be avoided.

On one hand, it was of course necessary to enable a creditor to resort to these regulations rather quickly and rather effectively, including, if necessary, to have a rather effective capability to recover collateral. On the other hand, it was necessary to protect the interests of pledgers, who in our country today, in a significant number of cases, are not entrepreneurs but ordinary citizens, citizens who may own a rather valuable property in the form of parcels of land, apartments and houses but who, as a rule, have nothing else in their pockets besides this property. And after pledging this property and subsequently losing it as a result of recovery,
these citizens could wind up with virtually nothing at all and be thrown on to the street. One has to bear in mind, the special characteristics of our society, characteristics relating to the fact that citizens are accustomed to relying on the state to protect them. Remember that although our law provided for the possibility of evicting citizens from apartments, including, for example, for failing to pay their rent, in reality our practice knew no instances in which a citizen was thrown on to the street for not paying his rent or for any other reason. If we were to say today that we will make it very easy to recover the property which they have mortgaged and to throw them out into the street, then I think serious objections would be elicited from very broad circles of our society.

For this reason, in drafting these regulations the legislators and those who drafted the law tried, on one hand, to create some kind of sufficiently effective rules for recovery and mortgages in general, and on the other hand, generally to protect the weak party in these relations, which is very often the pledgor. What is fundamentally new in the Civil Code, which has now made it through the State Duma and is being considered in the Federation Council, with respect to secured obligations and secured lending? I should say first of all that, in general, it offers two new means of securing obligations that were hitherto unknown in our legislation. They are the bank guarantee, which is distinct from the surety. I am not going to discuss it in detail because those who know the regulations governing guarantees developed by the International Chamber of Commerce in Paris can easily imagine what it involves. And the second method hitherto absent in our legislation is the right of creditors to put liens on a debtor's property. We had this right in our legislation as an isolated instance in transportation law: a carrier could put a lien on a cargo until he was paid for shipment. We had this in our legislation on commissions: a commission agent could put a lien on the property of a consignor until he was paid under the commission contract. Now a general rule has appeared - the institution of a creditor's right to put a lien on a debtor's property. But perhaps the most substantive changes in this sphere of the Civil Code pertain to changes in mortgage legislation.

The Mortgage Law that I mentioned and that is in force in the Russian Federation will not be rescinded with the entry into force of the first section of the Civil Code, but it will lose its significance to a considerable extent because of the fact that many of its provisions will be superseded, as it were, by the provisions of the Civil Code. It appears that the law will be repealed once and for all when our parliament enacts a Law on Pledges of real property and mortgages. And it must be said here that the Civil Code contains general regulations on pledges and provides for the existence of three special types of pledges: mortgages of real property, pledges of property in pawnshops, which may not be of much interest to this audience, and pledges of goods in circulation.

For the first two, the Code provides for the publication of special laws in a supplement to the Civil Code. The Mortgage Law is being drafted by one of the State Duma committees. The Pawning Law is not being drafted as yet, but it will obviously be a comparatively minor law.

At the same time, although the Code provides for the creation of these special laws, it also contains certain special norms relating to mortgages of real property and relating to pledges of property in pawnshops. Needless to say, of the greatest importance for pledges, secured lending and pledges relating to the field of entrepreneurial activity are pledges of real property and mortgages. This is the most serious type of security, the most serious type of security for a loan for a long period of time. And it must be said here that the Code makes some changes in the concept of real property per se that was already contained in our law and in the 1991 Fundamentals of Civil Legislation. In addition to the concept contained therein, a concept that includes land and everything that is firmly attached to it, the Code explicitly classifies sea-
going vessels, aircraft, and inland-water vessels as real property subject to state registration. Although you understand that from a purely physical standpoint these objects are moveable property, from a legal standpoint the law classifies them as real property.

Furthermore, when the Code discusses what kind of pledges are subject to registration, it says that mortgages of real property are subject to registration. In doing so it changes the provisions of the Pledge Law, which, in particular, provided for the registration of all vehicles. This will no longer be the case. Only mortgages of real property, including the vehicles that the Code itself declares to be real property, will be subject to registration.

The Code establishes a foundation for the creation in the future - I repeat: the creation in the future, not today - of an effectively functioning system of registration of real property and transactions involving real property, including, of course, secured transactions. There is a special article that provides for the creation of such a system. It is Article 131 of the Code, which says, in principle, that a unified state register of real property, a computerised register, is to be established in the country; this register will make it easy to obtain relevant information from any place in our country. The intention is to assign this registration function to legal agencies and judicial bodies, because the registration of transactions can be properly carried out only by people with legal training. This is not a question for today, and the law introducing the Civil Code preserves the existing registration system until such time as a special law on the registration of real property and transactions involving real property is enacted.

In discussing pledges of real property and mortgages, we must mention several special rules that regulate the question of mortgages of land lots and of buildings and structures on land lots. Rather complex conflicts can and will arise here, conflicts stemming from the fact that the owner of a land lot can mortgage only the land lot, and a mortgage agreement might not include a building on such a lot; or, on the contrary, conflicts stemming from the fact that the land lot itself and a building on it may belong to different parties. Article 340 of the Civil Code deals with such conflicts and sets down regulations as to how such conflicts are to be resolved. It establishes one regulation that is imperative in any case.

This imperative rule stipulates that a mortgage of a building or structure is impossible without a mortgage of the land lot or at least of the portion of the land lot on which the building is located, the part that functionally supports the capability to operate that building or structure. If the owner of the building or structure is not the owner of the land lot, then the right on the basis of which he uses that land lot must be pledged. In other words, the law precludes, from the outset, the possibility of pledging a building suspended in mid-air. As concerns mortgages of land lots, the law proceeds from the premise that, in principle, unless the parties have agreed otherwise, the mortgage of a land lot does not presuppose a simultaneous mortgage of any real property located thereon, unless this is explicitly stipulated in the contract. Upon subsequent recovery of a land lot and where the mortgage agreement pertaining to which says nothing about what happens to the buildings and structures located thereon, naturally the question of what is to be done arises.

The Code gives an answer to this question. It says that in such cases the owner of the building or structure retains the right to use that minimal part of the lot that is essential to the functioning and operation of that building and structure. This should prompt all creditors to take a very careful attitude toward entering into pledge agreements and mortgage agreements on land lots, in order not to leave unresolved the question as to what happens to the buildings and structures located on that land lot. Naturally, I am setting many things forth in what is perhaps a far more primitive way than the manner in which they are actually established and
set forth in the law, but the shortage of time simply does not allow me to do this in greater
detail.

The Code deals with issues of recovery of property pledged as collateral in a way that differs
from what is said in the current Pledge Law. Today, as you know, the Mortgage Law says that
recovery of collateral, in the event of default on the respective contract or lending agreement,
is possible only on the basis of a court ruling. This provision, which was originally included in
the draft Civil Code, too, was the subject of very animated discussion and debate among both
our own specialists and practitioners and our foreign experts. And in the end, it was decided to
disperse with it to a certain extent. The Code now takes a different approach to recovery of
collateral, depending on whether the collateral is real or personal property. As concerns real
property, the legal procedure for recovering collateral is basically retained. However, an
exception is made: The pledgee (the creditor) and the pledgor (the debtor) may agree, albeit at
the stage when grounds have already arisen for recovering the property, that the recovery will
be carried out without recourse to the courts. And I think that such agreements are quite
realistic, because recovery entails additional expenses, and these additional expenses will
ultimately be borne by the pledgor, because they will be retained from the proceeds from the
sale of the pledged property.

As for personal property, the Code takes an even more liberal approach. It says that recovery
is to take place on the basis of a court ruling, but only if the parties have not agreed otherwise.
In other words, for all practical purposes an agreement pledging personal property, which
today can be motor vehicles, railroad cars, or any kind of equipment, may form the outset
stipulate the condition that recovery of such property can take place in a manner bypassing
judicial bodies without the involvement of the courts.

And there is another clause that, strictly speaking, may not have been legally necessary in the
Code, but provides a certain direction in this respect, with respect to the recovery of personal
property. This clause states that in the case of recovery of personal property that was
transferred to the pledgee, in such cases, recovery may be carried out in a procedure stipulated
by the pledge agreement, unless the law establishes a different procedure. There is nothing
else fundamentally different from what I talked about, but such a clause was nonetheless
included in the Code.

Finally, we have to mention one other thing: the sequence of satisfaction of creditors' claims is
a matter that is also resolved unsatisfactorily in current legislation, because it is dealt with in
civil procedural legislation, legislation that, as I said, has unfortunately not undergone any
changes. If you look at our Civil Procedural Code and see how it establishes the sequence for
creditors to recover their loans, you will see that the state holds one of the first places. In
practical terms, if this sequence is observed, nothing will realistically be left for the creditor
once the state has taken all the taxes due to it and collected all the payments to off-budget
funds and perhaps many other things. We have now tried to solve this problem in material
law. It is addressed in two articles of the Code and relates to instances in which the property of
an individual entrepreneur is being recovered and instances in which the property of a legal
entity is being recovered; and here the sequence is somewhat different.

First come those who have a right to obtain compensation for damages caused to life or health,
which is to say people who have the right to receive money on account of loss of a
breadwinner or who have sustained an injury themselves on the job or as a result of some
other accident. Second are those who have a right to obtain wages. This is a rather large
category, but we cannot push these people down to some lower rank in this sequence either.
At some point, perhaps, with a change in our society's mentality, such changes will be made,
but today this is impossible. Third place is held by pledgees; pledgees have third priority. At the same time, you will understand that people ranking first and second may be absent; in any case, the number of people falling in the first and second categories could be very small. And the state ranks only fourth. This is a very substantive reform of the sequence for satisfying claims. The state and its taxes and other payments due to it come fourth.

I have spoken very briefly about the changes that have now been made in the Civil Code in order to secure loans and secure obligations. There are other changes as well. In particular, there are very detailed provisions relating to instances in which a pledgee has the right to prepayment, to early execution of the loan agreement, when he has the right to early execution of the loan agreement and early recovery of the property pledged as collateral - meaning immediately - without waiting for the expiration of any time period under one or another agreement.

There is also a large number of other regulations that merit attention, but, in conclusion, I would like to mention one circumstance that is of significance to this audience. Having broken up into a number of states, each of us has begun to fashion our legislation independently of one another. We continue to attempt to fashion our own legislation without looking at what our neighbours are doing, including in Russia, without looking to see what is being done in Ukraine, in Belarus, in Kazakhstan or in Georgia.

For example, Russia has drafted four or five draft transportation regulations, including a draft set of railroad regulations that was drawn up with absolutely no regard for what is being done in the neighbouring states. And I find it very interesting to think how our Ministry of Transportation or Ministry of Railroads would operate if these Russian railroad regulations were to take effect. Fortunately, to a significant extent, we have been able to preserve a unified transportation network, due to the fact that uniform transportation legislation is in effect.

We have also begun drawing up our own legislation on secured lending agreements, and our own mortgage legislation. Fortunately, we have come to our senses rather quickly and founded some necessary institutions. One of them is the Inter-Parliamentary Assembly, which has taken up the question of harmonising this legislation. We have made a number of positive steps in this direction. Specifically, a few days ago, the Interparliamentary Assembly approved a model for the first section of a Civil Code for the Commonwealth countries, a code that would be drafted with the participation of virtually all the Commonwealth countries, and, I might add, very active participation of the Commonwealth countries. The Inter-Parliamentary Assembly's plans for the beginning of next year include the drafting of a Model Law on Pledges of real property and mortgages. And in relation to this objective, this conference has been convened with the active support and assistance of a number of authoritative organizations.

Naturally, all that will be said here must be taken into account and utilised in drafting the Model Mortgage Law, the drafting of which will commence in the very near future. Thank you.

Valentin Borovtsov,
Borovtsov & Salei, Minsk

At the start of the conference it was said that it is very important that representatives of legislative bodies and the scholarly public, as well as practising legal specialists, are taking part in this forum. I do not know to what category I should assign myself. The fact is that I
was a public servant for 25 years, having worked in the Council of Ministers and the Supreme Soviet, then as director of the Institute for so-called Legislative Issues in the Supreme Soviet. That institute has now been renamed and has assumed a new look. For the past six months I have been a practising lawyer in the sense that I have established my own private law firm. And so I do not know that this will be a synthesis of my perceptions of our legislation; it may be rather eclectic. It is up to you to judge.

The law was enacted sometime in late 1993; in other words, after the Russian law, as is often the case in the former Soviet republics, and I cannot say that it is drastically different from the Russian law. In the same way, I cannot say that there is a Ukrainian or Kazakh law that has major differences vis-à-vis the Russian law and our own law or that those laws have any sort of fundamental differences: for example, differences that would alter the concept of the legislative act in question although, of course, there are quite a few distinctions.

The materials you have received in your packets contain an article that I wrote together with Mr. Eugene Sullivan, an American attorney, on a comparative analysis of the Belarus Mortgage Law and its Russian and Ukrainian, and to a lesser extent Kazakh, counterparts. It is true to say that the article underwent some rather strange metamorphoses. It was written in Russian, translated into English, adapted to the English, or American, to be more precise, consumer, and then translated back into Russian, with the result that it may have suffered in some way.

I would like to point out that the law took effect on April 1 of this year and for this reason we do not yet have extensive legal and arbitration experience with it. Property is mortgaged primarily for the purpose of obtaining bank loans, and transactions use such forms of secured obligations as pledges rather infrequently. It is clear that the difficulties in applying the document in practice lie not only in that it was perhaps drafted without due regard for foreign practice, and perhaps without proper adaptation of such foreign practice to our economic conditions, but also in that these economic and political conditions per se and the social and psychological atmosphere in our Belarus society are not conducive to the full enforcement of this law.

Let us put it this way: The Belarus privatisation programme is unfolding in our country at an extremely slow pace. For this reason, at least 80% of all property remains state-owned today. Under our legislation, and this is also apparent from other legislation including Russian legislation, the provision and transfer of property as security is possible with the consent of the owner.

With respect to state property, the situation is as follows. For property under the operational administration or economic jurisdiction of enterprises, virtually all real property, enterprises, buildings and structures, and now vehicles as well, may be mortgaged in the same procedure in which they may be expropriated. In other words, either with the consent of the Council of Ministers in certain cases, or with the consent of the Ministry of State Property and Privatisation, or, with respect to more minor properties, with the consent of the ministry in question. You yourselves understand that if the director of a state-owned legal entity wants to mortgage something as security, he will face the rather complex problem of obtaining the required authorisation. Whereas a plant director, for instance, may be interested in entering into some sort of agreement and obtaining a loan by assigning or pledging his property, the same cannot be said in the same measure of a ministry official, for example, who will be concerned with making sure that if the property subsequently leaves the possession of the state, nobody is going to reprimand him.
We must point out another circumstance as well: Our law stipulates that a large number of types of property may not be pledged. Specifically, these are types of property that may not be privately owned in general but can only be state-owned. These are types of property that are not subject to privatisation, at least in the foreseeable future, and types of property that are of cultural, historical or other value. Strictly speaking, it is quite normal that the state be concerned with making sure that types of property of historical and cultural value do not become objects of buying and selling. But when our law contains the words "other value", something that, as far as I recall, is not mentioned in the Russian law, this bothers me very much. This gives the Cabinet of Ministers grounds, legislative grounds, to include on this list any type of property that, from its viewpoint, is very valuable and of interest to the state. This naturally limits the sphere in which pledges can be applied.

These fears may be somewhat unfounded. When the government adopted the list of types of property that may not be pledged, in particular on the grounds that they are of special value to the state, it did not go as far as I had thought it might, and without giving the matter a lot of thought, it wrote the following: arms, weapons, ammunition, property belonging to the empowered ministries, and, in a kind of gesture to the cultural sphere, any palaces and club facilities that are maintained at the expense of the state, and collective-farms, state-farms, and all kinds of others. In other words, this was the first attempt by the first government. We will see how things turn out.

As I already said, the institution of pledges has not been used on an especially broad scale. In any case before coming here I inquired as to how broad our judicial practice is. Our economic court is analogous to the arbitration court in Russia. Cases involving pledges have arisen at the provincial level. As for the High Economic Court, they are looking at two cases by way of oversight, and these cases have not been heard as yet or resulted in any kind of resolution. It was said here that it is indeed extremely important to establish a system of registering pledge agreements and a system of registering property, in particular real property. This is indeed true, as I have already encountered an instance in which a pledgor and a pledgee found themselves in a very difficult situation in that the property that was pledged, it seems, could not be owned by the pledgor in the first place or could have come into the possession of the pledgor only by dubious means. I can cite one example for you.

Our Defence Ministry decided to sell some property in our border city of Brest. It has some property that it no longer needs, specifically certain vehicles that were important when the group of forces was in Germany and Poland but are now of no particular military interest to the Defence Ministry. And a certain joint venture expressed a desire to buy some of this property. A small amount, costing somewhere in the area of just over $200,000. But since the buyer naturally had no money, it applied to the bank for a loan, pledging, as is often the case in our country, the future property that it intended to buy as security. But this does not necessarily follow from our law. It is our practice that has developed along these lines, that not actual but future property is pledged as security. And so the venture pledged that future property. The venture intended to buy the property, but it began to come to light that property could not be sold or expropriated by the Defence Ministry. This is because the Supreme Soviet, and there is also a problem here with timing of a few days imposed a ban on the sale of any property of the Defence Ministry for a certain period of time, since embezzlement had assumed broad proportions. And now the bank has lent just over $200,000 in a secured transaction, but whether it will get that money back in the future is totally up in the air.

It is perhaps also in order to speak at some length on our Pledge Law, on the section pertaining to mortgages of land. There are certain differences here between our legislation and the Russian law which stem, in my opinion, from two circumstances. We should say in self-
criticism that the first one is the desire to have a certain amount of national distinctiveness, and sometimes this is done in a somewhat ill-considered fashion, in pursuit of individuality. Secondly, this stems from the fact that the concepts of property ownership and of land ownership generally are very different.

In our republic, private land ownership relates exclusively to land that is actually being used by a citizen. Today this means farming plots, dacha plots and parcels of land of limited size that are leased by private farmers. And one can pledge only this kind of property, which is to be transferred to the ownership of citizens, but by no means all of which has been transferred because the state legislation for land ownership have not been issued yet. There are two other special features.

First, a parcel of land may be mortgaged only for a bank loan and for no any other purposes except a bank loan. Second, since the number of owners is limited, it becomes very difficult to implement later such a mortgage agreement. For example, one cannot sell a parcel of land to a foreign enterprise, because under our legislation foreign investors do not yet have the right to hold property or to buy land. Sale to a legal entity is impossible, because in our country, under our laws, legal entities do not have the right to own land. Nobody knows at what price, or whether they will want to buy it. Second, selling it once again to a citizen, and again, with preservation of the original value of the parcel of land.

As concerns preferences, or the sequence for satisfying claims to the recovery of property if the debtor has property. We have a rather curious procedure. There are five differences between our order of preferences and other ones; they are reflected in the Civil Procedural Code, which is roughly similar to its Russian counterpart. Our second one is reflected in the law on enterprises.

William Atkin,
Managing Partner, Baker & McKenzie, Moscow

By way of introduction, this is a very intimidating moment in my life. I feel much like a first year physics student giving a lecture on the law of relativity to Einstein. Many of you are of long term practices and are very well known in the area of secured lendings and secured transactions. I am very much a novice, I think that part of the reason I was asked to participate was so that I could share the experiences of a practitioner who is involved in the day to day discussions with clients over these concepts about whether they should lend or not lend and what kinds of securities they can obtain or not obtain in Russia.

Now, by way of introduction, let me tell you why I am so intimidated. There are two books that I carry with me around the world. I practised with the firm Baker & McKenzie in Venezuela for two years; I lived and practised in Taiwan for four years; I have now been in Russia for this my third year. The two books that I carry with me each move: one is the Code of Professional Responsibility; those are the rules that govern the ethical behaviour of lawyers; the second book is a hornbook on the UCC, the Uniform Commercial Code. Last summer Professor White was here and was working with one of my colleagues in the USA and had to go to the embassy to execute an affidavit for an expert witness in the United States. I took occasion to send my hornbook with the paralegal that was working with them so that he could autograph it. It is one of my prized possessions in my office.

I was not quite sure how best to approach this subject because this is just Russia, I call Russia the land of good news and bad news. As an example, this morning the good news was that we
had water in our apartment, the bad news that it was not hot. The good news is that, yes I have
been involved in secured transactions with clients in Russia, the bad news is the security was
always taken off-shore. The good news is that there is security law in Russia, the bad news is
that it is very under-utilised if utilised at all. And I thought that vis-à-vis what I could share
with you this morning as a practitioner would be to talk to you a little bit about my
observations as to why, to date, people have been reticent to rely too much on Russian
legislation, why they have been more pleased to arrange their securities off-shore and then,
share with you a little bit my hope and expectation as the law has developed and is
developing. I think that during the rest of the conference you will have plenty of opportunity
to focus on the details on Russian legislation and legislation of some of the other CIS
republics, so this morning I'd like to give you an overview of some of the difficulties and the
efforts that are going and have been made to resolve those difficulties.

As I mentioned to you, the secured lending that I have been involved in with our clients - and
we represent multi-nationals engaged in business transactions here in Russia - the security has
always been taken off-shore. There are many reasons for that, but primarily the reason is a
lack of confidence or comfort in the existing legal system in Russia with respect to secured
lending. The transactions are essentially set up as follows, and it requires approval of the
central bank in each case, but the lending has been to companies, both equipment lending and
project financing, who have some kind of stream of hard-currency revenues outside of Russia,
and the security has always been by way of assignment of those revenues into some type of
trust or escrow account which is then governed by the laws of some other jurisdiction. And
that has been the model that has been used to date in almost every transaction that I have been
involved with. Now why have they not used Russian law, why have not they been comfortable
in basing their security here in Russia.

Our law firm has been engaged the last four or five months working with the city of Moscow.
The City of Moscow is very interested in trying to tap into international financing and using
the many properties they have in Moscow as a way of securing those loans from international
banks. We were approached to examine what structural changes needed to be made in order to
enhance the prospects of putting in place some type of lending programme against city
properties. There are a number of issues, and I will not bore you with all the issues. In
summary there were four or five areas that were identified as problem areas with respect to
implementation of any such lending programme.

The first are essentially all the problems still dealing with ownership in the Russian
Federation. What is interesting is that this aspect does not go at all to the Pledge Law, the
mortgage provisions. These are more underlined fundamental issues that have been focused
on. In spite of the new constitution, in spite of Decree 2278 of last December, there are still a
lot of open questions in respect to ownership. Among those include the classification of land
usage, which has by Decree 2278 been abolished but not replaced. Likewise the questions in
respect of foreign ownership still exist in spite of the revisions under Decree 2278 and in spite
of the new civil code provisions, there are still many open questions in respect of foreign
ownership, and last but not least, with respect to ownership of land, is the whole area of clarity
of title.

How do you establish a clean title with respect to real property in the Russian federation?
Closely connected with the issues of land ownership are issues with respect to the Pledge Law
itself, and that goes to registration too. The biggest difficulty most lenders have encountered
with respect to whether or not they would be satisfied with pledged assets under the Russian
Pledge Law goes to registration, particularly with respect to moveable or personal properties.
And finally, one of the issues that most concerns our clients is the enforceability of their rights in the Russian legal system. Now as I step back from having said those things very quickly, it is very apparent to me that not only do we need to focus on the Pledge Law and how to implement the Pledge Law, but we cannot forget that the Pledge Law is an overlay, it is an overlay on top of ownership rights, it is an overlay on top of judicial enforcement and judicial relief. Those areas have to be focused on and processed or progressed simultaneously with pledge rights.

When I first moved to Russia several years ago I had a meeting with the president of the Russian Bar Association. It was a very interesting meeting as we were discussing co-operation between several of the bar associations in the USA and perhaps the bar association here in Moscow. We were talking about the development of law in Russia, commercial law in particular. He made an observation which I thought was quite insightful, he said we are building a new legal house in Russia, he said but we have started with the roof and now we are going back to the foundations. What he was referring to was the number of statutory schemes that have been adopted but the lack of, and not the lack of effort or focus, but the failure, or less than failure but just the time that was required in order to go back to the very foundations of any legal system.

Now again the good news and the bad news. The good news is that Russia has worked very hard and the new Civil Code is giving the foundations that are needed to support the roof that is in place. There may be some patchwork that needs to be done on the roof, but now the foundations have started to be built up. In addition to the new Civil Code, the city of Moscow has been active in trying to implement the Pledge Law and this Fall they have implemented a system of registration for pledges. That is very good news, and taking that in conjunction with the new Civil Code I think you will see a lot more interest in the possibility in using the Pledge Law in Russia as a means for secured lending. In addition to those areas we are hopeful that there will be continued reform with respect to ownership and continued reform, and education in respect of the judiciary and judicial enforcement of individual rights.

There will also be a continued effort in understanding how to perfect your security interests under the Pledge Law and under the new Civil Code. The new Civil Code has established something that will be very helpful. It has opened the possibility of enforcement of a pledge without the assistance of a court, and I think that will be tremendously valuable with respect to the possible reliance on the Pledge Law now for secured lending.

I want to conclude very briefly. I was thinking about the origin of the term security, secured lending and if you trace it back it is simply comfort. Security and comfort are comparable terms. We need to give from a lawyer's point of view our business is to give our clients comfort that their legal rights are protected, and it is important that the law provides that comfort. Our clients want certainty and comfort with respect to ownership. Our clients want certainty and comfort with respect to the registration and priority they obtain in pledged assets and mortgages. And our clients want security and comfort with respect to the enforcement in the judicial system. Once they obtain that comfort, the confidence that they will start lending, and they will start relying on the Pledge Law. Russia has gone a long way, the Pledge Law is a modern law, it is a progressive law and all of the efforts that have been put in since the implementation of the Pledge Law gives us great comforts as practitioners in this area that our clients will now and in the future be able to rely much more on the laws as they are developed. Thank you for your time.

3. Secured Lending in Russia and the CIS in Practice
I will take only about ten minutes of your time to tell you something that all of you already know. I do not think I am going to be sharing any tremendously new things with you. It is very difficult for me to imagine a situation in this room over the course of the next two days where somebody will get up and say "No! No! No! I don't think we need a secured lending law and we don't need a juridical system that provides for enforcement of that law" and so on and so forth. I think there is unanimous agreement that we need it and we need more of it. The question is only how to get there? Being a customer of the legal system, more so than a contributor to it, I will just try to tell you what we are doing, what we are thinking of doing and what it will take for us to get to the point where we will do that. So I will try to answer all of those questions.

First, what are we doing now in terms of secured lending in Russia? The short answer is not much. As Bill Atkin said there is plenty of secured lending going on but the security is collateral taken off-shore. I will leave that to the side and just focus on the security being taken in Russia. The reason why we are not doing a whole lot is not because we were not offered or asked to do secured lending in Russia and offered collateral. We have been offered everything from real estate, intellectual property rights, to more innovative things such as animals, municipal property in various remote areas of the country and many other things. We are, at this point in time, obviously not able to do a whole lot of that for a few basic reasons which all of you know and the speakers who were here before me have already outlined.

Second, what would we like to do in terms of secured lending in Russia? We would like to do a lot of things, and I will go through a few examples and tell you why. First and foremost it is real estate. Let me tell you one thing that I have repeated many times to many people who visit us here. If you are a banker and you drive around the city of Moscow, what is the difference between Moscow and driving through the center of London, Tokyo or New York? The big difference is everything you look at in London or New York is debt, in other words, everything you look at has been mortgaged to the hilt, and most of it is security for the banks who have provided the financing. If I drive around Moscow all I see is equity, unencumbered assets: unencumbered assets to me mean borrowing power. Borrowing power, provided that there is some basic legal infrastructure in the place which would enable me to lend. You may say, "well this property is not worth a lot." I do not know what it is worth, probably per square meter a fairly small number, but I can sure see a lot of it, and that makes me excited about the possibility of doing that at some point in time in the future.

Maybe I can tell you a little about the institution that I work for since you may get a sense from that why we are excited about real estate. In addition to being the largest American Bank and the most international of any bank with presence in 95 countries in the world, we are also the largest mortgage lender in the United States the largest real estate lender. (The experience of the last few years of the real-estate market in the USA makes that number not necessarily a thing to brag about, but it is a fact.) We are rapidly on the way to becoming the largest mortgage lender in emerging markets. We are extremely excited about our housing programmes that we have introduced in Malaysia, where we have provided, for the first time in the history of their country, a one-stop shop for people who are buying basic town-houses.

We would finance the developer, provide a construction loan for the developer and when people were coming to buy the town homes, next to the kitchen and the refrigerator when they were looking at moving into this house would be a bank officer who would take basic
information about their income level and their other financial data and they would fill out an application on the spot to finance the purchase of their home. Prior to us doing that in Malaysia there was not any residential mortgage lending in Malaysia. I am told it is now a mortgage lending boom and a whole lot of middle income young professionals are taking advantage of it. That is what we would like to do here.

We are also the largest shipping bank in the world. We are one of the largest lenders to the aircraft/airline industry. We have a multitude of different leasing operations which are in the process of being expanded internationally, basically taking some of the same concepts to other markets. And we would like to do all of that here.

What we need is a few basic things that would enable us to look at the credit and not have to worry about our ability to recover the assets that are supposed to be securing the loan. What are those basic prerequisites? Again, I do not want to repeat what previous speakers have already said, and I am sure it is going to be repeated many times over the course of two days, but there are two basic things as far as we are concerned. Not all of you are lawyers, but most of you are. All of you have to tell me that the legal system exists that protects the right of the creditor to take the collateral and freely dispose thereof. That is precondition number one, prerequisite number one. Prerequisite number two is precedent. We need to see that the courts have gone through the process of actually acting and awarding the right to the creditor that is written in the law. The letter of the law is one thing, the way it actually works in real life is another thing.

In emerging market environments, such as Russia, it is extremely important for us to see that there has been a precedent where the things are being tested in practice and in fact work. We are not necessarily interested in being the first people to make a mortgage loan in any particular market. What we are interested in is a large, or potentially large market so we are not interested in being pioneers or being at the front edge of the sophistication. We will wait until we see what happens in a few cases where if there are five people who have managed to register the right to a particular piece of a real estate as was quoted in the papers recently. We will wait to see what happens to that and based on how the courts have dealt with that particular situation we will make our decision when it is the right time for us to be doing something.

The final comment that I would like to make is just an atmospheric type of a comment. Why is it important for Russia to have the right system in place because to have it only for its own pool of savings does not attract any money into the country from other pools of savings then yes, you have achieved something, but what is the point? In other words, you set everything up and nobody comes to the party. The purpose of it is that the one thing institutions such as us and many others that are looking at the same things can bring to Russia is size. If there is a real estate market that works and provides us with what we need to be able to do business in real estate lending, it is not an issue for my institution, if it makes that business decision, to have three or four or five hundred million dollars of real estate assets within six months or one year. We like size, we love size, because we are a large institution. That is precisely what we are looking for. So what we are talking about is not to set it up so that we able to do business in order to do 10 or 20 million dollars worth of real estate loans in this market. What we are talking about is if it is way that satisfies our requirements is a quantum leap in terms of savings of other economics which we are collecting around the world as deposits, being channelled into this market is able to provide high returns with acceptable risks for those savings.
So the purpose of the exercise is not just to set something up where nobody will use it. We will use it if it exists; we are very interested in using it the moment it exists. We look forward to efforts such as this to create the critical mass that will enable us to do it. As I said, I do not need a system of effective registration of property rights. We all understand that but there needs to be a critical mass that makes things happen. I hope that this gathering is going to be one of those things that bring that critical mass together and we get what we need to be able to do secured lending business. Thank you very much.

Melissa Schwartz,
Chadbourne & Parke, Moscow

I have been practising law in Moscow for a little over two years and one of the first transactions that I worked on was a secured financing for a joint-venture. What I would like to do in the next 10 minutes or so is to highlight the issues that we had to look at in that case and every case since then with respect to secured financings. These are the questions that we need to answer so that people like you will feel comfortable dispersing the funds for the financing.

The first thing that we look at is the establishment of the lender. If, as was the case in this first financing, it is a joint-venture formed under the old Soviet rules we check to see if it is still validly existing. If it is a new kind of entity that was formed in the last two years, a limited liability partnership or a joint-stock company we look to make sure that company legally exists as of the date of the loan. We look at the shareholders in the country. Many of the Russian partners in the joint-ventures of today are former state enterprises, and it is important to make sure that they were privatised properly. We check to make sure to the best that we are able that these companies are in good standing today. In order to provide some level of comfort to the lender, we look to see where the control is in the company, and look at the management structure. This is an issue that we will be discussing in greater detail tomorrow.

When a Russian company is going to receive a loan in Russia today, especially a hard currency loan, licensing issues are raised. In order to take out a hard currency loan that is going to have a term of more than 6 months the company is going to have to go to the Central Bank and obtain a licence. Depending on the activities of the company they may also have certain operating licences. For instance, if it is a telecommunications joint-venture they will be likely to have a licence from the Ministry of Communications. Part of what we look at is how strong the licence is today, and then the lender is always asking: "If we take over the company in the event of a default, what is going to happen to the licence down the road?" In most cases, especially in telecommunications and other industries, the licence is not transferable. It stays with the borrower and in that case many lenders have been asking for a pledge of the shares of stock of the company. That raises another interesting issue: if the borrower is a limited liability partnership the interests that are owned by the shareholders are not securities so there is not yet a system for registration of those interests. If the borrower is a joint stock company, then the stock is a security and there should be a means for registering the pledge.

On several transactions that we have worked on with the EBRD and other lenders, we have gone down a laundry list of security that the lender has requested. The Law on Pledge works very well with respect to what these lenders are asking for. The law specifically permits the pledging of most of what they are looking for. For instance, the enterprise as a whole is usually at the top of the list. The law allows pledge of that asset. The pledge of a leasehold interest, or other major contracts, also may be pledged. Receivables, a negative pledge on all assets, all future acquired property can all be pledged to the lender under the Law on Pledge. Tomorrow we are going to try from different people's perspective to go through a case study.
highlighting most of the issues I have just raised for you to determine how, under Russian laws today, we can create valid security interests so that the secured financings can continue. Thank you.


Allan Farnsworth,
Alfred McCormack Professor of Law, Columbia University, New York

FUNDAMENTALS OF PERSONAL PROPERTY SECURITY

Who among us has never felt regret at having made a promise? Suppose that I am a manufacturer and have promised to pay you a hundred thousand dollars but I now regret having done so because it will be very difficult for me to pay so much. Perhaps at the time I made the promise I was mistaken as to the profitability of my factory on which I based my ability to pay. Perhaps things have changed and hard times have come so that I am now less able to pay. For whatever reason, I regret having made the promise and wish that I were not bound by it. I would like to be able to renege on - to go back on - my promise.

But would I want to be able to renege on my promises whenever I wanted to? Would you have loaned me a hundred thousand dollars if I could not have made a binding promise to pay it back? Seen in this perspective it is to my advantage to be able to make a binding promise - a promise on which I cannot renege - so that I can trade my promises for things that I want in a market economy.

Take the United States government for an example. For much of the nineteenth century the United States government was not bound by its promises because of the doctrine of sovereign immunity. It could not make contracts that were legally enforceable. (If the government broke its promises the disappointed party had to go to Congress and have a special law enacted.) This situation was so disadvantageous for the government that it had Congress enact a law making its promises enforceable in spite of the doctrine of sovereign immunity and creating a special court in which they could be enforced. But most of us do not need such a law: the law of contracts -- like the new Russian Civil Code - gives us the advantage of making binding promises. A system of contract law is therefore a necessary element in permitting me to be a significant player in a market economy.

But though a system of contract law is necessary it may not be sufficient. You may not be willing to lend me a hundred thousand dollars even if I make a binding promise to repay it. If I renege you will have to go to court to enforce my promise. At the end you will get a judgement against me. If I do not pay the judgement you will have to attempt to have it satisfied out of my assets. But by this time there may be other persons to whom I have made broken promises and who have also gone to court and gotten judgements against me. You will be in competition with these other judgement creditors who are also going after my assets. In order to avoid this possibility you may ask not only for my binding promise to repay the thousand dollars but for some security.

You could, for example, simply ask me go get another reliable person to promise to repay the hundred thousand dollars if I do not. Such a guaranty is a common type of security for a loan. But if, on my default, the other person does not pay either, your remedy against that person may be as unsatisfactory as your remedy against me. In a market economy, therefore, you would be likely to think of another kind of security.
Perhaps, for example, I own a machine worth more than a hundred thousand dollars that I use in my manufacturing business: I could use the machine to secure the loan. Such personal property security is regarded as vital to the successful operation of a market economy. In such an economy a system of personal property security law is therefore just as essential as is a system of contract law.

The simplest way for you to use my machine as security would be to take it and keep it until I repaid the thousand dollars. Even for such a primitive pledge the law would have to recognise first, that I was the owner of the machine and, second, that I could transfer to you a kind of limited ownership right so that we both have a property interest in the machine. Thus if I did not pay you, you would have the right to sell the machine to someone who would become the owner of it. But if that person paid, for example, one hundred and fifty thousand dollars for the machine, you would have the right to only one hundred thousand - the amount of the unpaid debt - and I would have the right to the other fifty thousand. The disadvantage of such a pledge is that it deprives me of the use of the machine, which I may need in order to earn the hundred thousand dollars to pay you back. It is therefore in both my interest and yours that we be able to create a non-possessory security interest - one in which you do not take possession but nevertheless have the same kind of limited property interest that you would have if we had used a pledge. A system of personal property security that permits you to take a non-possessory security interest should consider protecting you against five different potential adversaries: (1) me; (2) my unsecured creditors; (3) the administrator of my estate in bankruptcy; (4) my other secured creditors; (5) and persons to whom I might sell the machine.

First, consider me. If I do not repay you, what can you do, aside from suing me in court and getting a judgement? Since I am in possession of the machine, a system of personal property security law should allow you to repossess the machine - putting you in the same position you would have been in if I had pledged it to you in the first place. It should then allow you to sell the machine and use the proceeds to pay the debt, with anything left over going to me.

Second, consider my unsecured creditors. Suppose that it is not yet time for me to repay you, but one of my other unsecured creditors sues me, sets a judgement against me, and seeks to use the machine to satisfy the judgement. A system of personal property security law should protect you against this possibility. But it might seem unfair to shield the machine from unsecured creditors who have obtained judgements if they see the machine in my possession and have no way of finding out about your security interest in the machine. The law should therefore provide a means by which such a creditor could find out about your interest: a system by which you can register your interest in a public office, accessible to all.

Third, consider the administrator of my estate in bankruptcy. Suppose now that it is not yet time for me to repay you but I have gone into bankruptcy, either of my own choice or that of one of my unsecured creditors. My affairs have been taken over by an administrator in bankruptcy who will liquidate my estate to pay my unsecured creditors who get judgements against me if I am not bankrupt, you should also be protected against the administrator who represents unsecured creditors if I am bankrupt.

Fourth, consider my other secured creditors. Suppose that it is not yet time for me to repay you but you discover that another creditor claims to have a security interest in the same machine - claiming to have been given that interest after I have such an interest to you. It may have been dishonest of me to purport to give both of you interests in the same machine. But the question for you is one of priority - which of you has the superior interest in the machine. A system of personal property security law should answer this question, taking into account
the fact that you had a chance to register your interest in a public office, accessible to a prospective secured creditor.

Fifth and finally, consider persons to whom I might sell the machine. Suppose that without telling someone I sell them the machine. Is the purchaser who has in good faith paid the full value for the machine an outright owner, free of your security interest? Again, a system of personal property security law should answer this question, taking into account the fact that you had a chance to register your interest in a public office, accessible to a prospective purchaser.

A further practical problem needs attention. We have been thinking about a machine that is used in my factory - part of my equipment. Suppose that I am not a manufacturer but a wholesaler, of carpets let us suppose. In the warehouse that I rent I have no equipment. What I have is my inventory - what I sell. If I want to borrow one hundred thousand dollars, can I give a security interest in inventory in the same way that a manufacturer can in equipment? There might be two objections to this. First, it could be argued that since giving a security interest involves a present transfer of a limited property interest, I can only transfer what I have at the time of the transfer: this would mean that I would have to make a new transfer each time a new carpet came into my inventory or each time a carpet was sold to create a new account. Second, it could be argued that your security interest could not be valid since you had not only left me in possession of the carpets but had given me the freedom to sell the carpets asking for your permission each time. In order for a system of personal property security to be truly effective, it must dispose of both of these objections.

By now you have probably realised that the system of personal property security that I have described is a simplified and thinly-disguised version of the American Uniform Commercial Code. The Code does all of the things that I have suggested. Indeed it does them so well that it would enable me, with little more than the stroke of a pen, to give you a non-possessory security interest in almost all of the personal property that I own - inventory as well as equipment. And that interest would be good against most of the adversaries that I have mentioned. (An important exception is that your interest in my inventory would not be good against buyers from me in the usual course of my business.)

This extraordinary power to encumber my assets and shield them from my unsecured creditors, both in and out of bankruptcy, has provoked a spirited theoretical debate over the very basis of our system of personal property security law. What, the theoreticians ask, is the justification of such a system? How can I improve my position by giving you a security interest? True, you will charge me less for the loan because you have the special rights that I have described. But once I have encumbered all my assets by giving you that interest, other creditors who know that I have done this will react by charging me more for making unsecured loans because I will have been left with nothing to satisfy their claims if they get judgements or throw me into bankruptcy. So, they argue, there is no benefit to me in a system of personal property security - unless it is supposed that there are some ignorant potential creditors of whom I can take advantage.

To many practitioners, who regard such a system as an immutable fact of life in a market economy, this argument calls to mind scientific studies that show that the bumble bee, with its relatively large body and relatively tiny wings is incapable of flying. But the bumble bee, unaware of this, continues to fly away. And in the same spirit, one can assume that, at least in the United States, the system of personal property security will continue to fly whatever the arguments of the theoreticians.
5. Secured Lending in Market Economies: Law and Practice

James White,
Professor of Law, University of Michigan, Ann Arbor

I am both pleased and honoured but also somewhat humble and cautious to have an opportunity to speak to you. In some ways current Moscow, with the large number of westerners here resembles what must have been the case after the Bolshevik revolution in 1920 and 1921. When it was said that there were many westerners here, these presumably were not capitalists like Allan Farnsworth and I, but the communists and socialists who are still our colleagues back home in Ann Arbor and New York, but no longer come here. In any event at that time it was said by Angelica Belabanov, who was the Secretary of the Comintern, that every westerner who came here fell into one of 4 groups, and these groups were all pejorative: superficial, naive, ambitious, or venal. Now I am certain that I fall into at least one, and possibly two of those, but it gives me some cause to wonder whether or not we who come here and talk about western law in a society which we are comparatively ignorant are saying things that can be adapted without substantial change. Nevertheless, I will fulfill my duty and describe to you some of the attributes of Article 9 of the Uniform Commercial Code which, of course, is the law of personal property security in the United States and which has been copied in a few other places, notably some of the provinces of Canada.

In many ways I think Article 9 of the UCC is one of the great contributions of our private law in this century. It is widely believed to be more modern and more up to date and more novel than much of the personal property law in other countries, even in western Europe and Asia. I want to talk about four or five of the attributes of Article 9 that are thought to be unusual or, at least, were thought to be so in the USA when it was adopted 30 years ago.

First, unlike our law that proceeded it, and unlike the law in many other places, there is a single right, irrespective of the form of the asset that is taken as collateral. Prior to Article 9 there was separate law that dealt with various kinds of tangibles, different kinds of intangibles in each law. Each type of collateral had its own rules, in some cases statutes that were designed for a particular kind of collateral with many ways to get it wrong and with many ways for the creditor to execute the wrong documents, file them in the wrong place, say the wrong things, and thus be found ultimately to have no security interest. Article 9 contemplates and grants a single right called a security interest and, irrespective of the nature of the collateral, so that if I, as a bank, wished to take a security interest in your patent, or your account receivable, or your horse, or tractor I sign the same document, called a security agreement, which will have the same basic attributes irrespective of the type of collateral. It means that one need not be an expert to understand the general idea and to take a security interest.

A second and important attribute of Article 9 is its exaltation of substance over form. It explicitly states that agreements between the parties which are labelled as leases or labelled as consignments, or many other labels, which themselves have the economic attributes of security interests, are treated as security interests and are governed by Article 9.

It is of course conventional to western lawyers that part of the lawyer's role is to discover ways to achieve his or her clients' ends by taking doctrines such as leases or consignments from one part of the law and transporting them to the other in the hope of achieving a certain end, while not suffering the consequences of executing a security agreement, for example. Article 9 is unusual in American law in that it disregards to a considerable degree the form of the
transaction and encourages the courts to look at the substance, and if the substance is a security agreement it is treated as a security agreement: so that is a substantial innovation in our law.

The third innovation in Article 9 is the simplicity of the documents. I can give you a security interest in my car by writing a single sentence on the back of a scrap of paper. There is no need for a notary to notarise my signature, there is no need for magic words, words of grant, or words that describe this as a security interest. It can be done very simply with simple documents.

The fourth quality is the filing system which has grown up and was installed as a result of Article 9 in the various states of the USA. As Professor Allan Farnsworth said earlier, those are elaborate and they are an important part of our system. There is, of course, some debate about who uses the filing system and about its necessity but I think most American lawyers and scholars would say that it is important that the users of the system confine filings and can put filings where there is confinement. With the revision of Article 9 in the USA, there has been recent consideration of changing that system and of using the power of electronic data storage and transmission.

For example, it is now possible in the state of Louisiana to make a filing in any of the parishes in that state that will be transmitted to the state capital, and can be retrieved from any computer terminal in any county or parish within that state. It is now possible in the USA, through some of the computer networks, to search the files in some of the states from a remote place by computer. And over the next few years I am sure we will see dramatic developments in data storage and data retrieval applied to filings under Article 9 of the UCC that will enable subsequent parties, buyers and lenders, at one place in the USA to discover all the filings with respect to a particular debtor. Needless to say there are some interesting problems here. For example, I suppose these Danish Hackers that got into the USA Weather system recently might cause a little trouble if they erased all the filings in the state of Nebraska overnight. So electronic data storage will bring with it some interesting problems, but it also offers interesting possibilities that I think are now going to be enjoyed in many if not most of the states.

The fifth attribute of Article 9 is that it says nothing, or almost nothing about default. The matter of whether any event constitutes a default is a matter of contract between the parties.

However, the sixth difference from traditional security law which to some extent with respect to personal property is reflected here in Russia, is that there is self-help repossession permitted as long as there is no breach of the peace and private sales are contemplated without the interaction of a court. The drafters of Article 9 believed, and I think correctly, that involving a court in a sale of a commodity after it has been received, does not necessarily improve the quality of the sale or raise the value that is recovered, and in some cases diminishes it because it takes time and to go through a court proceeding substantially increases the transaction costs.

In summary therefore there are four or five unique attributes about American personal property law. One is that the single device, the single security agreement, or security interest, covers all forms of commodity. The second is the substantial reliance upon public filing. And finally there is the private nature of the sale which is permitted and the private nature of the general process of realisation of the collateral after default.

Let me echo some of the things that have been said this morning by other speakers, particularly those who spoke about building the roof without having the foundation. Article 9
depends in many ways upon our economy, upon our court system, and upon our filing system, and other methods of records. Taking security is of no use if there is no market for the collateral after it is sold. Therefore, until a market exists for a particular commodity in Russia or in any other state, one wonders what the value of security interest is. So that it seems to me that a system of personal property security depends first on the existence of a market for the commodity in which a security interest is granted.

Secondly, of course, it depends to some extent on a system of priority that needs to be granted by law or somehow facilitated possibly by a filing. Americans place considerable weight upon the filing system. I realise that certain of the western European countries have a much less elaborate filing system and yet they have personal property security systems that work quite well so I hesitate to say that a filing system is necessary though an American would have to be convinced otherwise.

And finally, of course, a system like this depends upon a court system that is accessible and reliable in enforcing the rights of the creditor against the debtor and the rights among competing creditors when there is a dispute about the collateral. And I take it that it remains to be seen exactly how the collateral law which will soon be the law of Russia will be interpreted by the courts in Russia.

I conclude therefore with the acknowledgement that as I come as someone who is naive about the Russian economy, but in my naiveté at least I am hopeful that the new law drafted by Professör Makovsky and the members of his committee will ultimately lead to the development of a sound and effective system here in Russia.

Jan Hendrik Dalhuisen, 
Executive Director, IBJ International plc, 
Professor of Law, University of Utrecht

Let me begin with a confession. I have been active in this field of secured transactions for over 25 years as a scholar, a practising lawyer and a banker and I am not sure that after all that I am a great deal wiser. The reason is that there are in Western Europe, even within a small area, very different systems of personal property security operating quite happily side by side. There is very clearly no particular wisdom in any one of them. Apparently, this cake can be sliced in very many ways. Local traditions of credit have a lot to do with the end result. I am always surprised how in international negotiations practising lawyers seem invariably very happy with their own product and normally think it far superior to all others. Clearly, no one can disown completely where he comes from and everyone works in a given environment. Yet there seems no obvious advantage in any system. I say this to reassure you and I hope to embolden you where you have the advantage of starting without too much of a background. It seems to be a most wonderful situation to be in.

The consequence of an excess of tradition in Western Europe is that the systems are remarkably dissimilar and are all a product of historical accident. The Germans have developed a system which is substantially derived from case law. In France it is a patchwork, a bit modernised in the last 10 years, based partially on case law, partially on statutory provision. In the Netherlands we used to have a system which was very similar to the German system. We now have invented something totally different which cannot be compared with anything else. Belgium has a system much like France, very dissimilar from the Dutch. The English have a system, again totally different.
This is between countries that export between 30 and 50 percent of their national product across borders and that are apparently quite used to see their charges on these goods go into the mist as they may not be accepted elsewhere, exactly because of lack of familiarity. We seem to be able to live with that. In international financing bankers tend to insist more on early repayment when there is any trouble. They would much prefer to pull their loan early, when there is choppy water around the corner. So I think, and it has been said this morning before, that secured transactions and secured rights often tend to be more matters of comfort. I do not think that any banker would like ultimately to rely on it exclusively, certainly not if the relevant assets are likely to be moved or exist offshore. It may therefore be useful to put securities in context and I do not agree with those who say that all financing depends on good securities laws, although I do not underrate their significance.

If I may to some extent summarise where we are and what we have, I would say the following: in Western Europe by the turn of the century we really only had two types of traditional security in movables. These were the possessory pledge and the chattel mortgage. For the possessory pledge, the key was of course possession, otherwise the arrangement was quite informal. That proved often problematic as to which debt the pledge covered since anyone who had possession tended to keep the secured asset until such time that all debts were paid. No banker or creditor likes to abandon his security if there is still something of any sort outstanding, and there used to be trouble on that score. We still have the possessory pledge for commercial paper and negotiable instruments and that is the area where it is still important, and the same is true for bonds and shares. Otherwise I would think that the possessory pledge has become an antiquated facility. Another reason is that the debtor needs to retain most of his assets for his business. A pledge is then unsuitable as the debtor depends for the financing of these assets on non-possessory security.

Chattel mortgages are the traditional non-possessory securities but existed only in assets which were registered like ships and, in the modern times, aircraft. One would create these securities by filing in those registers. It has nothing to do with a modern registration system for securities which is totally differently organised and has a very different function.

With this very limited system of non-possessory security, there was a need to broaden the theme in a number of areas. First, there was a requirement to introduce security on claims, monetary claims especially, and therefore on receivables. And this was done in the form of an assignment for security purposes resulting in a collection right for the beneficiary. There is no question here of legal enforcement or foreclosure through courts. What this type of security is trying to do is to give the lender a collection right ahead of the owner of the claim. So it is really a collection facility in which the debtor postpones himself but which has also some third party or proprietary aspects if the same receivables are assigned several times and a collection priority must be established between the various assignees.

Then there was a need for more non-possessory security in assets. So there emerged the reservation of title in sold goods. It became popular in Western European countries like Germany and Holland, much later in France, where it remained defective until some adjustments were made to the legislation about 10 years ago, and more recently even in England (hire-purchase was practised there earlier). Then came non-possessory security in assets used in the normal course of business, like equipment and inventory. Then there was a need to have security in replacement assets, and also converted manufacturing goods and receivables resulting from the sale, as a form of tracing, and into new replacement inventory. And then banks being what they are, would like to have security in everything else, also future assets of all kind of sorts, anything that may be acquired by the debtor resulting in so-called
floating charges on whole businesses, in the UK even including real estate (which is quite exceptional).

All these modern non-possessory charges were usually best understood as some kind of conditional sale, although eventually some became more like securities particularly in the foreclosure requirement. Only in countries like the Netherlands, under the new Code since the last three years, this security (except for the reservation of title which is still a conditional sale) has taken the form of registered (but not published) non-possessory security or pledge. In France there are individual types of these (nantissements).

In all these countries there is a classical set of problems in these modern securities, with which maybe the UCC in the USA has been able to deal in a more conceptual way, but with which we in Western Europe (even under the new Dutch code) are still struggling and to some of which I should like to devote the rest of this presentation. There is first the need to be able to sell many of these assets in the normal course of business of the debtor free and clear and that can be achieved in two ways: on the whole, one can assume an implied licence to sell in the ordinary course of business or one can protect the bona fide purchasers. This latter approach is more limited as third parties are in trouble where the charge is published. In the end reliance on the implied licence to sell in the ordinary course of business seems to be the more modern approach.

Then there is the fraught question of registration or publication, the reason for it and its effect. There is no European tradition in this. There are, however, in France a number of typical charges which need to be registered with local courts, there being no central system. Germany has no registration system at all. So it goes for most other countries. Only in the United Kingdom there exists a registration system for floating charges in the corporate sphere. In the Netherlands we have a registration system which is not a publication system: it requires registration of all security agreements with a local notary to determine the date of the security so there can be no problem as to the priority and the rank where it depends on the time of the agreement. So there are registration systems in force without publication. If you hear references that the Dutch now have a uniform registration system, that is largely true, but there is certainly no publication. Wherever there is an implied licence to sell free and clear of the charge in the ordinary course of business there would in any event appear less need for it.

So the European tradition remains against publication. We seem to be comfortable with a system that does not provide it and it does not seem to have caused universal harm. All these unpublished securities or hidden charges seem to exist fairly happily in our domestic traditions. Even where there is registration or publication, there is the question of what it is meant to achieve. Is it meant to fix the priority or is it meant for something else? And I mention this because the English floating charge, even though it must be published, does not create any kind of priority. Publication exists there for the general information of the public, but it has no direct impact on the priority status of the charge which becomes only fixed and derives its priority from the moment of default, whilst in the meantime the goods may be sold free and clear of the charge in the ordinary course of business.

Another problem is whether a proprietary right is truly created through these charges. Are they maintainable against all the world or at least against any later charges? Do they provide for a separate execution right? If so, are they subject to foreclosure, that is to say an official court procedure, including an execution sale, which, may itself still be informally conducted? When can the assets be appropriated or collected?
The traditional example of appropriation is in the reservation of title. Reservation of title in all our systems (in Western Europe) leads to appropriation, so if you reserve a title in goods and if the buyer does not pay, generally you simply take the goods back. There might be an unjust enrichment action for anything that has been paid already but the assets return to the seller upon default. The law in the USA is quite different, and the EBRD draft also aims at a system of foreclosure.

What about priority rights which are really less than proprietary rights? French law calls them privileges or preferences. They are often granted by statute only, to persons who have rendered certain services in respect of an asset or to tax authorities or the workforce in respect of an entire estate. There is here no individual right to foreclose; the creditor has to go through, or wait for, an ordinary execution and can only take by priority his slice of the execution proceeds. In bankruptcy, he will have to wait until the trustee takes the action to foreclose or sell the properties which might be several years later and only then the preferred creditor will get his pro rata share of the proceeds. There is therefore no individual initiative possible for the creditor to safeguard his interests up front. This may also be relevant where an otherwise good charge and individual execution right shifts into replacement goods. It is in a reservation of title quite normal to retake the asset it remains non-paid. As I said a moment ago, if the charge goes into replacement goods it might be an entirely different matter. The retaking option may become remote and the creditor might only be left with a preference in the proceeds of any execution sale (especially in Germany). In the meantime, these preferences, not being proprietary charges, do not attach to the goods which may be sold free and clear regardless of the bona fides of the buyer.

Then there is the question of how far one can create charges in future assets. There is first the problem of identification and separation of the asset upon commingling and conversion into other products. That seems to be the simpler part although it is still questionable how far the charge then goes. There is a greater problem with absolutely prospective assets. Can you pledge the harvest of next year, or the year thereafter? Can you pledge future receivables of which the underling contract is not yet in existence? The vaguer one becomes here, the more contingent the charge is going to be and maybe also the greater need for some kind of publication.

I am not sure of this, but it may well be that in Europe we find less of a need for publication, not only because of an implied licence to sell the assets free and clear in the ordinary course of business, but also because we tend to be much more precise in what we require in terms of the assets that can be the subject of a charge. We want them to be determinable, or to be able to be set aside. We have particular problems with the bulk transfer of a whole portfolio of receivables or a whole portfolio of assets present and future which are not clearly defined, and if they are not sufficiently defined than they risk not to be part of the charge.

In Western Europe, we all tend here to be much more restrictive than the Americans would like to be, and maybe that is an additional reason why the American must rely much more on the publication system than we think necessary. So we tend to condense the field in a somewhat different manner on the asset side. There is also a question of identification on the liability side: which claims can be secured? The present debt of course; future debt is less certain, therefore what about any claim you may acquire over your debtor in two or three years time? Here again I think in Western Europe we are somewhat more hesitant than our American colleagues would be; we do not like it. In terms of past debt, perhaps, but we have to guard these against illegal preferences if past debt in this way is being given a priority over existing other creditors. These preferences can normally be set aside as being fraudulent or prejudicial to other creditors.
Then there is the question of the need to re-transfer an asset at the end of the security period when the debt is paid. If, for example, in a conditional sale we have transferred property to the creditor who is subsequently paid, must the asset be re-transferred, or does the property automatically fall back into the lap of the original owner? The issue arises if in the meantime the creditor who took the asset should go bankrupt and can not therefore re-transfer the property. Would that property then be part of the bankrupt estate of the erstwhile creditor and would the erstwhile debtor only be a competitor for the bankruptcy proceeds, or can he still reclaim his asset as full owner? Now most systems have a system of the property automatically re-emerging in the possession of the erstwhile debtor after payment but in Germany there seems to be an exception.

Another question is the ancillary nature of the security, very important if the creditor sells a receivable to a factoring company and is paid for it. The security might lapse as a consequence of this payment and the factoring company would not then have the advantage of the security. There again French law seems to accept that the security subsists with the debt; Dutch law may not.

Then there is the question of, what we call in some countries, the finance sales, of which leasing, factoring and repurchase agreements are examples. Where do they fit? That would be a whole lecture by itself. I can only identify the problems in this respect for these major financial products which have acquired a great deal of importance over the last few years. I would not pretend that I can speak for my American colleagues, but I would think that these financial products also have produced problems in the United States as to whether they fit under the system of secured transactions of Article 9. I myself would say, I have often said this, that where there is no credit agreement proper they should not be constructed as security agreements. Then again we are likely to have conditional sales which are not secured transactions and need to be treated differently. Foremost, there is no foreclosure upon default but rather appropriation of the asset.

Finally, let us go again into the various Western European systems. I can be quite brief now. We do not on the whole have a unitary system in any of the countries of Western Europe. As I said earlier we have basically a fractured system between countries but even within each country the various securities, finance sales or conditional ownerships result from tradition and local cultures. The new Dutch code has tried to do something about this. It pretends a unitary system but it has had to leave out of this system the reservation of title and the hire purchase which are both recognised as conditional sales leading to appropriation of the assets upon default. The status of finance sales is muddled and wholly unclear. Thus we have incomplete and fractured systems everywhere even in the most modern codifications.

I would finally also mention the effect of internationalisation. We cannot avoid within Western Europe, at least not within the EU, the consequences of the internationalisation leading to the enormous movement of goods across borders between countries which are often very small and see a very substantial part of their national products move into other countries. Increasingly it should also have a uniforming effect between all these countries in the area of secured interests attaching to these goods but we have seen nothing of the sort so far, although there have been some faint and unsuccessful attempts within the European Union at some unification some 20 years ago. Our colleague Professor Makovsky earlier this morning mentioned a need, and an opportunity, within the CIS to unify, which I think is very important now that it starts from fresh. We in Western Europe are far away from it. Maybe we will see in practice a more effective movement to unity through the new financial products with their imbedded security interests which are internationalised by concept and which might be
recognised within each of these national systems as becoming the custom of the industry. That may then lead to academic observations about the opening up of domestic proprietary systems, the informal introduction of new proprietary rights, whether these may operate without legislation and whether they can be fitted in the domestic system of securities and priorities. I must leave these modern developments as a question for you. We have hardly started to begin to think about the consequences of this and what it may mean. I am quite sure that in the coming few years we shall hear much more about it.

Ronald Dwight,
Director, IRIS-Poland, Warsaw

The lack of an effective collateral law in Poland is one of the principal blocks to the development of modern finance in Poland and a block to the development of the entire banking system. Anyone claiming that Poland now has a pledge system which, while complicated, is commercially effective is either terribly misinformed or deliberately practising to deceive. The present system precludes banks from obtaining the security they need to make loans, thereby depriving newly emerging businesses of much needed capital. Neither can Poland reasonably expect foreign investment of the 50 billion dollar estimate needed in the next decade with the present collateral environment. This paper will cover first, the bad news - the current state of affairs; second - why this situation has not changed for three years; third, the good news - the excellent proposal which Minister of Justice Cimoszewicz has already distributed for interministerial discussion; and finally, suggest what can be done to help.

1. The Bad News - the Current Legal Situation.

Article 1025 of the Polish Code of Civil Procedure presents the basic picture. If a creditor bank goes through the trouble and expense of a full scale lawsuit, wins a judgement, and the collateral is still around for the bailiff or komornik to seize and sell (and he generally gets 25 cents on a dollar), the proceeds of the sale must be distributed after the costs of the sale as Article 1025 provides. From this it ensues that even if a bank is not a secured creditor, it has the same status as those that are secured. Banks are fifth in line in the best of circumstances. In the case of secured creditors who are not banks, under Article 310 of the Civil Code and 1026 of the Code of Civil Procedure, assuming something is left over after banks get paid, the creditor with the most recent pledge is paid before creditors with pledges made earlier.

The most disturbing thing about Article 1025 is that tax claims, known or unknown, can always erode any collateral, and they do not have to be registered or publicly listed anywhere. And one cannot easily obtain certificates from the tax man that all taxes are paid in full. These are referred to as "secret tax liens," and they are the bane of any investor in this part of the world. The simple notation of a clerk at the Ministry of Finance prior to the sale, even years after a mortgage has been registered, can evaporate a creditor's collateral moments before the bankruptcy court gives final approval to award it to him. In every bankruptcy proceeding, it is a waiting game to see if the tax man will make an appearance at the 11th hour and 59th minute to take all. Recently, a foreign company which had purchased a piece of real estate with the best and most expensive legal advice available in Poland found that two years after the transaction closed, the Ministry of Finance claimed that, since the bankrupt seller had not paid its taxes in full, the title was defective. The buyer is left with a lawsuit against another government ministry which guaranteed good title. Bottom line, every piece of Poland and every object might be collateral for the State Treasury, but it is often impossible to find out if such a lien is there.
The Article 1025 gives priority to banks, regardless of whether or not they are secured creditors. This means that if bank #1 takes a security interest in a debtor's property, and then the debtor gets an unsecured loan from bank #2, in bankruptcy, all banks share equally. Thus any security interest is liable to be eroded if the debtor takes out any other loans at a later date from a "bank."

The lack of a central registry for collateral allowed massive fraud to occur in the early part of the transition to the market economy. Under present law, each bank keeps its own collateral registry. Case studies were prepared for IRIS by the Gdansk Institute of Market Economics illustrating how debtors used the same collateral over at a number of banks, pocketed the loan proceeds, and disappeared in the middle of the night along with the collateral. Bankers, their hands burned by these painful experiences with Poland's collateral law, now routinely demand the only worthwhile collateral - a cash deposit in their bank for 150% of the loan amount to cover principal and interest. Thus, in order to get a loan from a bank, a would be borrower must first prove conclusively that he does not need the money.

2. Why has the problem not been quickly resolved?

A nation's wealth which is widely distributed and enduring is a product of a legal and institutional infrastructure which carefully defines and protects individual rights. Only in such an environment are individuals willing to postpone consumption to save and invest. Legal infrastructures are not changed overnight, but like vast buildings are constructed brick by brick. The transition to a market economy legal infrastructure is a work of decades not years.

Poland began the transition with a legal infrastructure considerably better than most of its neighbours owing to its pre-war legacy. It was easy to incorporate and get going. But now after leaving the starting line, businesses are swimming in cement. Why? Let us briefly examine the legal reform environment in Poland.

The community of top civil and commercial lawyers in Poland and the other former communist states is very small, because for forty-five years or longer the vast majority of law students studied criminal law. The nomenclatura elite needed legions of criminal lawyers to stay in power, not civil lawyers. They already owned everything de facto, and sending the spoils to Switzerland did not require many civil lawyers. Those who studied civil and commercial law in Poland since the war have been a small group although often of very high quality. This demographic reality means that the Ministries of Justice in this part of the world and governments generally are still almost exclusively staffed by the criminal lawyer Krodowisko - and they are not about to give up their positions and privileges without a fight to a group whom they have regarded as peripheral for half a century.

Until Mr. Cimoszewicz became Minister of Justice last fall, the Ministry of Justice in Poland has been led by individuals with little interest or expertise in civil law. Their legal reform priorities included putting crucifixes and priests in public schools and pushing abortion into back alleys. This attitude meant that the Commission for Reform of the Civil Code - whose membership includes the top civil law minds in Poland - had a budget so ridiculously small that it could not afford to pay for train tickets for top experts to attend meetings in Warsaw. When they did come, it paid them $8 for a day's work - less than the cost of a round-trip taxi fare from the railway station in Warsaw.

Despite this situation, Professor Witold Czahrsksi, Chairman of the Commission for Reform of the Civil Code, and others with the support of Hanna Gronkiewicz Waltz, President of the National Bank of Poland, and with technical assistance from IRIS to underwrite research, have
worked for two years to draft a new Polish collateral law. It must be emphasised that only Polish lawyers, bankers, and academics can do this job properly. Earlier efforts to draft a Polish collateral law in London or New York were not only an insult to Polish legal expertise, but statutes whose enactment would have seriously disfigured Poland's legal structure. Foreigners cannot draft effective laws for these economies. A local coalition of experts is necessary to draft laws that fit properly into the legal environment and to implement laws which they understand and support as their own work. There are several examples where foreign drafted laws have been enacted and left unused or unenforced.

3. The good news - the current collateral draft and programme.

The good news is that this situation has now changed dramatically. Poland has a Minister of Justice whose top priorities include collateral law reform, the creation of a central lien and economic registry, and a Commission for Reform of the Civil Code with a budget - still too small but growing. In March 1994, the Commission finished the main work on the draft collateral law with improvements made the following September. The proposal calls for a central lien registry, permits all banks in Poland and later other creditors to file liens, abolishes secret tax liens by requiring the Tax Department to file their liens in the central registry or to relinquish their priority in collecting them, and permits creditors to repossess collateral and to have a notary public sell it without court proceedings.

4. What can be done to help in this reform?

Those in the financial community can continue to emphasise the importance of a new collateral law to all sectors of the Polish government. This means putting the enactment of a new collateral law explicitly into the conditions of disbursement. We cannot assume that Poland will enact this reform because it is rational and logical to do so. There are unfortunately many people here in business and government who regard the current atmosphere of legal confusion as well suited to their business methods. The World Bank has been helpful in this, but not as forceful as it might have been. Specifically, those dealing with the Ministry of Finance must emphasise that secret tax liens must go and that the Ministry must play on even ground by agreeing to register its tax liens in the central registry. This will be no small fight, since the Tax Department of the Ministry of Finance will be violently opposed to giving up its long held privilege of jumping to the head of the execution line. It should be emphasised to Minister of Finance Kokodko that the continuation of the secret tax lien system will mean dramatically lower foreign assistance and lending.

Foreign governments should be urged to put more funding into supporting reform of the legal infrastructure by locals. This means money for carefully selected groups of experts to hold meetings, to do research, to hold conferences, to travel to neighbouring jurisdictions, and to support civil and commercial law programmes in law schools. It also means supporting the judiciary with reasonable salaries, conferences, and other support. Poland's excellent and honest judiciary is being decimated by minuscule salaries, case overload, and its inevitable outcome - creeping corruption. Without a good judiciary, there will be a block to development resulting in the not unfamiliar scenario in the developing world; good laws but little justice.

In summary, the cart has probably been put before the horse in the development of an effective road to a market economy. Millions for privatisation, but pennies to build the legal foundation for the financial road upon which privatised companies must travel.
Questions and Answers

Vladimir Fedorov, Counsel, European Bank for Reconstruction and Development, London

I would like to turn to Professor Dalhuisen, who, as I understand it, is the most competent specialist in the field of comparative pledge legislation. What kind of useful advice could you give that could be used in drafting Russian legislation, advice as to how best to take into account the special features of each individual country, in this case Russia? Because, as is often the case in such situations, good laws are enacted on the basis of excellent foreign models, but one small point is overlooked: What is good for the Netherlands, so to speak, is not necessarily applicable to Russia. In view of your experience and expertise, what might you say and what advice could you give to our legislators?

Professor Jan Hendrik Dalhuisen

I will speak for myself. There is absolutely no benefit in copying anybody's system at all. I am not saying that it's always wrong, but the system that must develop in any country must be the product of the credit culture that will develop in that country and that is a process which will take time. Naturally legislation can set it off, but I would have thought that the initial legislation would have to be reviewed many times over before it will settle down after credit procedures have subsequently developed. Obviously one will not want to design a jacket which is immediately too small but there is no reason to develop or design a jacket which is far too big. Legislation is there to correct and to guide. There is no one system in my view which is necessarily better than any other. I would not suggest that anyone should copy the Dutch system, even though being the newest. I am not saying it is bad. But what is good for the Dutch, why should it be good for you? The American system has of course great academic support because of its conceptual clarity. But it has a sophistication which may well go far beyond what is needed in Western Europe or here. Now if I may speak for the EBRD draft - I am quite sure its draftsmen will defend it this afternoon vigorously - the EBRD draft is a wonderful catalogue of the issues which need to be answered. Again I am not suggesting that all the answers are the right ones. Most issues can be answered in many ways and it may be that another type of balance is found than the designers of EBRD draft are at this moment proposing. That is no criticism of the draft at all; I do believe it is an excellent document. But I see it primarily as a catalogue of all the things which one has to face. We talk about its merit, and this merit is very considerable, especially from this point of view.

Another issue that arose this morning was whether one should have a Mortgage Law in respect of private property and I think it demonstrates my point. Thinking about this myself, it depends indeed what for. We hear that maybe private property, someone's dacha for example, should become mortgageable in order to use the proceeds for economic investment. That sounds fair enough although it will be difficult to define the concept with precision. If it is merely for consumer spending then disaster is just around the corner, I would forbid it at this stage especially since we have seen in England the great social problems with second mortgages on houses, the proceeds of which were used for buying cars, TV sets and I do not know what else. Subsequently many people were not able to repay, not having understood what a second mortgage was in a situation where house prices drop. We now have there a host of repossessions leading to a scandal. In England, we allow this, it is the system, it cannot be helped.
But I can well understand that in a system of credit where the population is less used to it, one would be much more hesitant in this aspect and that is perfectly fair. It may be that after ten or twenty years when everybody knows what a mortgage or a second mortgage on his house is, the rules could be relaxed. I do not think it needs to be done in one day at all.

Professor Allan Farnsworth

Jim White mentioned several Canadian provinces have adapted our Article 9 and if you have an interest in American security law, you might do well to look at the Canadian version. I once made the mistake of showing the Canadian version to some of my American students, all of whom said they wished to take their examination under the Canadian statute, because they could understand that much better than the American.

In addition, there's a project going on at present to adapt Article 9 for the purpose of Puerto Rico, which has a civil law tradition of at least some dimensions and I believe that that version of Article 9 being drafted for them is an even more simplified and perhaps more understandable version that the Canadian one. I do know that the people who are involved in Puerto Rican venture would be honoured to be asked for their views as to how our Article 9 might be, or at least some of the ideas might be, exported elsewhere.

Ronald Dwight

I am told by Hugh Pigot, the English banking expert who works for us that in England there was a commission to review the complex English system, they recommended that an American type UCC Article 9 be adopted, of course that did not happen, but than the Scottish went ahead. And they have a very good collateral law that it is an adaptation of the American system. I do not think that I agree that none of these examples can be enacted, but I think that whatever Russia does, if it wants to have asset based lending, it needs to have a system that is easy to use, that is cheap to use and that there no huge fees required to be paid in order to use it. It needs to be secure and that there are provisions to prevent fraud there needs to be enforcement which is easy and effective. No matter what they do, if it does not have those things it will not end up enabling credit to flow to people who need it. We have written a short paper on the essentials of the collateral law, we call it "the tractor", it is a sort of a parable about somebody buying a tractor, how it works and what we think are the essentials.

6. Specific Aspects of Charged Property

Jan-Hendrik Röver,
Legal Adviser, European Bank for Reconstruction and Development, London

You have heard this morning that at the EBRD we have prepared a model law on secured transactions. You have also heard of the rich diversity of systems for dealing with secured transactions that exist in America and Western Europe. I would like to remind us of Professor Dalhuisen's comment: that existing systems have all arisen by historical accident. We prepared a model to create a reference point which attempts to produce a simplified base from which to work and a base which draws on the advantages of existing systems and hopefully avoids at least some of the disadvantages.
The model law draws on certain simple concepts and we are going now to talk to you about the concepts in relation to charged property. The different legal aspects of charged property will be dealt with by explaining ten general concepts.

Concept 1 is that **a charge is a right in property**. This first concept emphasises the close relationship between charged property and the nature of the charge. A security right is a right in identified property which enables the person to whom the charge is granted to sell the property if the debt secured has not been paid. The liability of the person giving security is, therefore, limited to the property given as security. And it is typical for a secured transaction that the parties focus their attention partly on the aspects of charged property. Hence, it seems appropriate to commence this section on detailed issues with some reflections on charged property.

Let me come to concept 2: **the charge can be given for all types of property**. The second concept emphasises that a secured transactions law is then of maximum use, when it deals with all types of property. The notion of property is used here in a wide sense. Two groups of property over which a charge can be given must be distinguished. First, things are the traditional property which can be given a security and there are a number of things which can become subject to a charge. Those things can themselves be distinguished into immovable and movable things. Secondly, less traditional is security in **rights**. They, however, play an ever-increasing role as security and must, therefore, be properly addressed in a secured transactions law. The importance of rights as security is particularly visible in transactions which are called project financings. The essence of the financing of these projects is that they rely on the stream of revenues once the project is finalised. Imagine a power plant in the Vladivostok region. Although its construction may cost several hundred million dollars it is in itself useless to someone who cannot run this and generate income from it. It is, therefore, an astonishing feature of these projects that the investor for the purpose of taking security is not so much looking at the tangible assets but at the stream of revenues generated by the project. He is particularly interested to take adequate security over the stream of revenue. This is nothing else than security on receivables, in other words security on rights. The provisions of the Russian Civil Code on pledge focus on movable things and rights. The Russian Civil Code is therefore broad in its approach in the sense outlined in concept two.

I come to concept 3: **a person cannot charge what it does not own or hold**. The person giving the charge must be the owner or holder of the charged property, a concept which we also find in the new Russian Civil Code. As the charge gives the right of selling property which is a power attached to ownership, only the owner or holder can create a charge. The countries of central and eastern Europe may still have difficulties in recognising ownership of rights and things, particularly as far as immovable property and enterprises are concerned. The problem is certainly particularly magnified in the context of a charge of enterprises where many assets are involved so that the verification of the chargor's ownership will be an enormous task. Even if ownership of things and rights can be verified to a degree sufficient for the purpose of the chargeholder, the risk remains that ownership may not be subsequently enforceable against others.

I come now to concept 4 which is things and rights: **a person can charge future things and rights**. In light of the previous concept it must seem surprising that future property can be charged. Future property may be property which does not yet exist. This is the case, for example, where finance is provided for a building which still has to be built. Future property can also be property which does exist but is not yet owned by the chargor. The chargor may intend to acquire a car in two weeks time but currently is not yet the owner. In both situations the important fact is that the chargor does not yet own the property. However it must be
possible that the charge can be created over this kind of property. Parties look to those things and rights that represent or will represent an asset of the chargor. Future property is a key element for the secured creditor and can be of real value to him. Let us take an example again. The lender proposes to finance the business of a car manufacturer. The manufacturer intends to enter into a series of a long term supply contracts to various wholesale sellers of cars. The rights to payment for the cars under the proposed contracts will be extremely valuable to the manufacturer and similarly for the lender from the perspective of security. Those future rights can be included in the charged property though not in existence at the time of the draw down of the funds. As in these cases the chargor is not yet owner of the charged property at the time the parties enter into the charging agreement, a secured transactions law has to create a special rule which allows a non-owner to charge future property. The rule may take a number of forms. For instance, a law can allow for the charge to be created immediately at the time of the agreement even without the property having been acquired. Alternatively, the law can provide for the charge not to be created until the property is acquired which is probably the view of the Russian Civil Code, or the law can provide that the charge is not created until the property is acquired but for priority purposes is deemed to be created at the time registration is made.

I would now very briefly like to cover concept 5: included in charged property are things and rights which are attached to charged property. A minor complication is that things may be related to other things which are, therefore, regarded as charged property by operation of law. Security right systems are generally careful to insure that a thing which appears to be a unit and functions as a single thing, includes other things, which on their factual appearance may be said to be separate things. It may be the case that moveable things are fixed together in a way that they must be regarded as one unit. Immovable property, such as a building, may similarly have movable property fixed to it. Charged property should automatically include those things which are attached or related to the original thing would pass with it on a transfer of ownership. The Russian Civil Code names the criterion in the light of which things are regarded as a unit to be the common economic purpose, but interestingly makes it possible to contract out of this provision. Another example for this concept is Article 140 of the Russian Civil Code, as mentioned today by Professor Makovsky. I will stop my remarks at this point and hand over to John Simpson.

John Simpson,
Team Leader, European Bank for Reconstruction and Development, London

Before taking up the remaining 5 concepts in relation to charged property, I would like, just for a moment, to tell you why we are two of us giving you the ten concepts, and why in fact there were two of us who produced the model law. In the United States and Britain we have a system of what is called Common Law, and on the continent of Europe there is a Civil Law system. Although the results achieved, as we heard this morning, in those two parts of the world may be similar, the way in which they are achieved is very often quite different. In producing the model law, what we have tried to do is, wherever possible, to pass over the distinctions that arise from different legal systems and to look at the fundamental concepts that are relevant whatever the system. Also working as a team of one civil lawyer and one common lawyer has given us some ideas of the problems of communication. Legal concepts are notoriously difficult to translate between one country and another. As was said earlier, lawyers do have a strange habit of being convinced that only their own system is the good one. That is why we tried to reduce our thinking to basic concepts because if those concepts are understood, then the necessary addition of detail and sophistication can be done in the context of the particular circumstances of the jurisdiction.
Let me get back to the concepts. The next one is concept number six: **charged property may be a changing pool of assets.** So far we have implied that we are dealing with an individual asset, and this is certainly the traditional view under civil law systems. Every charge is created over a single asset and it is rare in a civil law system that a group of things or rights can be charged as a group. However, there are two different types of charges, which we may call the static and the dynamic type of charge. Where the charged property is not changing, for example a building or even ten buildings, then it makes sense to have a specific charge over that single asset. There is however the dynamic type of charge which is best illustrated as a charge over the inventory of a business. A trader's stock is ever changing: it is dynamic. He is selling stock every day and he is acquiring new stock every day. But in commercial business terms what the lender wants is a charge over the stock that is there at whatever time. That is why we think that in any law of charge then should be the concept that you can take a charge over a dynamic, changing, pool of assets. One can extend this principle in its ultimate form to the enterprise charge. You should be able as is provided in the Russian Civil Code to take a charge over the whole of an enterprise. An enterprise is never the same thing from one minute to the next, but that fact should not prevent you from taking a charge over it.

On to concept number seven: **charged property must be identified either specifically or generally.** This is obviously quite closely related to the previous concept. Charged property must be identified: it is important to the parties involved, it is important for other parties who may be dealing with the property; it is also important for other parties who may be dealing with the chargor. But how it is identified is not important; what is important is that it is identified. Let me give you as an example a library of books. You can either take the catalogue of the library and list every single book in the library or you can refer to the library collectively. It does not actually matter which you do. Either way you have described the library of books and you have identified the property. You may actually find it simpler to refer to the library rather than taking the whole catalogue. Whether one has a specific or general description will depend on the type of assets and often the importance of specific assets. One may also include a combination of a specific and a general description: for example, a charge over three specifically defined machines and all other machinery and equipment used in a production process. But if it is to be possible to have a charge over a pool of assets, as we discussed just now, then it will also be possible to identify this pool in a general manner: for example, all the inventory of the trader or, in the case of a project financing, all the receipts generated by the project.

On to concept number eight: **the person giving security can continue to use the charged property.** This was discussed this morning and we heard the reference to the possessory charge being a more primitive form of charge. Certainly if a charge is to take account of commercial reality, more often than not the person giving the charge needs to be able to continue to have the charged property at his disposal in order to keep carrying on his business. When a trader is giving a charge over gold bars, he may not mind too much that the gold bars are locked up somewhere and he is not able to use them during the life of the charge. But most traders, most commercial enterprises are not going to be giving charges over gold bars. If they had gold bars they probably would not need to give a charge. They are going to be giving charges over their inventory, over their raw materials, over their machines, over their properties, over their receivables. In every case they need to continue to have use in order to carry on their business. The continuing use can be in several different forms. It may be used in the form of enjoyment of a building or a machine. It may be used in the sense of consumption of raw materials. Or it may, in the case of trading stock for example, be the sale of the trading stock in the ordinary course of business. It is very difficult in a law to legislate precisely how much use a chargor should have. The extent to which the person giving the
charge can use or consume or sell the charged property is basically something which needs to be agreed between the parties when they enter into the charge. And it is highly desirable that there is a good degree of commercial flexibility in that agreement. But the basic principle should remain that use, consumption or sale is permitted when that is necessary for the continuing carrying on of the business.

The next concept: the person holding the security should be protected against deterioration and loss of the charged property. It is obviously a primary concern of a chargeholder that the value of the charged property is maintained during the life of the charge. There are two particular dangers that the chargeholder faces. The first is that the property may lose its value because it is used or because its market value deteriorates or because it is damaged in some way. The second danger is that the property is lost because it is either transferred or because it is destroyed. Now again, a law on secured transactions can include some provisions to help in this respect, but the most important requirement is that the law allows sufficient flexibility between the parties to include whatever they consider appropriate for the maintenance of the value of the property. The person taking the charge has to identify the risks to which that charged property is subject and then the parties have to consider different types of agreement that they might use to give protection against those risks. They could either regulate the use of the charged property, for example, they may provide that the chargor may only use the property for certain defined purposes. They can agree that insurance should be taken out for the charged property. And if they do that they obviously must also provide that the benefit of the insurance is included in the charge. They could also impose an obligation on the person who is giving the charge to maintain the value of the charged property. In the case of a charge over inventory or stock it would be quite possible to provide that there must always be a minimum value of inventory during the life of the charge. In the case of a charge over shares, the parties may agree that if the market value of the shares goes down then the chargor must include further the shares in the charged property in order to maintain the value. Once again the role of the law is to provide the framework and the commercial flexibility for the parties to agree whatever is appropriate in their particular circumstances.

Finally concept number ten: The move towards a unitary concept of a charge makes security easier to use and increases the benefit to parties to commercial financing. This is something we have already discussed to some extent this morning. I think it is very important and I think that it also underlines one of the advantages that you will have when actually creating a new system for charges. There is a tendency in the development of a modern secured transactions law that differences between charges over different kinds of property are diminishing. This is what is known as a unitary security right and it seems to be the way that modern security law is actually moving. This development has reached the stage where security is now reduced to two main types: Security over rights and movable property and security over immovables, principally land.

The new Russian regime for security is an example of this development and it makes the same distinction. The tendency towards the unitary security right means that the creation of the charge over different types of property follows principally the same rules. In essence the charge can be the same legal animal whatever the type of property it is covering. And in my view this also applies to land. The difference is principally one of formality and this is what your Law on Pledge recognised.

I would like to conclude with some general comments, some basic principles, which underlie all the concepts of charged property that we have been discussing. First, I will go back to absolute basics. The purpose of security is to assist financing. It is to persuade lenders to
lend, it is to persuade them to lend for longer and it is to persuade them to lend at a cheaper price. It will only achieve that purpose if it provides real value to the lender. This morning there was reference to security effectively meaning comfort but it must be comfort of substance not merely of form. It may be that the banker never intends to use his security, certainly security is the remedy of last resort. But if he believes that when he does use the security he is not actually going to recover anything from it, then (if he has any logic to his reasoning) he is not going to take the security in the first place. At the same time, the security must not impose unnecessary restrictions on the borrower. I think there is a view held by many that security is very undesirable since it creates restrictions on the way one carries out one's business. And that may have been the case under the same systems in the past, but there is no reason why it should be the case under a properly constructed modern law. The objective is to develop a simple and flexible legal framework for secured transactions which lenders and borrowers can adapt to suit the commercial circumstances of their transaction.

Lane Blumenfeld,
Director, IRIS-Russia, Moscow

I am the Director of the IRIS-Russia Project and its Russian Commercial Law Reform Initiative. Among our activities in Russia, IRIS has worked with the presidential commission that is drafting the new Civil Code. As most of you in attendance today are fully aware, the Civil Code covers the entire spectrum of private law issues, from legal entities, to contract and property law, to torts, intellectual property, and inheritance, as well as international choice of law issues. The Code will be the fundamental legislation governing all market relations in the Russian Federation, in effect, its economic constitution. Just last month, the State Duma of the Russian Parliament adopted a third and final reading of the first part of this Code, containing the general provisions, which is scheduled to go into effect on 1 January 1995.

With the adoption of this comprehensive legal framework, commercial transactions will no longer be subject to haphazard regulation by an ill-designed and outdated patchwork of parliamentary laws, presidential decrees, and governmental directives, many of which date to the Soviet period and its command style economy. The Code outlines the rules of the game for entrepreneurs who, up to now, have had to navigate the rough sea of Russian business law without a functioning legal compass.

A critically important section of Part I of the Code concerns issues of collateral, or, as Russian jurists refer to it, pledge. In Russia, deficiencies in the laws and institutions combine to deter banks from extending credit to the emerging private sector. Without security, financial institutions will not lend, and without lending, business cannot flourish.

Today, I will examine a single aspect of the lending process, outlining the specific types or forms of property that may be pledged as security under Russian law. Then, I will explore a variety of problems that arise with respect to each of these forms of property, if and when a bank attempts to use them as collateral to secure a loan. And finally, if time permits, I would like to touch upon what I see as the three major legal and institutional impediments to secured lending in Russia, namely, the notarisation system, collateral registration, and the related issues of debt recovery and judicial enforcement.

First, using the Law on Pledge of May, 1992 as our guide, let us examine permissible forms of secured collateral. I will draw distinctions introduced by the new Civil Code, where appropriate. The Law on Pledge permits any form of property to be used to secure a loan as long as that property is alienable. This is a broad definition that in principle allows the lender
to take any form of property as collateral. The scope of the definition of chargeable property includes real or personal property, extends to rights in property, future required property, and contracts or obligations.

What are some specific examples of chargeable (or pledgeable) property? First and foremost, there is the mortgage of an enterprise as a whole, which includes the fixed assets, capital, and other assets reflected on the balance sheet. Second, pledgeable property could include goods in circulation (inventory) or in the manufacturing stage. The pledgor is free to dispose of these goods, as long as the total value of goods in possession does not fall below the level specified in the loan agreement. The Law's definition also permits various types of movable property, such as equipment, tractors, or televisions. Additionally, a pledge of rights, that is, contractual rights, such as a lease or accounts receivable or a bank account, may be pledged. Securities, such as stock certificates, may also be pledged. Furthermore, land and buildings are acceptable, as long as they have been privatised. And finally, the law implicitly allows a negative pledge, an agreement that the borrower will not pledge the identified property to another creditor in the future.

Note that the new Civil Code makes some very important changes in the Law on Pledge. However, there is only one change in the definition of what property may be pledged under the new Code: all alienable property may be pledged, except that property which is withdrawn from the scope of civilian transactions. Another difference relevant to this discussion is that while the Law on Pledge contains specific provisions on mortgage, the Code does not. Rather, the Code directs that a separate law on mortgage, or "hypoteca," be drafted, containing detailed procedures for mortgaging real property.

We have now reviewed the specific forms of property that may be used as collateral under Russian Law. Unfortunately, in practice, banks are reluctant to secure loans with any of these types of property.

Hard currency on deposit in the bank, in the form of US dollars, is obviously a very attractive form of pledge. However, new Central Bank restrictions limit hard currency transactions. Letter number 70 of the Central Bank of January 1994 appears to prohibit banks from taking hard currency as collateral, because it prohibits banks from depositing hard currency into clients' hard currency accounts. Letter 107 of September seems to be even more restrictive. Although the Letter's full meaning is unclear, it has been interpreted by some banks to require a freeze on all withdrawals of hard currency from hard currency accounts. The combination of these two regulations greatly discourages banks from taking hard currency as collateral.

Roubles are even less attractive. Inflation, marked by wild fluctuations in the rate of the rouble, as was experienced on Black Tuesday in October, continues to deter banks from accepting roubles to secure loans.

Universally, real property - land and buildings - is a popular form of collateral. It is a stable asset that tends to maintain its value. Moreover, land and fixtures have the attractive quality in that they are stationary, and thus do not tend to disappear, as movables can. But even security in land raises a host of problems. First, the small and medium size enterprises, frequently most in need of financing, generally do not own sufficient amounts of land to use as collateral. Second, until there is a greater clarification of land title and ownership rights, I think banks will be reluctant to look to land as a comforting form of security. Buildings raise similar issues. SMEs tend to lease, not own. The lease itself can be pledged, but once again, banks must have assurances of clear title by the underlying owner.
Lending to individual households is also dampened by the lack of attractive collateral options. In the United States, as well as in Russia, I believe, a person's most valuable asset is the home. However, it is particularly difficult to use apartments in Russia as collateral. First, the "propiska" or right of inhabitancy system means that there could be more than one person with a right to live in the same apartment. It is often difficult to verify whether the person pledging the real estate is the only one with a right of residency to it. Finally, a bank is not going to take a loan, using an apartment as collateral, if it lacks confidence that a court would actually evict the resident if he defaulted.

Banks tend to see movable property as a riskier form of collateral for the obvious reason that it moves: movables are harder to keep track of, can more easily disappear, and need to be more closely monitored than real property.

What about a pledging an enterprise as a whole? The main problem in this area is one of confusion. If you take a look at the 1992 Pledge Law, it provides two steps for the bank to acquire the enterprise upon default. First, it must assume control of the enterprise and run it in an attempt to generate enough capital to pay off the loan. If that fails, the bank can auction off the enterprise. However, the procedures for determining at what point the bank can switch from the take-over stage to the auction are poorly spelled out. The new Civil Code does not address these procedures in sufficient detail either, relegating them to the future mortgage law.

Allow me to switch from this discussion of specific aspects of chargeable property, and the problems associated with it, to a more general commentary on the barriers to collateral-based lending in Russia. The first major block is notarisation. A pledge contract must be notarised in the following cases: when land or buildings are being pledged, in the case of a mortgage of an enterprise, with aircraft, railroad rolling stock, or marine vessels, and if the pledge secures a contract which itself must be notarially certified. This requirement should not pose a major problem. In the United States, it costs approximately two dollars to notarise a document. In Russia, the cost is an astronomical three percent of the deal; simply put, the three percent notarisation fee is a deal breaker. No matter what changes the Russians make in their legal system to improve their laws and strengthen their courts, significant amounts of secured lending will not occur until this choking tax on financing is lifted.

With respect to the problem of collateral registration, I would like to address your attention to an article on a mortgage scam that recently appeared in the local press. The facts are briefly these and I think they speak for themselves. A company used the same building, a building it owned, to secure loans from five separate banks. One piece of property, five banks, five loans. According to the article, at least three of those banks registered their interest in the building in the proper registry. Yet, when searching the registry, not one of those banks discovered the pre-existing lien, the pre-existing creditor, until after it made the loan. The company defaulted on the loans, and the issue is which bank gets the building that they all claim as collateral. The courts are currently trying to unravel this mess in a case that banks will watch very closely.

The lesson is that the recording system is unreliable. Until it is overhauled so that lenders can determine, with confidence, where they rank in priority as creditors, no measurable secured lending will transpire.

Finally, the old Pledge Law required a court order before a bank could seize any form of property upon debtor default. The necessity of judicial enforcement discourages banks from taking collateral because the courts are time consuming and expensive. Until just recently, the court fee was 10% of the claim; fortunately, the fee has now been significantly reduced.
Additionally, as a creditor awaits the court's decision, the value of its claim in this high inflation economy decreases significantly. The fact is the banks will not make asset-based loans in such a rigid system. When they do, they resort to private enforcement mechanisms to seize that collateral, by which I mean, bluntly, the use or threat of physical force.

In this area of collateral realisation, the new Code departs dramatically from the old Law, introducing a more efficient system for debt collection. The new law permits lenders to seize movable property upon default without a court order, if the parties pre-agree in the loan contract, with the caveat that the seizure cannot breach the peace. This reform encourages banks to begin to use movable property to secure loans, lubricating the lending system, particularly with respect to SMEs for whom movables are principal assets.

This afternoon, I have highlighted some of the barriers to secured lending in Russia. As the latter part of my talk suggests, however, Russia is beginning to introduce major improvements in both the laws and institutions to facilitate lending. The reduction in court fees will encourage more creditors to use the judicial system, rather than resort to hired guns. Simultaneously, the removal of the requirement that creditors seek a court order prior to seizing movable property upon default will open up asset-based lending. These reforms increase the attractiveness of both formal judicial enforcement and legitimate self-enforcement mechanisms. There is much still to be done, but these are promising signs.

7. Enforcement

Vasily Vitransky,
Deputy Chairman, Supreme Arbitration Court, Moscow

My task, esteemed colleagues, is to open the discussion of recovery under secured obligations. Unfortunately, I am going to speak more about problems than about actual judicial practice. Despite the fact that the Mortgage Law has been in effect for two years now, I must say that we cannot speak of any stable judicial practice in hearing cases involving the recovery of property pledged as security. The reason may be that the Mortgage Law has excessively complicated the procedure for recovering property pledged as security. I would like to recall that, as a rule, property pledged as security may be recovered by decision of a court. In addition, in the instances stipulated by the legislation, property pledged as security may be recovered on the basis of a notary's executive endorsement, and, in the instances stipulated in the law, property may be recovered in an extrajudicial procedure.

For instance, tax agencies, tax service and the tax police make very broad use of the possibility of recovering property as payment for delinquent taxes. They are empowered to do so by the Law on Principles of the Russian Federation Tax System. In this connection, the new Russian Federation Civil Code establishes a somewhat different procedure for recovering property, a more explicit procedure.

Article 349 presents four different cases of recovery of property. The first situation is for when the collateral is real property. The general rule that real property is to be recovered on the basis of a court ruling is maintained. However, allowance is made for the possibility of recovering the collateral of a mortgage in an extrajudicial procedure. To do so the Code requires the existence of an agreement between the pledgor and the pledgee. The agreement must be entered into after the pledgee has received the right to recover the property; in addition, this agreement must be certified by a notary.
The second situation deals with other property, personal property. With respect to this type of property, provision is made for suppletive norms, to the effect that the collateral must be recovered on the basis of a court ruling, unless the parties' agreement specifies otherwise. This means that the parties have the right in their agreement, or perhaps directly in the pledge agreement, to specify a different extrajudicial procedure for recovering such property.

The third situation is when the property pledged as security has been assigned to the pledgee. In this case the procedure for recovering the property pledged as security is set forth by the parties in their agreement.

Finally, the fourth situation in Article 349 is a norm specifying certain cases in which the property pledged as security may be recovered solely on the basis of court ruling. The Code defines such instances as situations in which the consent of a third party was required in order to enter into the pledge agreement and to pledge the property. For example, in this situation the pledgee may be a state enterprise, since the authorisation of the owner would be required; I am referring to a state unitary enterprise. The second situation is when the property pledged as security is of historical, artistic or other cultural value. And finally, the third situation is when the pledgee is absent and his whereabouts are impossible to ascertain. This is a brief description of the procedure for recovering collateral in accordance with the new Russian Federation Civil Code. However, I am not sure that the new versions of the respective norms allow one to say that we will have a rich judicial practice with respect to issues relating to the recovery of property pledged as security.

Another method of securing obligations is the guarantee. We are seeing a trend toward a reduction, a significant reduction, in the number of disputes in which creditor-banks file suit against guarantors. I believe that the main reason for this is that in accordance with the principles of civil legislation, surety and guarantee contracts are used as synonyms. In view of this regulation, we can no longer view a letter of guarantee from a bank as a unilateral transaction. We are forced to view this letter as an offer for a surety contract. A surety agreement can be deemed to have been entered into only if this is followed by acceptance by the creditor-bank. The only exception, perhaps, that judicial practice makes is that a stipulation by the creditor-bank in the loan agreement to the effect that the loan is being granted under a specific letter of guarantee issued by the guarantor-bank is recognised as acceptance. For this reason, I think that the basic difficulties in these arrangements lie not in recovery and not in the bringing of claims by the guarantor and the satisfaction of such claims, but in the difficulty of defining the parties' relationship as a guarantee relationship. Although there are difficulties here, I am referring to difficulties in bringing claims, since the norm establishing a preclusive three-month time period for claims by a guarantor's creditor remains in effect to this day.

The Civil Code broadens these possibilities and extends the period to one year. In this respect, the new Civil Code provides for a completely new institution, a new institution for Russian legislation; in paragraph six of Chapter 23 there is a whole series of articles relating to bank guarantees. I am not going to go into their substance as I do not have the time. But the most important point is that a claim by a creditor-bank that is acting as a beneficiary and a guarantor that has issued a bank guarantee are not linked with the primary obligation, with the credit agreement, and with the performance of the main obligation by the borrower who is the principal. I think that this will also broaden the possibilities for wider use of the institution of the bank guarantee as a means of securing obligations, although, I repeat, I am not sure that this method will be widely used either. The fact is that actual banking practice in Russia always looks for some sort of unique path, and the circumstance that such traditional means of securing obligations as pledges, guarantees and sureties are used infrequently does not mean
that banks are not finding any ways to secure their credit agreements. In reality, banking practice has taken the path of using some totally unique means of securing obligations.

In recent years we have dealt with a tremendous number of disputes involving suits filed by banks against insurance companies. I did not falter when I said that this is a unique means of securing obligations; because it is hard to characterise as an insurance contract an arrangement in which the subject of the contract is not a risk, when the insured event is not an event that might or might not occur. In reality, the insured event in these arrangements is defined, and this is specified in the insurance contract, as a default on the loan amount and interest charges for the term specified in the loan agreement. It is default by the insurer and the borrower on their explicit obligations under the loan agreement with the bank that is regarded as the insured event. We could perhaps characterise these relations as a special method of securing obligations, insofar as this is not an insurance contract. But unfortunately we are unable to do so today, because Article 68 of the Principles of Civil Legislation establishes a finite list of means of securing obligations.

Therefore, a very curious situation has arisen in judicial practice. Even though we know full well that we are not dealing with an insurance contract, we cannot apply by analogy the norms that regulate means of securing obligations, and we are forced to apply the norms of the insurance law. Moreover, I can tell you that both the banks and the insurance companies have a stake in such insurance contracts. In many cases we encounter so-called co-operative activity agreements that banks enter into with insurance companies.

Under these agreements, the banks, in particular, undertake not to make loans and not to enter into loan agreements with borrowers until they bring to the bank an insurance policy from the insurance organisation in question. Both sides are satisfied - I am referring to the parties to the co-operative activity agreement. In our view, these agreements should be declared invalid, although it is true that there have been virtually no direct suits. They violate the rights of third parties, the borrowers; on the other hand, both the insurance companies and the banks are left with a guaranteed profit, for the banks perform their service of directing borrowers to the insurance company: for a fee, naturally.

And this is a path that the practice of securing loan agreements in the Russian Federation has taken. Maybe this is the main reason why normal means of securing obligations, such as pledges and others like bank guarantees, are not being widely used. I therefore submit that the task of those officials and legal specialists who will be working on the second part of the Civil Code, and on the norms governing insurance contracts in particular, will persist in ruling out the possibility of using insurance contracts as such distorted means of securing obligations. And, on the contrary, in making possible the development of normal means of securing obligations, such as pledges and bank guarantees.

Victor Cujba,
Deputy Chairman, Supreme Arbitration Court, Moldova

Before turning to the issue of recovery, I would like to say a few words about the legislative foundation that we have in our republic in the field of pledges. The concept of pledges in the legislation of the Republic of Moldova is contained in the 1964 Civil Code and the President's decree on pledges of October 29, 1994, which confirmed the provisional pledge statute that was put into effect on December 15, 1993, and also the republic government's resolution of January 31, 1994, on measures to implement the provisional pledge statute. The pledge is also
mentioned as a means to secure the repayment of a loan in the law on banks and banking activity that was enacted in the republic in 1991.

It should be pointed out that the drafting and enactment of a new Civil Code in the Republic of Moldova has been stalled somewhat. The Moldovan Parliament's resolution of September 22, 1994, envisions for 1995 only the formation of a working group to draw up the respective draft. However, with the Inter-Parliamentary Assembly's adoption of the model Civil Code, in whose drafting the Moldovan delegation participated, let us hope that efforts in this area will be invigorated. There is no separate Pledge Law, and there are no plans to draft one.

What is the substance of the provisional pledge statute of October 29, 1993? The statute defines the areas in which pledges may be used, areas that are spelled out in the statute. They include the bank pledge. The provisional pledge statute says that any property that may be expropriated by a pledgor may be used as collateral in a pledge, and this applies to objects, securities and property rights. State-owned property may be pledged as collateral only with the consent of the State Property Fund, and property subject to privatisation may be pledged as collateral only with the consent of the privatisation department. At the present time these agencies have now been merged into a single Ministry of Privatisation and State Property Management. As regards pledges of rights, the statute says that such rights may be a pledgor's rights of ownership and use, including his rights as a lessor, other rights, claims arising from obligations, and other property rights. In agreements pledging rights that do not have a monetary value, the value of the collateral is established by agreement between the parties. As regards collateral in the form of securities, such securities may be only securities issued by the Republic of Moldova or securities cleared for circulation by the state commission on the securities market. An agreement may also stipulate that a pledge extends to objects that may be acquired in the future. The statute also establishes the concept of pawning, in which the property pledged as security is assigned to the pledgee. It also provides for the possibility of pledging goods as security by giving the pledgee a commodity-transport document that pledges goods that are in circulation or being processed.

A pledge agreement has to be in writing. In instances stipulated by legislation and the provisional pledge statute, it is established that a pledge agreement must be certified by a notary; specifically, an agreement pledging as security civilian aircraft and river vessels, rolling stock, and other types of vehicles must be notarised.

The provisional statute also requires the registration of pledge agreements. It also says that an interested party may appeal a denial of registration or the illegal registration of a pledge to an arbitration court or the court with jurisdiction over the area in which the registering agency is located. Pledge agreements are subject to certification and registration by notary offices with jurisdiction over the area in which the property pledged as security is located or over the area in which the property owner who is a physical person resides. Registration is affected by entering the information into a register, the form of which has also been confirmed by the government.

The provisional statute establishes that a pledgor may be the person to whom the property being pledged belongs, who owns that property. The provisional statute contains no information as to whether the right of operational management of a property may or may not be pledged as collateral. Pledgors are required to maintain pledge books. The procedure for maintaining such books is established by the government. The form of these books has been approved by the government. Subsequent pledges of property that has already been pledged as security are prohibited pending the debtor's performance of his primary obligations.
When stipulated by the parties' agreement, the notary office, at the same time it certifies the agreement, imposes a ban on expropriation of the collateral. Recovery of property pledged as security is affected on the basis of a court order or arbitration award, unless specified otherwise in the parties' agreement.

The generalisation and study of practice in using pledges as a means of securing the repayment of loans extended by banks shows that as a general rule, goods, i.e., personal property, are used as collateral in pledge agreements. On account of the procedures involved, such as obtaining the consent of the state property fund and the privatisation department, state-owned property is virtually never the subject of a pledge. Banks and commercial structures most often resort to securing the repayment of loans by insuring the risk, although the 1993 Insurance Law in effect in the republic does more to protect the interests of insurance agencies and companies.

Practice confirms that pledges as a means of securing the performance of obligations are used only in the field of credit relations. Such practice can be subdivided into two periods, before and after the enactment of the provisional statute. Although not very much time has passed since the entry into force of the provisional statute, it cannot be said that pledges are being actively used as a means of securing performance of obligations. Prior to the enactment of the provisional statute, that is, when a pledge registration procedure was lacking, banks took a more pro forma approach to pledge agreements; in other words, the existence of the collateral was not studied or verified. Agreements lacked terms on safeguarding and preserving the property pledged as security. With the introduction of registration of pledges and, in certain cases, notarisation, the situation with respect to the use of pledges has changed. But given the lack of a properly regulated mechanism for recovering property pledged as security and satisfying claims against property pledged as security, the statute is ineffective, and banking organizations are not resorting to this method of securing the performance of obligations.

There have been very few arbitration cases involving the recovery of property pledged as security in 1994, only two or three. The collateral was canned goods, vehicles and machinery. There was one interesting case that did not involve a pledge but had a bearing on securing the timely repayment of a loan; it was an instance in which the government - to be more precise, government leaders, a Deputy prime minister of the government and the Ministry of Finance - issued letters of guarantee to the National Bank to secure the repayment of a loan that the National Bank made to some agricultural enterprises and processing industry enterprises. The guarantees were made at the expense of the state budget, and this meant that the government or the Finance Ministry had exceeded its authority. By decision of an arbitration court, the letters were declared invalid.

Practice also shows that economic entities are more willing to try to recover a debt, even when a pledge exists, by having the debtor declared bankrupt. Although the bankruptcy procedure in our republic is somewhat lengthy, and a decision is rendered after the expiry of six months. The overall time period for reviewing disputes is one month. At the current time we have more than 100 bankruptcy cases. Rulings have been handed down in 13 cases.

The procedure for seeking arbitration has been changed somewhat; as of September 2, 1994, the state fee was reduced; it now amounts to 3% of the amount of the suit, instead of the 10% that was in effect prior to September 2. In conjunction with Italian specialists, experts are now working on this question, and changes and amendments in the bankruptcy law have now been drafted. The changes and amendments provide for the possibility of shortening the procedure for declaring bankruptcy to three months in some cases and other modifications.
We hope that with the enactment of the new Civil Code, the completion of privatisation, and the consolidation of a market economy in the Republic, arrangements in the field of pledges will improve, obtain proper legal regulation and become an effective means of securing obligations, including loan obligations.

**Stephan Breidenbach,**  
**Professor of Law, Europe University "Viadrina", Frankfurt/Oder**

**ENFORCEMENT OF SECURITY INTERESTS**

**Introduction**

Market economy is driven by capital, but capital will not be provided by banks if they have to fear that it is not repaid. The creation of legal and institutional mechanisms to ensure repayment of credits is the key to success in every transitory process to a market economy. Repayment of credits depends on three elements:
- First, a good business concept underlying the financing transaction is the best guarantee for repayment.
- Secondly, to cover the remaining risks, instruments for securing the financial lending should be available. Fast and efficient ways to bring in available assets as security are necessary.
- Finally the third element which shall be the focus of my short remarks: repayment is not guaranteed by the mere existence of security. If enforcement fails, repayment is simply not ensured. Without a fast and effective enforcement any claim is almost worthless. Enforcement translates law into reality.

I will divide my following remarks in four parts:

**Part I: The aims of enforcement,**  
**Part II: The models of enforcement regulations,**  
**Part III: General remarks concerning the models of enforcement,**  
**Part IV: Phases of enforcement**

**I. The aims of enforcement**

The overall goal of enforcement is to bring a legal right into reality. The enforcement of security interests deals with non-payment and gives the investor the right to turn to the debtors' assets. Enforcement is only a substitution for the failure of the debtor to pay the secured debt.

In order to come as close as possible to a normal repayment enforcement has to fulfil several subgoals:

- First of all, enforcement has to be as **fast** as possible: the faster an investor can get his money back the more he can feel protected.
- Secondly, enforcement has to be as cheap as possible: the costs of enforcement are out of pocket costs of the investor and add up to the original investment.
- Enforcement has to be as simple as possible: the more complicated the procedure of enforcement the more formal mistakes can endanger the success.
- Enforcement of the charges also has to make sure that an adequate equivalent for the charged asset is realised so that repayment is fully secured.
- Finally, since there can be other investors seeking compensation from the same asset, there have to be rules for the distribution of the proceeds of sale. In particular, it has to be
foreseeable whether there is a charge ranking ahead of the investors' charge with the consequence that another chargeholder has priority to the proceeds.

These subgoals of enforcement are however only one side of the story. Enforcement of secured interests on the other hand has to protect the debtor against losses suffered as a result of wrongful or abusive enforcement by the secured creditor. For example, in several countries one device for the protection of the debtor is the existence of compulsory delays in enforcement. But delays increase the interest and cost burden on the debtor. And on top, during delays, assets may lose value. This applies, for example, to foreign currency receivables or to goods which may simply perish. The consequence is that every legislator should think twice whether a compulsory delay in enforcement is really necessary for the protection of the debtor: especially in the corporate context where the investor is a credit institution which is subjected to supervision so that protection of the debtor can be seen in a different light. Finally, there can be interests and rights of third parties which have to be protected.

II. The models of enforcement regulations

The possible regulations of enforcement procedures represent a continuum between two poles.

At one end there are regulations that subject every measure in enforcement to a formal court procedure. On the other end of the continuum there are regulations that leave measures of enforcement to the secured investor and therefore rely on self-help.

Some jurisdictions, for example the German system, go more in the direction of court control. Priority is given to the protection of the debtor by subjecting enforcement to judicial monitoring and by favouring public auction sale instead of flexible regulations for the sale of charged property. But practical needs have found their way and the fiduciary transfer of property as security was invented. Here realisation is usually executed by private sale. So the German legal model for a charged movable asset, the pledge, has lost through banking practice almost any practical importance.

Other jurisdictions, especially common law based jurisdictions, rely more on self-help. The secured investor has a flexible choice of measures if the security document is drafted in a proper way. His rights include private sale as well as taking possession for example of a business through a third person to operate it and collect the profits. But the protection of the investor is not neglected. In these jurisdictions, the protection is guaranteed by the imposition of duties of fair realisation on the enforcing creditor.

III. General remarks concerning the models of enforcement

In the light of the above-mentioned goals of enforcement elaborate formalism in court procedures or public auctions are hardly avoiding delay cost and complexity. Almost every jurisdiction is suffering from the serious delays in court procedures caused by the overload that the courts face. Eastern European courts have not only the problem of overload, but additionally they have to cope with a constant but unavoidable change in the legislation during the transitory phase to a market economy. To rely on the courts in the field of enforcement of security interests is therefore dangerous at least in the corporate context. The loss of time which can add up to years makes security almost worthless. Even if now, according to the new law in Russia, private sale is possible, one has to be careful, if the system will accept the new rules.
Let me give you an example from the Czech Republic where I was a member of the board of the first private Czech bank. In the Czech Republic, the most important step in a legal framework of secured transactions, the regulation of mortgages, is still missing. Since real estate is the most important asset many companies have to offer, the banking practice in the Czech Republic established a sort of pledge. The regular enforcement through judicially monitored compulsory auctions takes a minimum of two years which endangers banks with a small capital base. Hence, banks drafted security documents that allowed private sales when it comes to enforcement. But they did not take into account the reaction of the land registry. These people confronted with an enforcement simply asked the landowner, who already gave his consent to private sale in the security document, if he would agree to a private sale. Of course in many cases the surprised but delighted debtor said "no" and so the banks had to go to court with a claim based on the security agreement to get consent for the private sale.

It is therefore of crucial importance for commercial lending that courts are only very carefully, if at all, involved in the enforcement of secured transactions.

In the following part IV, I will try to come to more detailed conclusions how enforcement of secured interests can give practical protection to the investor without depriving the debtor from essential rights. This makes it necessary to take a closer look at the different phases of enforcement. This distinction of sophisticated rules is a precondition for the design.

IV. Phases of enforcement

Generally two phases of enforcement can be distinguished: the protection of the charged property and the realisation of the charged property.

The first phase is the protection of the charged property. Without the right to protect charged assets especially from any disposal of the debtor or a third party in possession of the security, enforcement is not effective. Protective measures may include taking possession of movable things or at least taking steps to prevent the persons in possession using it or transferring right to it. In some cases, where the secured investor has not the authority to take certain measures, for example to enter upon a site, it might be necessary to appoint a third person with the necessary authority to take these steps to protect the charged asset. Any delay in these measures might, for example, caused by the necessity of court proceedings before taking these measures, endanger the efficiency of protective measures. Often speed alone is the key to the protection of the assets.

The realisation phase normally means the sale of the charged property and the transfer of title to the asset from the debtor to a purchaser. This phase especially demands balancing the competing interests of the secured investor and the debtor. On one hand, the secured investor has to have the right to sell the charged property without the additional consent of a court order and therefore without delay and unnecessary formality. The more flexibility is provided to the chargeholder the more the goals of enforcement are fulfilled: speed, no additional costs, discretion in the appropriate form of sale in order to secure an adequate equivalent in proceeds, and no formality leading to complexity and formal mistakes, which might endanger the result. On the other hand the debtor has to be protected especially in two ways:

- There either has to be the general possibility to prevent the sale or
- if the sale is unavoidable, it should at least be secured that the debtors' assets are not sold for any price but that the price is a fair equivalent for his lost property.
The first need can not only be met by court procedures. For example, it is also possible to guarantee a certain period of time after the commencement of the enforcement procedures before any transfer of title is possible. During this time the debtor or a third party can take measures including an application to the court. If in the first phase, the protection of this charged property, the secured investor is able to take efficient protective measures, this compulsory delay in the realisation phase is bearable.

There are two sorts of regulations, which realise adequate prices for the charged properties:

- One possibility is to reserve the sale only to a formalised public auction.
- A second possible regulation leaves the form of the sale to the secured investor.

In this case the protection of the debtor can be guaranteed by the imposition of duties on him to conduct the sale in a way which is reasonable and appropriate. The reasons to favour the second possibility with the emphasis on self-help are at least threefold:

- Public auctions, as experiences in many jurisdictions have shown, tend not to realise an adequate price and often cause enormous delays.
- The interest of the chargeholder and of the chargor are at least partially identical, because the chargeholder has at least to realise through the sale his secured investment including costs and interest which gives him an incentive to act reasonable.
- The danger of an abusive enforcement can be met by an obligation to act in a reasonable and fair manner. This is a sufficient protection for the debtor if it is accompanied by the possibility to claim compensation if this obligation is not fulfilled.

To conclude: the best advice for any legislator is KISS - Keep It Simple and Stupid!

8. Insolvency Aspects

Jan Hendrik Dalhuisen,  
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Professor of Law, Utrecht University

I would like to continue the story which I started this morning with the status of charges in executions, executions outside bankruptcy and bankruptcy executions themselves, two types. The first aspect I would like to concentrate on is what the principles of priority are. A difficult question but I think one can distil some principles. The first principle is that charges rank amongst each other according to time.

First in time, first in right. It must be the basic principle; it seems to be adhered to in one form or another everywhere, but of course there are a number of problems, as one would expect. The first problem is when, for this purpose, are these charges created? One possibility is to take the time of the contract. In those jurisdictions which maintain a system of registration and publication it is more likely, though not always the case, that it is as of the time of registration or publication. But systems that maintain a registration or publication system may also use a certain lead time. It might be that for thirty days for example, the security is perfected for ranking purposes even though there is no registration; any subsequent registration, but within the thirty days, would then remedy that deficiency. Naturally there is a problem with future assets. When is the charge perfected in respect of future assets? Is it in those jurisdictions that have a registration as of the time of registration or is it only as of the time that the asset emerges, and that could sometimes be years later. Registration systems
often stick to the date of registration even though the asset is not yet there, to make it simple, I suppose. Then there is the other question of future debt: if the debt is not yet there, can assets in advance already be secured for a future debt through a registration system? Some jurisdiction do so, others find it much more difficult to accept that kind of facility. So those are some of the problems attached to the principle of first in time, first in right: the basic rule.

Then there are special rules. Specific charges may prevail over general charges. So if there is competition between, for example, a reservation of title and earlier floating charge over the whole business of the debtor then it is likely that the later reservation of title still prevails over the earlier general charge, and that I think is very common in almost all systems, even though the reservation of title might not be registered at all in jurisdictions that otherwise maintain a registration system.

The third rule is that sometimes possessory charges prevail over non-possessory ones. This is so especially for documents of title and negotiable instruments in the United States. So if you have a possessory charge in those countries over say a portfolio of stocks and shares, even though that charge might be much later to non-possessory charges in respect of the same assets, possession may prevail and may give you a better right. Especially in connection with negotiable instruments it is very common. Then there are the contractually arranged charges which may prevail over statutory preferences, or privileges, for example, of the tax man or statutory purchase money security or any other types of statutory preferences which as I said this morning are often rights only in execution proceeds, but not proprietary charges. The contractually arranged charges will on the whole prevail over these statutory ones, except, as one would expect, that tax man's claim, even though only benefiting from a general preference, may sometimes result in a superior right and may prevail over any kind of contractual charges or proprietary rights in the assets. We call it a super-privilege.

Then we have the very difficult question of rank and status of foreign securities. Where do in all of this, if at all, foreign securities fit? Can they be recognised? How are they recognised? How are they adapted to fit into the ladder of priorities maintained by the execution law. As I said this morning this is a very new area where I think research is only starting. It is not easy. The problem one faces is for example whether if a good is exported subject to a reservation of title which allows appropriation, but moves to a country which requires execution through the courts, this proprietary right is then transformed in the new country and treated as a reservation of title in that country or can one still appropriate under the law of the country where the asset comes from. It might make a very substantial difference whether you can take an asset back without a sale or whether you have to go through a sales procedure in the new country.

Finally, let us briefly raise the question whether execution sales can be free and clear. In other words, where there is an execution sale, can the buyer buy the property without any kind of proprietary rights attached to it, or does he take subject to all other charges, except the one which is being executed?

The second subject after the issue of status and rank, which I think I need to discuss here is the situation of the indirect securities. The first one is the set-off. So the debtor has a counter claim against a creditor. How does this work? Usually there are a number of restrictions. Set-off will often only apply in respect of monetary claims, so you can only set-off two claims which are expressed in money, usually in the same currency. You would not be able to set-off a dollar claim against a rouble claim. Both claims would also have to be mature, so you could
not set-off a mature claim against a claim which would only mature in one or two years time. These are the most common limitations.

Then we have retention rights, usually the repairer of a watch will have a retention right for the repair costs. He may not, and in the traditional form usually had no right to, execute and sell the property. His position is one of a person who has a nuisance value. He can hold on to the asset, nobody can do anything with it, nobody can reclaim it from him until such time that he had been paid, in this case for his repair. These retention rights, or the right to retain the asset, are in most jurisdictions limited in respect of a number of claims: professional fees and repairs, thus to a fairly limited set of circumstances.

Then in most jurisdictions a default will give rise to a rescission of the contract, but in some jurisdictions the rescission of a sales contract will also allow the seller to reclaim the title in the asset, so the asset automatically reverts to him by statute. This is so, or used to be so, in the Netherlands, in particular. So there is an automatic reversion of title which does not necessitate a reservation of title.

Now these are the most common indirect securities which play a role in executions. Where the subject becomes of greater interest is when we have contractual enhancements of these indirect securities. In the case of set-off, we then talk of netting. That is a very popular subject for all kinds of reasons. What does one try to do in netting? I said a moment ago, the set-off is usually limited to monetary claims in the same currency and which are both mature. Now contractually, one may try to create a set-off also in situations where you have one monetary claim and another claim for the delivery of certain assets which, through a formula, one tries to reduce to money in order to make the set-off possible. Where one has claims in different currencies, rouble against dollar, one may try to do something similar. Obviously one would then have to include in the contract some currency exchange formula. One may also try by contract to reduce non-mature claims to money which of course requires an interest rates formula. Your retention right may also be contractually enhanced. It is very common in banks to try to retain all assets that a bank has or happens to have of a debtor until satisfaction of all debts. You see it in general conditions of banks which are trying to create in this manner a universal retention right on all they have or hold for clients. Where a retention right does not lead to an execution right it is also possible and common to try contractually to introduce an execution right. As to the rescission rights with an automatic return of title, can one by contracts achieve a position like that in countries that do not give it by statute?

Now, of course, in a contract you can say whatever you like, but the key is will the applicable execution law allow these enhancements beyond what under its own rules it accepts and that is the problem. For example under English law we do not know whether the contractual enhancements of the set-off concept will be maintained in the bankruptcy: maybe yes, maybe no. There is a Court of Appeal case in the United Kingdom which rather seems to suggest not. And it is very clear why; because by doing this you can expand the realm of your priority rights very greatly indeed. The ranking that is produced by these indirect securities is usually the very highest: a set-off or netting creates or forces the highest priority; a retention right, especially if you can execute the extension right since you have the asset in your hands equally creates the highest priority in that asset. So if you can expand the notion of your set-off or retention rights, well then you sit very nice and pretty, which is of course the reason why these contractual enhancements are used all the time and why we try to expand them.

Now ultimately in bankruptcy, what happens there? There are two types of bankruptcy, the first type basically accepts the ranking of securities and indirect securities as they exist outside the bankruptcy. So it follows the normal priority ladder as I just explained. The other type of
bankruptcy rearranges the priority ladder itself. This is in liquidation proceedings, bankruptcy leading to liquidation, the more exceptional case, but even in bankruptcy liquidations you find that there are other priorities and preferences created: usually the trustee and other professional advisors claim a very high priority for their professional charges and you usually also find that all commitments entered into by the trustee pending liquidation, for example to keep the business going for a short while, also acquire a very high ranking over and above the ranking which I explained outside bankruptcy.

Finally, in bankruptcy leading to reorganisations, when the bankruptcy statute is very much reorganisation minded and wants to give the company another chance, like the Chapter 11 proceedings in the United States, you find an entirely different attitude towards secured transactions and preferences, including the preferences of the tax man. First, you would expect to find, in those proceedings, a general stay of all individual executions, that is to say that the secured creditor cannot execute his security outside the bankruptcy and reorganisation process any longer, therefore he loses his immediate individual execution right; he must wait and see what the bankruptcy trustee wants to do and it is obvious why this should be so because if everybody immediately executes his charges then the company would disintegrate right there and then. So in order to give the reorganisation a chance at all, it is almost unavoidable that there has to be a stay of all executions under the proprietary charges. It is usually the first part of the rearrangement of security rights.

The second part is that, especially in systems which allow almost all present and future assets to be used as charges, you will find that there might be excess security. Banks, to put it bluntly as a banker, always try to grab everything, two or three times over if possible. Now it is that extra or the excess security, in a reorganisation, that might have to be used to attract new money. Therefore in a reorganisation, you will often see that a trustee has certain rights to reduce the excess security and free it up to attract other money at the very beginning of the reorganisation process, even though at that stage we might not know whether the reorganisation has any chance of success at all. It creates flexibility for the trustee.

Thirdly, in the reorganisation process it is conceivable that there is a complete elimination of all separate executions, so not only a stay. Banks and suppliers who keep the show on the road during the reorganisation, might in the meantime be given a special status or a higher priority, even with respect to past debt, as a kind of trade-off for the fact that they are helping out during the evaluation period. Finally, as part of the plan it is even possible that the secured creditors might have to join in and might have to accept alternative security, for example if the trustee as part of the plan wants to sell factories which have mortgages on them. He may want to sell free and clear whilst offering equivalent security. In some systems it is even possible, that the secured creditors are, as it is called, crammed down further and might have to accept a reduction in their security or a delay in payment under the plan as long as such is deemed fair or equitable or not too detrimental and discriminating.

Richard Conn,
Managing Partner, Latham & Watkins, Moscow

This afternoon you may not realise it but you are about to hear about the Russian economy, and in fact the heart of any economy in a capitalist society. That is bankruptcy law wedged here with the last few hours of your day.

Insolvency, whether you are talking about a rehabilitation proceeding, where a company continues to exist, or whether you are talking about a liquidation, where a company no longer
exists and the assets are sold off, is indeed the very center of how an economy is structured. Why do I say that? Because whether you are an unsecured creditor, engaging in your activities, selling services to other companies or whether you are a secured creditor, providing money and other values in exchange for a security interest, how you go about doing that will be determined entirely by the way you will be treated if everything goes to pot, if everything falls apart. That means you will look, in the first instance, to how the insolvency laws of the specific jurisdiction will treat your client. If Russia has insolvency laws that protect secured creditors, secured creditors will come to Russia. If Russia does not have those laws, secured creditors will not be active in this market.

Today in Russia, very few private dollars come into this economy because Russia does not yet, as we all know, have sufficient protection for secured creditors. That is not to say there is not progress; we will talk today a little about President Yeltsin's decree back a year or so ago, that sets up the bankruptcy laws. But the bottom line is that if secured creditors are not protected, private funds do not flow into an economy. Let us take a few basic points to make sure we are all understanding one and other.

What is a secured client in its simplest sense? That is money lent with a promise of repayment. If the money is not repaid the creditor has the right to a certain specific asset that the creditor can take and either use himself or sell. What is the difference between that and an unsecured creditor? An unsecured creditor, in a bankruptcy proceeding, can only look to the general assets of a company. It cannot look to any specific asset of a company. Let us take a simple example: you have a company that is worth five million dollars, it has five million dollars in its bank account. The claims against that company total fifty million dollars, that is all the people who have sold goods; that is everything that has been done on an unsecured basis. All of those unsecured creditors will receive in a simple context, roughly ten cents out of every dollar that is owed to them. What that means is, if you have provided services or money to that company and you do not have a security interest, you will receive only ten percent back of what you gave to the company.

If on the other hand, you had the wisdom to become a secured creditor, and you have obtained a security interest in, for example, a building that the company owns (and we will talk about how you get your security interest in a moment); but let us assume you are secure, and that building is worth five hundred thousand dollars and you have lent the company, let us say one million dollars, you are a secured creditor to the extent of five hundred thousand dollars, and you will get back out of that bankruptcy case probably your five hundred thousand dollars plus your ten percent of your remaining five hundred thousand dollars which will be treated as every other unsecured claim will be treated. So we are not talking here about theory, we are talking about a major difference in terms of how money will be distributed in the worst case scenario, that is a bankruptcy case.

We have talked about, in earlier sessions today, you have heard a term perfection of security interests. And in Russia particularly, the term perfection means absolutely nothing. What does a concept mean? In a bankruptcy case in the U.S. and in any other country that has a system similar to the U.S. structure, the only people who are protected as secured claimants are those who have a perfected security interest. Perfected security interest simply means that notice has been given to the entire world, that a specific creditor has a security of a specific type.

Going back to that building that I mentioned, if you and I agreed that I have a perfected security interest in that building and tell nobody else in the world about it, no one else in the world would know, when they are dealing with a company, that the building is not an asset of the companies assets, that it is in fact my asset as a lender. The concept of perfection means
that we have found a way to tell everyone in the world that that building is mine, and if they want to do business with the company then they must understand that that building will not be there to satisfy the debt if they are not paid their money.

There are many ways to perfect a security interest. In Russia, however, in my view there are basically none. We have some Pledge Law now that really does not do the trick in terms of setting up perfected security interests. The bottom line is, in order for Russia to take the next step forward, utilising some very good laws which have been put in place, specific mechanics have to be established that allow all the lawyers who are working on these transactions, and all the others who are sitting out here in this audience, to know that they have obtained a perfected security interest such that when a bankruptcy case begins, the court will honour that security interest and allow you to get far more of your money back than if you did not have that perfected security interest.

Let us talk a little bit more about the situation you find yourself in if you are a secured lender and you are in the bankruptcy case. We have talked about briefly the concept of what it means to be a secured claimant. That is not an absolute status. In the example I gave you, which is where you have a building worth five hundred thousand, but let us pick four hundred thousand so you can see the difference. The building is worth four hundred thousand dollars, you lent one million dollars, and you have a perfected security interest in the building, under that scenario you are perfected only to the extent of four hundred thousand dollars.

In every jurisdiction that has basic bankruptcy laws, you will find that there are court proceedings you go through to determine the value of your collateral, because I, as the holder of the collateral, will go to the court and say that building is worth one and a half million dollars, and I am owed one million of it. The company will come into court and say that building is worth one hundred thousand dollars, and the other nine hundred thousand dollars is an unsecured claim, which he gets ten cents on the dollar in return for. So one thing that the law does not yet do, but must address, are these very important evaluation issues, there must be a mechanism that allows for the quick and accurate determination of a secured claim.

Let us talk briefly about the question of priority and the role of secured claims here. We heard a bit about priority just a few moments ago, although the focus there was slightly different. I am talking now about priorities vis-à-vis the payment of claims in a bankruptcy case. Under Russian law, as well as many other laws, there is a provision that says that a secured claim is not actually part of the bankruptcy estate, that is the secured property is not part of the estate. Now that is good news for a creditor, because it means that the creditor, in theory, does not have to go through the procedures in the bankruptcy court to get his property back. Do I believe that? No. We are going to have to see what happens both in the bankruptcy courts here in Russia as well as the normal civil courts in terms of how long it takes for a creditor to get his property.

But there are two provisions I call your attention to. One is Article 6 Section 4. The Bankruptcy Law passed by the Supreme Soviet just prior to that does not have even such favourable provisions for creditors. But today in Russia, people tend to view President Yeltsin's law as more likely to be in place today. What does Russia have to do now to move forward to provide lenders and others with the protections they need in order to make secured loans? Well number one, obviously we all need to see some history, we need to see how the bankruptcy courts actually operate, we need to become satisfied that the judges have the expertise to evaluate these cases, we need to be satisfied that the procedure is not corrupt, that it is accurate, that it is timely; we need to see that the perfection issues are resolved so that the
starting point can be obtained so that we can know that client has a perfected security interest in some type of asset.

The bottom line is that there is good news: Russia is now starting to adopt laws with the help, frankly, from the groups such as IRIS and the EBRD and many others who are operating now in Moscow, to set the framework for the treatment of secured claims in bankruptcy. With work from all of us here in this audience, and others in the community we can hope that the future will remain relatively bright and we will get there one day. And if you are considering making secured loans at this point you should do so with, in my opinion, very great caution.

Victor Golubov,
Deputy Chairman, Russian Federal Bankruptcy Agency, Moscow

I am grateful to the organisers for having invited me to take part in such an interesting meeting. I am very grateful to my colleagues who spoke before me and who focused their attention on problems relating to security and obligation relations in the process of liquidating insolvent enterprises. Allow me to express my personal position and, to a significant extent, the position of the Federal Bankruptcy Administration on the central question.

The question of securing obligations through the system of pledging the property and assets of subjects of entrepreneurial activity in the process of satisfying creditors' claims against an insolvent debtor is, on the one hand, a component part of the overall problem of securing loan guarantees, and we fully realise this. But on the other hand, especially with regard to current Russian realities, this task is an extremely important independent problem that has to do with attracting foreign investment in Russian industry.

A few statistics. Since August, after the promulgation of the relevant regulations, we began maintaining a list of unsatisfactory balance structure, that is, having one of the main indications of insolvency - such enterprises now number about 1,000. In several cases involving such enterprises, decisions have either already been taken or have been prepared and are awaiting approval, or they are being formulated at the present time. Decisions taken by the federal administration with respect to such debtor-enterprises are already being implemented and will be implemented in the framework of both the judicial procedures established by the current bankruptcy law and the substantially broader spectrum of extrajudicial procedures, which are established by Russian Federation Presidential Decrees Nos. 2264 and 1114 on the sale of debtor-enterprises, as well as by Government Resolution No. 1001 on special terms relating to the sale of enterprises and Resolution No. 490 of May 20. During this time we have drafted about 40 standards and procedural documents, the most important of which can be read in the specialised economic publications. But it can already be said that according to various estimates, between 30% and 50% of all Russian industrial enterprises have an unsatisfactory balance structure and could be subject to both judicial and extrajudicial procedures, including liquidation procedures. In any case, in view of this present situation of the Russian economy and of Russian industrial enterprises, we can speak of liquidation procedures with respect to several thousand enterprises.

When we speak today of enterprise bankruptcy in terms of Russian legislation, the Federal Bankruptcy Administration has in mind, first of all, the liquidation of a business, i.e., the liquidation of a legal entity; and least of all, liquidation of the production on which that business was based. The fact is that the mentality that currently prevails in Russian society, unfortunately, usually associates the concept of an enterprise with the concept of production. We, however, have quite explicitly determined for ourselves that we associate the concept of
an enterprise with the concept of a business. And the strategy that will be pursued by the Federal Bankruptcy Administration will consist in that even in the process of competitive production, we are going to try to form a competitive mass, in order, if this is possible even in some small way, to form lots to be offered for sale, lots that will be of independent significance for both the commencement and continuation of a business by a given owner. In our opinion, this will undoubtedly help make it possible to reduce the production downturn that is inevitable in the process of structural reorganisation and, naturally, to preserve at least some jobs, since jobs are what support production. I think that it is rather clear to everyone sitting in this room that implementing such a strategy is impossible without the establishment of a legal mechanism to secure loans. If there is no system for securing loans, there will be no real investments in production.

Meanwhile, it is perfectly clear that if there is no way to attract investment, potential buyers of such lots will have no interest in buying. It is therefore clear that only a favourable climate will make it possible to implement the strategy. Everyone is familiar with one smoothly functioning mechanism for attracting investments: it is the mechanism of the mortgage loan. In other words, a loan secured by real property. This is no accident. Real property is a unique object of ownership that, to a certain extent, depends on processes linked to the inevitable decline in the value of a currency. In this instance we are talking not just about the rouble, but about any currency of any country. The experience of Poland, as the esteemed Professor Dwight informed us, is that bankruptcy mechanisms have been placed at the end of the line. There exists a rather unique, I would say, result, if the collateral pledged is the output that an enterprise produces. It is probably not fatal if the collateral is real property that is apart from the basic production cycle. But today, unfortunately, we encounter instances in which, either by virtue of insufficient competence or ill intent, property and equipment that are a direct part of an enterprise's basic production cycle may serve as collateral. In this situation, the removal of a portion of that property will inevitably lead to the shutdown of a production facility that may be operating normally in principle and be potentially capable of making a profit.

For this reason, it seems to us that the strategy and mechanisms proposed by the Federal Bankruptcy Administration could prove more civilised and more suitable to Russian conditions, when as a result of the liquidation of a legal entity i.e., an insolvent business, we are nonetheless able, while satisfying creditors' claims, to preserve as many elements of still-sound production as possible. We therefore believe that the procedure for satisfying creditors' claims in the liquidation of debtor-enterprises in both judicial and extrajudicial procedures, in the event that the property and assets are insufficient for satisfying the claims of all creditors since there is no problem if such assets are sufficient, should be uniform and establish a single order of priority in satisfying claims.

At the same time, the rights of creditors whose obligations are secured by a pledge must be specially stipulated in this mechanism and procedure. The order of priority for satisfying creditors' claims is currently established in Article 30 of the bankruptcy law. It says that the claims of creditors holding pledges are to be satisfied in a pre-emptive fashion, which is to say that they are outside the general order of priority for satisfying creditors' claims. In my opinion, this is a good standard, these are rather serious guarantees. And this standard fits in well with the Federal Administration's concept that I spoke to you about. But, unfortunately, Article 64 of the new draft Russian Federation Civil Code states that a pledgee becomes a third-priority creditor. And now this standard is on the verge of becoming the law in our country, since the first part of the Civil Code, as you know, has already had its third reading in the Duma and will be published and enter into force in the near future.
I do not think this is the best standard that could have appeared in that section, it could, of course, influence the reduced intensity of investment policy in Russia, but we feel, nevertheless, that without violating even this standard of civil legislation, we will be able to establish rather good guarantees for creditors' obligations to whom are secured with pledges in the course of further work on changes in the bankruptcy law and the development of the regulatory base for implementing this regulation and others that will appear.

On account of limited time I cannot, of course, describe in detail the mechanisms that we are currently studying, and so I will only outline the areas in which we are working to solve this problem. First, in any case we are going to divide property pledged as security into a separate lot in the process of forming a competitive mass. Second, if property has been pledged as security in a way that is detrimental to the possibility of establishing a new efficient business - the examples I cited, the part of the production cycle, the sound production cycle - we are going to provide a mechanism, with the creditor's consent, for replacing the assets pledged as security with assets that have less of an effect on the production cycle; with the creditor's consent, we will replace one lot with another lot in favour of that creditor. We are also studying the time aspect of the concept of order of priority in satisfying creditors' claims, since the lots could be rather sizeable, in effect independently operating production facilities, and I am not convinced that the sale of the entire competitive mass would be possible at the same time. And so there is something to think about here too; we are looking at mechanisms that will strengthen guarantees for creditors holding pledges with a view to safeguarding their rights.

Finally, we are working on a restrictive mechanism for satisfying the claims of creditors having different priority. For the time being I would like to confine myself to what I have said on this matter.

And in the small amount of time I have left, I would like to talk a little more about another problem. This problem is of a somewhat different character and concerns securing another type of obligation to a somewhat different type of entity. I am referring to current problems in securing obligations to first-priority creditors. As you know, this category includes, above all, persons whose health has been harmed by a debtor - to put it plainly, people who have been disabled or injured on the job. In our difficult social and economic conditions today, the disability payments they receive from enterprises are often their sole source of support. At the present time, we have in the bankruptcy law and the new draft Civil Code a standard stipulating that the amount of obligations to creditors of this type is to be calculated on the basis of a temporary capitalisation of payments, to include interest charges. Now please tell me how we are going to calculate the amount of these obligations if they are to be paid, by court order, to the person throughout his lifetime? To determine this, we have only to solve one very simple problem - knowing exactly how long he is going to live. The existence of this standard in the current law and the new draft Civil Code essentially makes this problem insoluble. And I think that the solution to this problem, which you and we must solve together, lies in introducing in Russian Federation legislation a system of insurance and insurance obligations to creditors of this category.

There are various ways of solving this problem, both with and without the involvement of the state, but it will have to be solved by introducing mandatory insurance for this category of citizens and enterprise employees, with a transition to subsidiary liability of the insurer for the category of first-priority creditors in the event of an enterprise's bankruptcy. This issue is controversial and difficult. There are differing views and differing positions; I have heard it said that we should limit possible payments of this kind to a certain period. Others, including authoritative legal specialists, have expressed the view that not all obligations are to cease
upon a physical person's death, so why should these obligations cease after the liquidation of a legal person. But I think that in Russia's current conditions, this problem is a fundamental one, and it seems to me that its solution should be sought in the insurance mechanism that I spoke of.

9. Registration

John Schelderup Olaisen,
Director, Norway Group AS, Oslo

I will do my best to give a compressed representation of the Norwegian system for registration of financial pledges. Let's start with the Norwegian tradition. The process of legal registration of a document is in Norwegian expressed as 'Tinglysing'. Tinglysing goes back to the Vikings and can best be translated as 'public announcement' it includes both the registration and the certification of the legality of ownership, to pledges, or order of rights or encumbrances. The objective of 'Tinglysing' was and still is to protect one's rights against any other claims from any third party. The 'Tinglysing' was in the old days, shouted out by a herald every Sunday at the church. And it could sound something like 'and I hereby declare that Mr. Perelson has acquired real-estate of Beverly Hills by mortgage of first priority for the amount of Norwegian Kroaner one thousand in the favour of Mr. Hansen' that was the old Norwegian register. The 'Tinglysing' was and still is executed and the register kept by the local courts throughout the country. But a lot has changed since then and the Norwegian system today is totally computerised. We will say that the implementation of computerised registers has increased the efficiency of the registration procedures and the registration time is 1.3 days for entry into the real estate register and three days for entry into the register for moveable assets.

Of equal importance to the financial industry is that the system has been simplified for the users allowing easier access to the registry information as well as a better overview. And the ability of quick direct access to reliable updated information has for the banks led to a better security on lending and thereby also increased the borrowing power of the enterprises. But the system has at the same time, not forgotten to secure free access to the public to public information.

The banks in Norway had, up to 1981, few options to secure its lending by taking a charge over the clients moveable assets. This situation was a limitation to the industries' capacity of financing and the industry and the banks had been for some years lobbying for a law reform in this field and by the new collateral law in 1980, we established two separate systems for registers. There is one separate system for real estates which is kept by the eighty eight local court offices throughout the country. And there is another system for moveable assets with a central location for the whole country and its kept by the Brønnøysund Registries, that is a state agency, that was established in 1980.

While the registration of the properties identification numbers and also ownership into the real estate register is compulsory, any registration into the register of movable assets is voluntary. The real estate register includes all information about different properties like real estates, land and also buildings, and it also includes charges to machinery and other assets that is identified by their property ID identification number. The movable assets register include assets like stock or goods, motor vehicles, farming equipment and machinery, livestock and crops, fishing tackles, receivables existing and future. There are, however, some common rules for those two systems and the collateral law of 1980 regulates, or gives regulations, that govern the two systems.
All the registration or pledges and claims is voluntary in both systems. Claims enforced by a court order are however automatically registered. The collateral law also established the principles of the negative credibility, meaning that any claim not registered has no right over other third party claims. And the collateral law also states the rank of priority or states that the rank of priority is ruled by the date of registration. It means that all documents filed for registration on the same day have the same priority and this regulation rules also for enforced claims, taxes or whatever. There are however some minor exceptions almost of no financial importance. The content of information registered per document is the name and address and ID number of debtor, creditor and owner and the object itself. Also the category of the document like pledge, enforced claim, or whatever. There is a description of the object, for real estate and motor vehicles; there is also an ID number. And then the amount and dates. Certified originals of the registered documents are bankable negotiable documents that can be transferred to a third person and still be valid without registration of the transport. It means that the creditor may change during the lifetime of the document without being registered again. The state is responsible for any mistakes made by the two registers, but we have a record that shows that there are very few mistakes made. To symbolise it we can mention that the total income for the state treasury from the fees paid for the registration from the real estate register was in 1993, about US $ 215 million. The yearly amount of claims covered by the state treasury has been less than one per thousand of this amount. For the register of movable assets the situation is even better as the amount of covered claims has only been the amount of US $ 20,000 totally for the period of 1980 to 1994.

Let's then go to the registers. Norway is a fairly small country. It covers about the same area of land as Poland, but when we look upon it, it is much more stretched. And if you measure it from West to East it goes from Amsterdam to the East of St. Petersburg. And from North to South it goes from Oslo to Rome. It means if you turn the map totally around you find Oslo up there and at the bottom you find Rome, it means that when we engineered or decided the Norwegian system we covered a great part of Europe in respect to land. The real estate registers, as I mentioned, is kept by eighty eight court offices throughout the country. It has been computerised since 1992 and it includes 2.6 million properties and as I mentioned the registration of the properties is compulsory. All information is registered on the property level and the court office keeps copies of all the registered documents on file. In 1993 there were 930,000 documents registered. There is a central Norwegian real estate register that contains all information from the local databases. This central register is updated on a daily basis, or more correctly through the night. All information is public information that can be reached free of charge but it means you have to show up in person at the court office. Information at the central register is sold to the professional commercial market, like banks, insurance companies, real estate brokers and so on and delivered by an on-line data communication system. In 1994 there were 600,000 enquiries made through the on-line system and the total fees for the state treasury was US $ 5 million with a profit margin of fifty percent for the state. The system will, on enquiry, report all properties all over the country owned by a named person, identified by name, address, and ID number. And all pledges, encumbrances whatever, are reported on the property level. From beginning of 1995 this register will be integrated with the GAB, the Ground Address Building Register that comes from the local municipality and includes all technical information about the properties.

The register of moveable assets was established in 1980 and the register was delegating the responsibility for this country-wide register. The registry is also responsible for some other central registers that I will not mention now. The register of moveable assets is voluntary but requires a fee to be paid, with the exception of enforced claims by a court order. The registry covers documents of two types: we have the voluntary agreements like financial pledges or
agreements, leasing agreements, marriage settlements, and amendments to previous documents and deletions. The other type is the enforced claims based on court orders only. The registry of moveable assets do not keep any documents or copies of the registered documents; all documents are after the scanning process sent back to the center, or that is normally the creditor, with a certified stamp on it. These certified originals are bankable negotiable documents of value for their holder. The registration gives a legal protection against and about any third party claim, even from the state. When the registration process takes place the system automatically checks the correctness of the name, address, ID numbers by data communication by the other databases Bremas in Office. An on-line computer data communication by an auto phone or fax, manual phone or fax or by hard paper.

Registers in Norway can both be reached by the professional market of professional users, through the same data communication network. The key element in establishing a register is the ID number, and the ID number is crucial to the quality of the register and also then to the reliability of the screening reports. That again is the basis for the risk management for the financial institutions, so when starting to develop a register system, do not forget to develop the ID systems. By the end of 1993, such voluntary registering of pledges into the promissory registered, counted for three million documents, and the total value of them represented US $ 50,000 million. This illustrates the increased borrowing power for the industry. You will always be welcome to exploit our experience in developing and operating such registers.

Marina Vit,
Russian State Duma, Committee on Property and Privatisation and Economic Affairs, Moscow

It was of course very interesting to hear the previous speaker and to compare what he said with the state of affairs with registration that we currently have in Russia. Needless to say, we are in a very difficult situation. On the one hand, we want to make up for lost time, and on the other hand, we realise that we are not in a position to create a civilised registration system very quickly. For this reason, the State Duma's Committee on Property, Privatisation and Economic Activity has set up a special commission of representatives of all ministries and departments to draft a law creating a system of registration of property rights and other perpetual rights to real property. The commission has established a standing working group, and on November 22 a hearing will be held at a meeting of the commission on the first working draft of such a law.

First and foremost, we have come to the conclusion that a registration system in Russia should be established in a consistent fashion and in stages. To this end, the government should adopt a special state programme for the stage-by-stage creation of a system for registering rights to real property. In the first stage of the creation of this system, it would be advisable to maintain all the existing state structures that are currently engaged in registering various types of real property. It must be said that a disparate system of registering various types of real property has come about in the various constituent members of the Federation. Land ownership is registered separately, ownership of buildings and structures is registered separately, and ownership of apartments in these buildings is registered separately.

For this reason, we must first of all gradually combine all real property: parcels of land and all other types of real property on them. At present all these things are totally separate. Some constituent members of the Federation have now moved forward and are creating consolidated state structures that register, for example, land and the buildings and structures on that land at the same time. But as a rule, the registration of apartments is still separate. For this reason,
taking into account this dissimilar development in our Federation's constituent members, of which there are now 89, and in view of these members' varying degrees of readiness to create registration systems, we have concluded that we need this kind of staged introduction of a unified state system for registering ownership of real property. In the first stage, given this disparate system of registering various types of real property, the constituent members of the Federation may create - and I say "may" create because all this is essentially at their own expense - a single registration center.

And simultaneously with the development of these registration systems, a unified data base on real property and ownership thereof will be established. It must be said that we currently lack such a data base; we have had and continue to have technical inventory offices in each district and city that have always kept inventories on the technical parameters of various properties. And it must be said that even this inventory system is extremely imperfect, and that for purposes of describing real properties and listing ownership of it, the system can be used only if the information is verified in each individual case. This is because as a rule, the information in it is out-dated, even information about property on the land.

Now let us regard land per se. Land-management agencies have maintained records on land resources. These records on land resources have been better where agricultural lands are concerned; in the cities, land resource records have been extremely deficient. Therefore, even the descriptions of land parcels will be very incomplete when it comes to issuing title deeds of land ownership. We understand this and are now introducing into our system the need to pull together the entire registration system for parcels of land and to assign cadastral numbers to them. But at the same time, we realise that such cadastral numbers can be assigned and should be assigned now, as a rule, apart from the performance of land-management work. In our country, land-management work is lagging behind the level of development of land ownership and behind the need to issue deeds and descriptions of parcels of land. For this reason, the cadastral number at present can consist of a code for the constituent member of the Federation, a district code, a city code, and a code within a city or district; the number of a given land parcel per se is then assigned in the registration process. To all intents and purposes, then, the registration number is the final part of cadastral number assigned to a real property. And in describing this real property we will gradually be forced, especially in the process of developing the real estate market, to improve the description of real properties and to supplement the description of these properties in the process of closing transactions involving real property.

Concurrently with these efforts to create registration systems, some constituent members of the Federation are now starting to develop a unified data base on real property and ownership thereof. And again, such a data base can be most reliable only if it is developed in the process of registering ownership of real property. We have a data base that is being established on real properties in the inventory process, but as a rule, this data base will not be able to serve the development of the real estate market and potential owners to a sufficient degree. Therefore, we are making provision once again for the development of this data system. This creation of the data system, like the development of the registration system, will also proceed from the bottom up, from the district, city, and constituent member of the Federation, and sometime in the very distant future we will be able to say that we have an information system - maybe not as perfect as we would like - that approaches the real property information system that Sweden now has. We are in general studying Swedish experience, and in this respect, of course, we would like to strive for a streamlined registration system and streamlined data system on real property like the one in Sweden. In this regard, a register is also of great interest. It is known as either a register of charges or a register of mortgages; the Swedes are now separating it out...
and making it an independent register, against the backdrop of the register of owners, the register of property rights, and the register of various servitudes.

And so there will be a separate register of pledges. For us, of course, the establishment of such a register is especially relevant, and it would be quite possible to enlist banks in this effort; there are even commercial banks that are interested in creating such a separate register of pledges. And so in this respect we hope that we will be able in the first stage to create such a register of mortgages. But this first stage, which we can be said already to have entered, is of developing a registration system; this first stage is bad in that the state cannot yet guarantee your ownership rights and cannot protect them. There is nobody to protect such rights as yet and no way to do so. We do not have the personnel, the funding or the pertinent legislation. For this reason, the job of protecting these rights is essentially shouldered by the owners, and owners are given an opportunity to defend their rights in court. But we hope that as insurance funds are created and as the registration system is improved in the course of the subsequent stages of the system's development, the state will be able to guarantee such rights and to protect them.

Marina Artamonova,
Senior Adviser, Department of Commercial Operations, Tokobank, Moscow

I would like to welcome those present in this hall and to thank you on behalf of our bank, as we are the only participants in this conference, and to thank the organisers of the conference and, without belittling the contributions of others, in particular our share holders, the European Bank for Reconstruction and Development. I would like to say a couple of words about the bank. Our joint-stock commercial bank, Tokobank, was the first Russian bank to obtain general foreign-currency license No. 1 from the Russian Federation Central Bank. Hence we have exactly five years of banking experience now, and we marked our anniversary on October 31. And so the practice of pledge legislation has a direct bearing on our activity. Since I do not have a lot of time, and some rather authoritative speakers have already covered the practical aspects of registration of pledges, I would like to focus a little attention on their enforcement in practice.

The preconditions are now in place in the Russian Federation for pledges to become all but the chief means of securing a debtor's obligations, above all for banks and lending institutions. The growing role of pledges is being promoted to a significant extent by such negative phenomena, characteristic of the transitional economies, as inflation, declining production growth and the nonpayments caused by that growth. It is also no secret that in current conditions, there has been an inordinate increase in the danger, especially for banks, that a debtor will default. And in the conditions that obtain, trust in a partner to a transaction, including a lending transaction, has now been lost to a considerable extent. And as a result, instead of means of security based on trust in the person of the debtor, we are now having to base this on methods that rely only on trust in objects - i.e., on pledges.

For secured transactions, of course, the most important factor is the recognition of such transactions as valid; in other words, such transactions must be entered into in a manner that complies with the legally established procedure and form. The legally established form is a condition for the validity of a pledge agreement itself and, at the same time, it establishes the moment of its entry into force. For this reason, the adopted Pledge Law, being an act of direct effect, has of course filled the vacuum in the sphere of pledge transactions under the law of obligations, and it represents a major step in this direction; but it has proved so exhaustive for practitioners that it sets forth only the basic provisions of this civil law institution. Pledges can
protect the interests of a creditor in the fullest and most reliable way because in such cases any change in the solvency and property situation of a debtor cannot in this instance affect the satisfaction of the creditor's claims. But since the law introduced state registration of pledge agreements, especially the most reliable types of pledges, while the mechanism for this registration is still currently lacking, for all practical purposes, this situation has confronted practitioners with great difficulties in enforcing such agreements.

The law also provides for notary certification of such transactions. The cost of notary certification is currently set in the amount of 3% of the value of the transaction. Of course, neither the lender nor the borrower, if the transaction is a very large one, wants to pay for notary certification at his own expense. This is especially so if a short-term loan is involved because short-term loans in this situation do not justify such costs for notary certification if there are sufficient conditions that show the creditor rather clearly that the transaction can be enforced. At the same time, it must also be borne in mind that in practice, efforts to properly enforce such orders are unsuccessful solely because this mechanism is lacking. Even obtaining the knowledge that pledges are subject to state registration and create for creditors a guarantee of real satisfaction of all claims that could arise in the event of the debtor's defaulting on his obligations is, in practice, virtually impossible. And so the banks are having to resort to other types of pledges that do not involve state registration and notary certification.

In our situation, our bank has had virtually no precedent in which a lender has applied for recovery of property under foreign-currency transactions, and there has been only a negligible number of cases of recovery in rouble transactions and only for citizens' personal property.

Given the lack of such a mechanism, the bank for the most part, tries in practice to be guided by the parties' agreement, and naturally to avoid a judicial settlement of such disputes, since for banks in this situation, in contrast to all other legal entities, it is preferable to use the funds in clients' foreign-currency accounts and pledges of deposits in these banks as security. In this situation, the bank is authorised by the client himself, in the event that the client fails to perform his obligations on time, with the client's own consent, to use his money in that bank, in a compulsory fashion, to repay these loans. But if the given borrower is a client of that bank, naturally. Of course, a more problematical situation arises if the borrower is not a client of the creditor-bank in question.

In these situations the banks resort to another form of pledge, a pledge of rights, a pledge of rights to contracts, a pledge of rights to the receipt of foreign-currency proceeds from exports, proceeds that also pass through current foreign-currency accounts opened by the client in the creditor-bank itself. Or they have to rely in other cases on the integrity of the debtor himself. Although it goes without saying that in assessing the importance of requirements for the mandatory registration of pledges of certain types of property, it must be borne in mind that the law also permits multiple pledges of the same property to different parties and simultaneously strengthens the principle of priority in obtaining satisfaction.

Consequently, the absence of state registration does very great harm to banks, since the existence of state registration and a strict accounting system could serve as a source of this kind of information for each subsequent creditor. Therefore, the existence of separate provisions relating to pledges in a number of laws, in the special law on foreign trade, on foreign-currency regulation and on banks and banking operations, as well as the large number of publications of mandatory departmental and interdepartmental regulations, the high percentage of the state fee for notary certification of certain types of pledges, the absence of a unified state registration system and of a unified register of pledge agreements on the territory of the Russian Federation, and the lack of a clear-cut registration procedure and a list of

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registering agencies and their powers have led to a situation in which for all practical purposes, the articles of the Pledge Law and the law on state registration and notary certification are not working at this time.

During this time, the committee for state property management was one of the first to issue a provisional statute on reconciling pledge transactions, but it deals only with transactions involving pledges of state-owned federal property. It remains for us to hope that Russian Federation legislation will be brought into conformity with the Pledge Law in the near future, so as to bring order to the process of registering pledges of property and property rights and to safeguard the rights of both physical persons and legal entities to access to reliable information on pledge transactions. As a result, in the future, and rather soon, I hope, pledges will be used in the Russian Federation as one of the primary forms of securing the performance of obligations, as they are in all foreign civil-law systems.

Ildar Kurbunov,
Chairman of the Legal Department of the Presidents Administration in Azerbaijan, Baku

Since our time is limited, I am going to tell you briefly about the state of affairs involving the registration of secured commercial loan transactions in Azerbaijan. After hearing the previous speakers, I think that the problems they discussed here are problems that probably await us in the future, because Azerbaijan is distinguished by the fact that until very recently, it did not have a special law on secured commercial loans. Finally, literally a month ago, a Pledge Law was enacted and filled this gap. I will focus only on aspects concerning registration under this law. The law has several general provisions on registration. Specifically, Article 13 says that state registration is a mandatory requirement for pledges of property that has to be registered with state agencies. The registration is to be completed by the agency that is charged with registering the property that is the collateral. The same article stipulates that the procedure for state registration is to be confirmed by the Cabinet of Ministers.

I think that the very problems that have been discussed here are what prompted our legislators to adopt this procedure, because the fact is that the state agencies that carry on registration, mainly of real property, or to be more precise, the structures of these agencies, are not entirely suited and not completely up to the work that is expected of them. And for this reason, in devising the procedure for registering pledges, no doubt the Cabinet of Ministers will reconsider the activities of these agencies; certain structural changes might be made in these agencies, or perhaps some sort of single agency will be created in which the registration of pledges will be concentrated. In any case, Article 45 of the law provides for the keeping of mortgage books, although the law does not state what specific agency is to manage these books. Apparently, this question will be decided by the Cabinet of Ministers too. At the present time the Cabinet of Ministers has not yet finished devising the registration rules. Therefore, it is still too early to say anything.

At the same time, the law has several provisions aimed at avoiding certain problems that were mentioned here today. In particular, the law provides for the mandatory keeping of a registration book by the pledgee in which all information concerning a pledge is to be entered and which the pledgee is required to make available in response to any inquiries, in particular inquiries from the pledgor and third parties. The pledgee can be held liable for damages resulting from the failure to make this information available or to keep such a book. The legislation also requires registering agencies to provide extracts from the register, again, at the request of the pledgor, pledgee and third parties. A state fee is charged for registration,
although the amount of the fee has not been set yet - as I mentioned, the law took effect only a month ago. The law also provides for the possibility of appealing to the courts illegal actions by an agency registering a pledge, and it provides that such agencies can be held liable for damages caused through the fault of its personnel. In general, this small amount of information is all I can give you about the current state of registration of charges in Azerbaijan.

10. Closing Remarks

Mikhail Mityukov,
First Deputy Chairman, State Duma of the Russian Federation, Moscow

Allow me, on behalf of the State Duma and the Federal Assembly of the Russian Federation, to welcome the international conference on commercial loans, mortgages and guarantees in Russia and the countries of the commonwealth.

The problems you are discussing are not only of a theoretical and legal character, but are also directly linked with the economic and political reality of our country. There is no question that the present and future of reform in Russia and the CIS states is, to a certain extent, linked with investments in our economy and credits. And there is a vicious cycle here.

Many of our foreign friends say that as soon as the proper situation is established in the country, the credits will begin flowing. But this situation, in turn, largely depends on economic recovery, in which no minor role is played by investments, including foreign investments. There is no question that legal security is a guarantee of growing trust on the part of foreign investors and creditors in our state and in Russian entrepreneurs. Russia is establishing the legal basis for a market economy in the very contradictory conditions of the transitional period. Legislative acts have been enacted on property, banks, investments, foreign economic activity, foreign-currency operations, mortgages, and private farming.

This first-stage legislation is very contradictory. It must be said frankly that this legislation is the fruit of many political compromises, the fruit of a combination of that which cannot be combined, and of many ideologies, both economic and political. We are now rethinking and adjusting both enacted laws and the outlook for legislative activity in the Federal Assembly as a whole. A good start in this effort was made by the 1993 Constitution and the first section of the Civil Code, which was recently adopted by the State Duma. But this is only a start, an ideology for the second stage of the transitional period. The parliament's immediate plans include, above all, the modernisation of banking legislation.

Two bills are now ready and will be discussed in the near future including investment legislation and the adoption of laws on mortgage, joint-stock companies, securities, and improvement of the legal system for resolving economic disputes. New versions of the laws on arbitration courts and of the arbitration procedural code will be adopted. There are a total of 76 legal acts relating to the economic sphere that have to be enacted by December 1995. I would like to say that, unlike the old Supreme Soviet, the State Duma is turning its attention specifically to economic reform. But political passions and debates do not allow it to take up these important aspects in earnest, and so it is not surprising that presidential decrees are largely filling in the niches and gaps in regulating the economic activity of our country. Many criticise this situation, but I take a very impartial and objective view of it, since as we establish a new parliamentary system, it is hardly possible for the parliament to keep up with the realities of economic life. Not everything is proceeding smoothly. Obviously, major debates
lie ahead on the draft of the new land code. The main topic of these debates will obviously be
the problem of the boundaries of private land ownership, of how far we should go in this
matter. The Agrarian Party, which is to a certain extent the sponsor of the new version of the
land code, is naturally trying to limit these boundaries. The democratic factions have proposed
their own draft land law, in which they approach this issue from market positions.

It must be said that the outlook for co-operation with the West will largely depend on our
legislation, not only legislation regulating the economic sphere, but also legislation regulating
the political institutions of our country. Above all, such co-operation will depend on these
laws and how they are applied - on the citizenship law, the future law on foreign and stateless
persons, and even such seemingly far removed laws as those on elections and referendums.
Needless to say, this series of legislative acts that have to be enacted by the end of this year
and early next year could be continued. The current conference offers tremendous food for
thought for legislators, and we must think about the ideas that have been proposed and the
possibility of converting them into not only legal realities but also practices for legal
enforcement. Many speakers here, especially in the first section, correctly pointed out that
laws can be enacted, but how are they going to function? They could become a dead letter.
Yes, the enforcement of our laws largely depends on the level of public consensus that now
exists and that will be achieved in our country. Many interesting ideas have been put forward
on important aspects of commercial loans, contract law, ownership, mortgages, recovery of
property, bankruptcy, and the subjects that are being discussed now - registration of charges,
transactions and property. I think that the published proceedings of the conference will be an
aid in the lawmaking activity of the State Duma, and we will naturally study them in all the
committees. And I hope that this report appears not several months from now, but in the near
future. Allow me to thank the conference organisers and the Supreme Arbitration Court for the
opportunity to hear these interesting ideas, and also for the criticism on the enforcement of
current legislation.
1. Case Study of a Secured Lending Transaction

Prepared by Melissa Schwartz, Chadbourne & Parke, Moscow

Borrower: Soviet Joint Venture established under Soviet law, which has been transformed into a Russian limited liability company. The Borrower is engaged in manufacturing at a site in Moscow.

The current shareholders are a Russian open-type joint stock company (‘RCo’) and a foreign company which has no other assets in Russia which is subsidiary of a multi-national company (‘FCo’). RCo is a former state enterprise which was converted into an open type joint stock company and privatised within the last two years.

Lenders:
1. International lending institution. The funds will be used for purchase of new machinery. The international lending institution will provide US$ 15 million with a completion guarantee by the parent of the foreign shareholder.

2. Russian bank will provide US$ 5 million for working capital needs.

Security Requested by Lender 1: The Lender has requested that the Borrower pledge the following:

- Enterprise as a whole (including a first charge on all movable and immovable assets of the Borrower)

Also the Lender has asked for security over the following assets:

- Leasehold interest in factory/office space
- Equipment and other tangible assets
- Receivables under long-term supply agreements to customers
- Main contracts for purchase of new machinery and upgrading of factory facilities
- Assignment of insurance policy with Lender being named as loss payee
- Bank accounts

In addition, the Lender has requested a negative pledge on all assets from the Borrower.

The Lender has also requested that RCo and FCo pledge their shares in the Borrower.
Nicolas Ollivant,
Credit Officer, European Bank for Reconstruction and Development, London

I have to say first of all that I am not a lawyer, and so if I say anything regarding the law of secured transactions I will have enough people here ready to correct me. You can look at me as being the entertainment on a Saturday morning after a hard day of legal discussion yesterday. I am the light relief. However I have been asked to introduce the context of discussion of this case study to be able to focus peoples’ minds a little on some important issues, credit issues, and issues which affect a bank, specifically with regard to security. I think the key question to ask at this point is why a bank would want to take a security. In a sense what I am going to do is make some comments which are related to the conclusion to the case study, but I will talk about these points first. Then we will go through the case study and come back to the points specifically related to security.

The point about security is that this is not a source of repayment for the bank. When a bank makes a loan, it makes a loan based upon the cash flow of a business as a going concern. The expectation is that the company will operate over a period of time whether it is a short term trade transaction or a long term loan and in the course of the business producing profits will repay the loan facility.

Banks never want to take the collateral and have to sell it. It is a difficult, time consuming, frustrating, and ultimately loss making process. One of the significant problems is the cost of going to court. It is very frustrating to find that you have recovered money under a loan and all the proceeds of the recovery are devoted to legal fees.

So why then do we take security? The reasons for taking security are, as a lender you want to have some measure of control over what the company is doing. If a bank is lending to a major international corporation, then clearly this is simply not possible because the company will have far more leverage than the bank will have. But for the purposes we are talking about, the bank needs to be able to exercise a measure of control during the lifetime of the loan. If the bank has security over the company's assets, over its means of production, over its bank accounts, this does not mean the bank is going to interfere with the running of the company, but it does mean that if the bank starts to see problems with the company, and these problems could be due to poor management, poor market, lack of profits, accidents, there are a variety of reasons why a business can go wrong, the bank can exercise some remedial measures: it can step in and operate if necessary, it can take over the company, and quite possibly it might require a change of management, a change of policy, it might even require additional lending, it might require a rescheduling of the company's debts.

The aim of the bank would always be the continuing operation of the company, so that the loan will be repaid. A company has value so long as it is producing profitably. When a company is broken up into its basic assets it is worth considerably less as it would be as a going concern. Therefore, liquidation is the last resort. A number of speakers yesterday have approached this subject from different points of view. The bank never wants to liquidate collateral. The idea is that the bank should make a loan in order to help the company develop its business.

I think one of the speakers yesterday referred to legislation with regard to pawn shops. It is important to realise the fundamental distinction between a bank and a pawn shop. A pawn shop, you hand over your collateral and you get your loan. The lender does not care if he ever
sees you again, because if you do not appear, the collateral is sold and that is the end of the story. This has been or continues to be an issue with some banks that we are working with in the Russian Federation in some of the smaller cities. They want to be conservative, and so they will often demand 150% or 200% for the value of the loan in the form of security, but then they will never review what the business is doing, they do not spend time understanding what the problems of the company are, and what kind of financing they need. Consequently when there is a default on a payment, the bank moves in and takes the assets, which instead of being worth 200% of the loan, suddenly, magically, become worth maybe 50% of the loan.

The concept of going concern is very important. We have discovered with the banks that we have worked with that a constructive approach to credit analysis, to understanding the credit process, to understanding the company and what it is doing, allow successful repayment of the loans. In fact, in the short period we have been operating with some of these small banks in Nizhny Novgorod, in Tula, or Tomsk we have had a 100% repayment record, which I must say is very satisfactory, however I have to say this is only over the last 12 months or so, these are short term loans. But it is beginning.

Now I would like to just go through the case study. It is a manufacturing company based here in Moscow. The loan is US$ 15 million for purchase of machinery which will be imported. It will be a hard currency loan because requirement is to buy the machinery from two sources, from a Swedish manufacturer and from one of the partners in the joint-venture. The structure of this facility and this project is kept fairly straight forward, because the purpose of this is to engender a discussion of the requirements, the collateral, and the security, rather than dealing with specific terms like Interest Rate Risk, the strength of the partners, the analysis of the partners and so on. We can come back to the terms of this particular facility as this discussion goes on.

Once I have made some comments on the credit aspect I will come finally to the specific points to do with collateral, at that point Melissa Schwartz will take over to discuss those aspects which I am not qualified to talk about.

Now we are talking about a capital loan which is going to be for a term of about 6 or 7 years. We have a short period of time in the beginning which is known as the grace period, that would normally be appropriate where a manufacturing facility is being constructed or it could be a building where there is no cash flow from the operation. In this particular case, we have a factory which has been producing, and where the participants are going to address the new market, which is the market for airbags for Russian automobiles and for automobiles in Poland and elsewhere in Europe. So 50% of the company is owned by Chicago Resources Russia Limited and the other half is owned by a Russian joint stock company Griboyedov Enterprises. I have chosen Chicago Resources as the U.S. company because, as an aside, I should tell you that my banking career was spent mostly in Chicago with two financial institutions there and also at the business school in Chicago and so if you have questions about banking, please do not ask me about the English banking system, because I am relatively uninformed about it.

The U.S.$ 15 million loan is designed to pay for new equipment to manufacture airbags. The 5 million for the buildings and the 5 million for the infrastructure, I assume in this case, come from the partners that already work with this company. This company exists and so we would describe this as being an in-kind contribution of equity.

There is an important question about how you address important issues of valuation here, but this is not the forum in which we need to discuss it, but clearly if a company in Russia is
contributing a building, some land or some machinery we have to be able to reach some kind of agreement as to its monetary value.

The other point about this is working capital. We have assumed for the purpose of this case study that not only will an international bank be providing long term capital but there will be a Russian bank, which we have named the Bolshoi Bank which will provide working capital. What do we need that for? We need that because of the fluctuations in the company's ability to produce, its level of sales, its level of inventory and level of receivables. Clearly a company operating in Moscow will need the services of a local bank. In this case we are working on the basis that the local bank will have a U.S.$ 5 million equivalent in roubles available for working capital needs. This will be an unsecured loan. Clearly in a situation like this where an international bank is making a long term loan, it will wish to have as much security as possible. The local bank that is making the working capital facility available may well require security of its own. In relation to the banks we are working with in Nizhny Novgorod, for example, this is an issue which would be for discussion between the partners and between the two banks. The summary capitalisation shows you the contribution of equity and debt.

Generally speaking when we are reviewing projects at the EBRD, we would like to see a minimum of about one third of the project supported by equity. Clearly the more equity you have the lower the financial risk. Financial risk is based on the fact that if you have debt you have to make repayments of principal and payments of interest, regardless of the company's profitability. The equity holders receive dividends, in theory only when the company is sufficiently profitable. If the company is in a relatively low risk business then clearly it can support a higher level of debt because it has a consistent income.

A company that is involved in high tech manufacturing, in a new process, in markets that are difficult such as fashion clothing, their profitability is going to be higher, but their financial risk is also going to be higher. In projects of that sort, we would expect to see more equity and a lower level of debt. In this case under discussion we have one third equity and two thirds debt, which would seem about right for a manufacturing company.

The issues that we come to shortly, the issues that Melissa Schwartz will address, are the legal issues of how you secure the loan, but also the issues of the structure of the company. We are assuming that this company was originally set up as a joint-venture under Soviet legislation and has recently been transformed into a joint stock company. In fact there are a number of projects the EBRD is looking at where there is the issue of whether or not the company wishes to convert, to make this conversion from the joint-venture status to a limited liability joint stock company, because there are major legal issues, there are expenses and so on, and this is something the bank, and specifically the bank and its lawyers will want to address in detail.

Coming onto the key credit issues, these relate specifically to the ability of the project to continue to operate. Now in the case of this project, where we are assuming that there is some building work to be done, the installation of machinery and so on, we want to make sure, as a bank, that this project will actually come together in a meaningful way. Generally speaking we will require a completion guarantee. Now this is not a guarantee of the loan it is a guarantee by one of the participants, in this case Chicago Resources, that if additional money is needed to complete the project, that the money will be forthcoming, either in the form of equity or inter-company debt. The last thing the bank wants to have is a project which is two-thirds complete and where the partners walk away, where we have neither an ongoing business nor a completed assets. No bank is in the business of manufacturing airbags. The technical experts are in this case Chicago Resources and Griboyedov Enterprises so a completion guarantee is always vital.
Now in this case we are saying 'well, the completion guarantee is from a company based in Chicago which has a credit rating of, for example, A+ by Standard and Poors. Are we happy that they will be able to put in additional cash if necessary?' The way we would determine this is by conducting a credit analysis of the U.S. company. If we were talking about a privately owned company, or a company that was relatively weak, we might conclude that we did not have enough certainty, in which case we would seek support possibly from the Chicago company's bank. We would say 'Please, would you get us a standby letter of credit or guarantee from your bank saying that if you have to put in the additional cash that in the event, you, Chicago Resources are unable to do that, then the bank will put the money in instead.' In this case there will be a limit of say one, two, or three million, whatever is appropriate. The financial statements of the company itself to which we are lending.

In this case, we have a company which has been unprofitable for the last couple of years, it has an accumulated deficit. We need to know what is going on with the company. For this particular project, I have assumed that the financial statements have been compiled by an international auditor. Now a compiled statement may look like an international set of statements produced according to the Generally Accepted Accounting Principles or any other international standards. The problem is that a compilation means simply that the accounting firm has taken information from the company and presented it in a standard format. It does not mean that there has been an audit of the company, a review to make sure that the information provided by the company gives a fair and accurate picture of what the company is doing. In a case like this, the bank might well require that an audit be conducted of this particular borrower. This is an additional expense and so this would be another point for negotiation between the bank and the borrower. These are the issues of technology, the market, how many airbags can the company sell, who will buy them, if we have an off-take agreement, how can we assure ourselves that the entity which has contracted to buy the product of the company will be able and willing to pay for the product. So it may require the credit analysis of the companies who are the customers of Moscow Manufacturing.

I mentioned earlier the subject of management. This is absolutely crucial. If the management is not competent or management changes during the period of the life of the loan, this can have a dramatic effect on the company's profitability.

There is the issue of the credit worthiness of the local bank. If the local bank has problems we do not want our customer to lose cash balances and indeed we want to make sure that the working capital line remains available. We may have to do an analysis of the local bank. In this case we have assumed that the local bank, the Bolshoi bank, is a shareholder in the Griboyedov Enterprises, so it has a strong interest in ensuring that the working capital facility is available.

This is, such is the structure of the loan whether the loan should be fixed rate or floating rate, whether the loan should be in dollars or DM, or Swedish Krona, these are all the issues which have to be discussed in order to assure ourselves that the financial risks that the company is taking on are manageable.

The last point of the key credit issues is the fundamental issue that the support of the company by the shareholders is vital. If the shareholders have contributed a significant amount of equity, if they have spent management time involved in the company, of technology, we can assume that if problems arise than shareholders, instead of walking away and leaving the bank
to pick up the mess, will take whatever action is necessary to ensure that the company continues.

At this point, I would like to just conclude by summarising a couple of points from yesterday's presentation as to why bank needs security. We heard about the certainty and comfort with the respect to ownership. Security is required for comfort. The bank does not want to possess the company. It does not want to have to run it, it does not want to have to liquidate it. It is an ongoing business to which the bank is lending. If the business ceases to be ongoing, then the value of the security is dramatically reduced. Security is the last resort for the bank to get paid. I made this part of the beginning and want to conclude by stressing it: the bank will take possession of or liquidate security as last resort, otherwise there is no guarantee the bank will get its loan back. And even if it does get its loan back, the amount of time and effort and management concern that the bank has to put into it will ensure that although the principal may be repaid the actual value to the bank of having a loan on its books for a period of years or they will effectively be completely lost. The cost of administering a bad loan is extremely hard even when the bank can be assured that it will be able to recoup its principal completely. At this point I would like to hand over to Melissa, who will go to the points about the types of security that we will be looking for in this particular case in order for that the bank can have some measure of control over the company and can assure itself that the company will continue to operate.

3. The Role of the Lawyer in Russia and the CIS: Creating Security under Russian Law

Melissa Schwartz,
Attorney, Chadbourne & Parke, Moscow

I am going to try and cover the legal issues that relate to what Nicolas has just explained, going through the case study. There are three points that I want to go through which are the typical points that we would look at if we were brought in to advise the lender or the borrower on this transaction.

The first is the standing of the borrower and of the shareholders. The second has to do with the actual terms of the loan and any approvals or licences that are needed. And finally, and probably most importantly, for today's discussion, is looking down the list of security requested by the bank and seeing whether the borrower can provide that security under Russian law today. When I go through these issues I know I am going to raise more questions than I can answer, especially with respect to tax issues. And my goal is not to answer all the questions but just to flag the issues especially with respect to the tax side, so that when you are looking at the transaction you at least know when to be sure and to call in the tax specialist.

With respect to the borrower the first thing to look at is: does the borrower legally exist. As Nicolas mentioned in this case and has happened in many other cases, the borrower was a joint-venture created under the Soviet rules of Decree 49, and the following question comes up: what happens if the borrower does not want to re-register in one of the forms that is permitted under current legislation. On the books there is a rule that says that the Soviet joint-ventures must re-register, but there are no sanctions, on the books, in the case that they do not re-register in a different form. In the past we have found in loan transactions that the lender typically will require the borrower to transform itself, and there are basically two popular types of legal entities: either limited liability partnerships, or joint stock companies. They are both private, enjoy limited liability, and the important thing to check is that legal
succession is provided for, so that all the rights and obligations of the joint-venture transfer over to the new legal entity.

What we would ask to see to ensure that the borrower legally exists are all of its foundation documents, its charter, registration certificates any amendments to their documents, we would look at both local and federal registration certificates. Unfortunately in Russia today you cannot get a draw down, you cannot get some sort of certificate of good standing. So the best that you can do, is to see that the company was registered - let us say 1 year ago - and to check those registration certificates and ask for representations and warranties that the company is in compliance with all laws. It may be possible to get a certificate from the tax authorities that the taxes have been paid or that at least as far as they know nothing is outstanding. But in our experience, the registration authorities will not issue a certificate saying as of today the company is legally registered, there is a difference.

The second step is to look at who are the shareholders of the borrower with respect to the Chicago company. It is fairly simple. The US is more accustomed to providing the kind of documents that the bankers are looking for. With respect to the Russian partner, you need to go a little deeper. In the scenario that we have created the Russian partner is a former state enterprise. As it has been privatised, you need to look at their charter, their privatisation plan and more registration certificates to be sure that the privatisation was completed in accordance with the law, and to be sure that it cannot be undone. And you have to make sure that at the time that the joint-venture was formed that they had all of the appropriate approvals to form the joint-venture.

In our hypothetical case here, it was a Soviet joint-venture under Decree 49. The Russian partner at that time was probably a state enterprise. Did they get all the proper state approvals both to participate in the joint-venture and to make its contribution to the charter capital? With respect to that, if there is a lease, if they are providing the factory space, if they contributed certain equipment, who actually owned it at the time the joint-venture was formed is very important so that you can be sure they had the appropriate state approvals.

When they were privatised along the way, I am sure their name changed; an amendment should be made to the charter of the joint-venture reflecting the changes in the corporate status of that shareholder.

The third point to look at with respect to the borrower, is whether it has all of the authorisations and licenses to carry out its business. Our case is a little similar, intentionally so, because we selected manufacturing. If this were a telecommunications joint-venture for instance, it would be very important to look at the license that the joint-venture has, to try and get some sort of certificate from the Ministry showing that the license was still in effect.

One point that I just want to raise here, and then set aside, because it does not relate to this case study, is that licenses, including licenses from the Ministry of Communications, are not transferable. Nearly all of these licenses say at that bottom in large letters that the license 'May not be transferred, assigned, or pledged' and a few more descriptive words so the question for the bank is if the company goes into default and you have a pledge of the enterprise, and you want to run the company, what risk do you have that the license will be revoked.

The fourth point relating to the borrower relates to their management. Many times clients have come to me and said, we are a partner in a joint-venture, we have operating control, it is a fifty/fifty joint-venture (like our case here) but we control this joint-venture. And then I look at the documents, what I see is a deadlock on every important issue. Under Russian law there
is a small group of issues that must be decided by three quarter vote. That involves change of charter capital, liquidation and changes to the charter. Aside from those there are other operating decisions that typically the charter will say need to be made by majority vote. Fifty/fifty does not give you control.

What some joint-ventures have written in their documents is the partner A gets to nominate the general director but it is subject to confirmation by partner B. And if there is no mechanism for a deciding vote, I do not see operating control. It is very important if you are looking at management, to see who can break the tie. Typically it is the Chairman of the meeting of participants of the shareholders meeting, of the board of directors, who is key to look at that.

In this scenario, one of the things Nicolas and I were talking about is the idea of a technology assistance agreement. This would enable the Chicago company to provide certain technological assistance to the joint-venture, to ensure that the project is completed successfully. There are two issues relating to this that really need to be focused on. First is the people who are coming in, who are going to be on the ground, providing the assistance, who do they answer to? How much flexibility do they have under the terms of this technology assistance programme. How much flexibility, how much authority, and what happens if there are disputes between these people being sent in and current management.

The second set of issues relates more to the Chicago company: if they earn income from providing technological assistance in Russia they are subject to Russian tax, which as an aside is something they should really be considering.

Once you have gone through all that and you know the borrower exists, the shareholders exist, the management structure is suitable to achieve the goals of the project, the next big area to look at is the actual loan. In this case because the equipment is not a capital contribution it is subject to customs duties, it is going to be subject to Value Added Tax, and when the bankers are calculating how much money is needed for all the equipment, it is again important to look at the tax side. That brings me to security, probably the most important part of my talk.

I have compiled a laundry list of security that I believe would be asked for in this transaction, and discussing it with the other panellists, we think this is very comprehensive. My conclusion is that most of the securities that will be requested can be provided under Russian law. The question due to high notary fees and registration requirements relates to the cost and time needed to create enforceable security interests.

The first thing typically requested by the lender is a pledge of the enterprise as a whole. The Law on Pledge specifically allows the pledging of an enterprise as a whole, the pledge would extend to all of the assets, all of the valuables on the balance sheet, and then you have got the whole package. You have also got a notary fee in the amount of 3% of the value of the enterprise, and you have a requirement for registration of the pledge. One thing to consider is do you need the pledge of entire enterprise, or would the pledge of certain components be sufficient to meet the needs.

The second thing typically asked for is a pledge of the leasehold interest. In our scenario we presumed that the joint-venture leases its factory space. In this case my presumption is this is typical in many manufacturing joint-ventures, is that the leases between the joint-venture and the Russian shareholder. If the Russian shareholder actually has title to the building, to the factory, then state approvals may not be needed, especially in our case where the Russian partner has been privatised. You need to take a careful look at the lease agreement to
determine whether the lessor's consent is required for the pledge, but in many cases it will not be necessary. In this case, because it is manufacturing specifically a pledge of the receivables will be important. In this case, it has been proposed that the bank receive a pledge of the receivables under the long term supply agreements. Again, the Pledge Law specifically allows the pledge of rights; this is a right to receive funds in the future and it is acceptable to provide a pledge of receivables right now under Russian law. Likewise it is possible to pledge other main contracts for the purchases of the new machinery that will be required. You can pledge the equipment and other assets of the company.

The next item on the list is typically an assignment of the insurance policy benefits. This too does not present a problem. Under the Russian Law on Insurance this is permitted. The lender should just be named as a loss payee under the insurance policy.

The lender typically wants a pledge of bank accounts. This raises two different issues: if the bank account is in a Russian authorised bank, it can be pledged. If the pledge is of a bank account in a foreign bank it can also be pledged, but the lender should just note that Russian companies must have a license in order to have an off-shore bank account. The licenses for off-shore bank accounts, typically contain a series of conditions for the maintenance of the account. It will provide where the money can come from, where the money can go to and you need to be sure that your pledge is not going to interfere with the terms of the license.

A negative pledge on all future assets is also permitted under the law, and finally, a pledge of the interests in the joint-venture by the shareholders is permitted. This is true under the old Civil Code, the new Civil Code. With respect to the pledge of the shares, there is one important point to be made. In our case, where the joint-venture has now been re-registered, it is no longer a joint-venture, let us say it is a limited liability company, the interests are not deemed to be securities under Russian law. So the pledge of the interests is not subject to registration. If the joint-venture were re-registered as a joint stock company then the shareholding interests would be securities and you would have to register. In terms of the comfort level of the bank, it may be better if it is registered but you should note that the pledge agreement does not become effective until the date of registration.

4. Putting It All Together: Documentation and Registration

Alexei Zverev,
Linklaters & Paines, Moscow

Melissa Schwartz spoke in detail about the role of the attorney in Russia in giving advice and providing consultation services to bankers, Western bankers who are extending secured loans to Russian enterprises. You heard about the difficulties that confront lawyers and about their problems. I would like to add a few words about these difficulties. It was just said that there exist at least two levels of legislation in Russia: federal legislation and local legislation. As for the system of mortgage legislation, it too is being developed at several levels. In my opinion, federal legislation regulates these issues in an extremely meagre fashion. As for local legislation, I must admit that the Moscow government has gone somewhat further - issues relating to security in Moscow are somewhat more developed.

In addition to the complexities relating to the existence of several levels of legislation, there is also the difficulty posed by the existence of various types of authorisations that must be obtained by the lawyer or banker who intends to extend or obtain such a loan. These authorisations, to be more precise, the quantity of them, sometimes reaches an absurd number.
Several days ago one of the newspapers carried an article about how one of the largest oil companies, Lukoil, had to go through 49 agencies and obtain approval from 49 agencies in order to build just one fuel station in Moscow.

In addition, there are difficulties posed by different legal regulations governing mortgages. The regulations governing personal and real property and pledges of rights are completely different. Incidentally, this is in contrast to the model law that was drafted by specialists from the European Bank for Reconstruction and Development, which proposes a single set of regulations, as John Simpson just said.

Another problem confronting lawyers in this case is the lack of an enforcement mechanism in many instances. This was discussed in a fair amount of detail yesterday, and this has to be brought up again and again in order to finally bring legislation to the required understanding of the problem. The Anglo-Saxon legal school has the institution of representation and warranties. In Russia the rights of investors have to be protected by the investors themselves, for the most part, since this institution is lacking. So this has to be done by either the bankers themselves, as in our case study, or by lawyers who work on their behalf, representing their interests, and verifying all the information that has to be verified. What has to be verified by the bank in our example and by its lawyers, where do they find the information, and how is the security registered - these are perhaps the primary issues confronting lawyers.

And there is one other question: why does all this have to be done? But I think that all the conference participants have been answering this question for two days now.

The fact is that the importance of securing the performance of obligations for investors, foreign and domestic alike, is hard to exaggerate. And as is rightly noted in the introduction to the Model Law on Secured Transactions drafted by the European Bank, guarantees of the repayment of invested amounts are in many cases the first and main concern of investors. Perhaps the key issue here is the registration of secured transactions. It is the registration of a pledge that creates legal consequences in the form of a security interest in real property or other types of property or rights, a pledge of which is subject to state registration. The fact is that in practice real property has been registered up until now, which is to say that the technical registration of parcels of land or buildings has been carried out. But the registration of rights to this real property has been virtually absent or not carried out. Moreover, there has been no acceptable mechanism for verifying encumbrances with respect to various properties.

And so, it is no accident that various types of amusing situations arise in practice. One such curious incident was mentioned yesterday by Lane Blumenfeld, when a Soviet-Hungarian joint venture was able to obtain loans from five different banks secured by the same building. However, legal optimism is offered by recent efforts, in particular by the Moscow government, to streamline the system for registering transactions involving property, registering mortgages, and introducing a unified register of mortgage agreements. For example, Moscow Government Resolution No. 788 of September 20, 1993, "On Introducing a Unified System of Registration of Mortgages [Pledges] and a Unified Register of Mortgage [Pledge] Agreements on the Territory of Moscow," specifies the pertinent regulating agencies charged with state registration of mortgage agreements on the territory of Moscow. It provides for the introduction of a unified register of charges, establishes a list of types of property subject to mandatory registration, stipulates instances in which registration of mortgages is to be denied, and establishes liability of registering agencies for failing to observe registration regulations and failing to ensure accurate and full information.
It is noteworthy that, as stated in the introduction to the Moscow Government resolution, this statute pursues the aim, among others, of safeguarding the rights of physical persons and legal entities to obtain reliable information regarding mortgages. And so what agencies will be contacted by the lawyers representing the interests of our bank, that is the bank in our case study, and what are the functions of those agencies? There are currently about 12 registering agencies in Moscow; they are divided by areas of registration, which are classified mainly in terms of types of property and their specific attributes.

The main such agencies of interest to us in here, in this example, are now before you. Ranking first is Moscow's Property Management Committee. It registers mortgages of buildings, structures and nonresidential buildings and authorises the registration of mortgages of enterprises that constitute state municipal property of the city of Moscow and real property assigned to them. It is followed by the Moscow Municipal Technical Inventory Office, which was already mentioned today and is discussed in the Moscow Times article that Lane Blumenfeld mentioned. The Moscow Municipal Technical Inventory Office and its district offices register mortgages of residential buildings, buildings, structures and non-residential facilities that are not part of the city of Moscow's municipal property. I have put in third place, not in terms of importance, but simply in terms of order, the Moscow Land Committee and its district offices. In accordance with the delimitation of powers established by Moscow acts, it registers mortgages of tracts of land, as well as mortgages of buildings, structures, facilities, enterprises, and greenbelts and other groups of trees that are not included in the forest fund, along with the tract of land. Then comes the Moscow Registration Chamber.

The Moscow Registration Chamber simultaneously maintains the unified register of mortgages. It registers mortgages of enterprises of any type of ownership, if the mortgage relates to the enterprise as a whole and its structural units and divisions as property sets, including sets that include material and nonmaterial assets, personal and real property, and the enterprise's debts, and it forwards information on the registration of a mortgage of an enterprise directly relating to land to the Moscow Land Committee. In addition, the Moscow Registration Chamber conducts voluntary registration of pledges at the request of pledgors or pledgees. As the agency that maintains the unified register of pledges, the Moscow Registration Chamber keeps a data bank, operates a unified archive of copies of mortgage agreements, assigns a number or code in the register of pledges, operates an automated information service system, maintains entry books, and so forth.

And so as I mentioned, there are about 12 different agencies in Moscow at present, each one specialising in a given sphere. In connection with the fact that mortgages of real or other property, as well as mortgages of rights, are subject to different legal regulations, and in connection with the fact that the procedures for registering various types of property have their own specific features, the bank in our case study could and should have sought advice on drawing up not one but several mortgage agreements.

Melissa Schwartz spoke about the types of these agreements: they would be, it seems, a separate agreement pledging real property, and a separate agreement pledging a bank account and pledging future proceeds and goods in circulation; in addition, the new draft Civil Code also provides for a pledge of goods in circulation. Since the Mortgage Law leaves the regulation of very many issues to the parties, the concrete form of these agreements is the subject of a separate discussion, and I will not go into this.

Let us go back now to the registration of mortgage agreements pertaining to property, any mortgage of which has to be registered. There is a certain list of requirements that must be met in order for a mortgage to be deemed registered. The mortgage agreement or the mortgage
itself is deemed to be registered when, first of all, a code number of the unified register of pledges has been assigned to it; second, when the mandatory entry of the mortgage's registration has been made in the aforementioned register; when the required number has been entered on the mortgage agreement and the affidavit; and when the properly executed copies have been forwarded to the unified mortgage agreement archive and to the agency maintaining that register, which is confirmed by the signatures of officials of the registering agencies and their stamps. The written consent of the Moscow Property Committee to a mortgage is required in instances in which the mortgage of a building, structure, facility, or enterprise that constitutes state municipal property is being registered. The same written consent to a mortgage or consent of the property owner or its duly authorised agency is required in instances in which a mortgage of an enterprise is being registered. It is also necessary to append documentation on the valuation of the collateral, and, in ninth place, a description of the documents submitted, since, as you can see, there are nine points requiring documents: a very, very large number. What are these documents to be submitted to the registering agency?

First, there is the mortgage registration application, which must be submitted in two copies. Second, there is the mortgage agreement and two notarised copies of it. Next come all the documents mentioned in the mortgage agreement, two notarised copies of them. There are receipts showing that the state fee has been paid, and the geographical code certificate, which shows the characteristic geographical points of the property, if the mortgage of an enterprise, parcel of land or other type of real property is being registered.

About five months, just under that, have passed since the mayor of Moscow issued Directive No. 288 of June 16, 1994, on the registration of transactions involving the property of physical and legal persons in the city of Moscow. During that time the property registration administration has registered nearly 50 mortgage transactions. Is that a little or a lot? I think it is an extremely small number. The fact is that only very sophisticated investors and their lawyers are taking advantage of the possibility of verifying the correctness of the documents drawn up and checking to see how clearly the rights of their partners have been registered. I hope that this situation will be rectified in the near future above all in Moscow where, in my opinion, most of the work is going on although, it is true, I am not very familiar with the practice of other cities, and that new acts will be adopted at the federal level to protect investors' rights and interests more fully.

5. Conclusions and Summations

David Fagelson,
Director for Law and Governance, IRIS Center, University of Maryland

This conference has highlighted numerous crucial elements of a regime of property institutions that are necessary to free up the vital credit that is necessary for investment. Russia and the other member states of the CIS are moving steadily to building the necessary institutions, protecting the secured interests, but the very realisation of how important it is to take these steps reminds me of an incident that a colleague of mine mentioned to me on a visit to another country with a much different attitude about property and the enforcement of property and contract rights. He was meeting with the Minister of Justice of this country and who told this person that the lack of protection of property rights and the lack of provision of security interests made their country's laws unfriendly to investors from within the country and from without. He said to him he doubted whether anyone would risk their money without those protections. And the Minister replied, 'We don't want anybody to invest in our country
for profit or to protect their property, we want our investors to invest because they love our country'.

Well I think that this conference has shown us, if it has shown us nothing else, that love is not enough, it is not a sufficient incentive to make people invest their money and to risk it. But while love may not be enough, it does appear that comfort and security is a main motivation for people to put their money at risk. And in order to achieve this comfort, this conference has discussed the important legal and political and administrative mechanisms and institutions that are necessary to be put in place. Some of the main elements that were discussed to provide this security were the clear title and ownership of property, the enforcement of property rights, and the ability to establish and to enforce priority of secured interest. There was a second theme which also was discussed, which was implicit in the discussions of this conference, and which was mentioned by Professor Makovsky and speaker Mityukov, who bracketed the first day's discussion. That was that the economic goals of a secured property regime are shaped by the political institutions and the political preferences and the history of the country that is establishing this regime. These issues are now being debated by the political institutions and by the people of the member states of the Commonwealth. And it is of course for them to decide on their own what direction that will take. But to the extent that this conference has helped to suggest some of the technical elements of secured lending and what the implications of it would be if taking one path or the other then it will have played a vital and instructive role.

I would like to thank the organizations who have made this conference possible, in particular I would like to mention the Inter-Parliamentary Council, the Assembly of the Member Nations of the Commonwealth of Independent States, the High Arbitration Court of the Russian Federation, who have generously hosted our proceedings, the Research center for Private Law, the European Bank for Reconstruction and Development, and the US Agency for International Development. If any of you, or your colleagues who were unable to attend the conference, would like to refer to the discussion that took place these past two days, they will be available in both Russian and English from the IRIS center, or the European Bank for Reconstruction and Development.

Andre Newburg,
General Counsel, European Bank for Reconstruction and Development, London

Allow me to thank the hosts and organisers of this conference. We have learned quite a lot in the past two days about security legislation in Russia and in the other CIS states, and about achievements in this field. I hope that the subjects of the conference, as well as the European Bank's model law, were useful. I expect that such exchanges of views will be useful in the future as well.

I believe some key points have been made during this conference. Security plays an important role in financial transactions. Even though a bank may not be relying principally on collateral in determining whether to make the loan, the collateral, as we have seen today in the case study, provides the kind of comfort without which banks are unlikely to lend. In order to attract the type of financing that is going to be required for Russia and the other CIS countries, it is therefore necessary to have effective and simple security laws. Significant progress has been made in Russia, other countries of the CIS and the other neighbouring countries in creating a legal framework. But, as this morning's study shows, there remain practical problems of implementation and enforcement, especially in the area of extra-judicial enforcement.
Let me repeat my thanks to our hosts. I especially want to thank IRIS and Lane Blumenfeld for the tremendous organising work that they did. And to thank all of you for participating.