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BATTLE FOR THE LAW OF REAL SECURITY: THE THIRD STEP IN REFORMING RUSSIAN PLEDGE LAW[1]

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The paper is dealing with the latest reform of the Russian pledge law that entered into force on July 1, 2014. It contains the analysis of the routes and sources of the reform, particularly their origins in relation to the previous legislation and case law. The author examines the possible difficulties of interpretation and application of the new pledge law which the economic actors may face and offers ways for their resolution.

Keywords: real security; pledge; mortgage; hypothec; charge; lien; foreclosure.

[1] This article was developed in conjunction with the European Bank for Reconstruction and Development (EBRD), which has been involved in the reform of Russian pledge law. However, the opinions and interpretations expressed in this article remain the author's sole ones.

In Egypt, there was a custom of pledging deceased parents; the creditor would not allow them to be buried until he received his money. For the debtor, such disgrace to his parents was deemed to be the worst dishonour.

Joseph Kohler[1]

1. INTRODUCTORY COMMENTS

Modern Russian pledge law has a brief but tumultuous history. It was born in the very beginning of the 1990s (I refer to RF Law No. 2872-I dated 29 May 1992 "On Pledge" (the "1992 Pledge Law")) and immediately (in 1995), during its "school" years, it faced a serious regulatory problem: in fact, two parallel laws (the 1992 Pledge Law and the 1994 RF Civil Code) were competing to "provide education" for this long-awaited child of the financial system. Things seemed to have calmed down when one of the "caregivers" prevailed (in 1996, when courts declared that the 1992 Pledge Law was *de facto* repealed when the RF Civil Code was adopted). Russian pledge's "teenage years" were rather relaxed: it was gradually growing up and taking in wisdom from the "younger brother" of its main "caregiver" (commercial courts, which were moulding certain character traits of the "student"), but… the 2008 financial crisis happened, this pledge "teenager" ended up alone in an aggressive environment, and it became clear that the overprotection that it had when it was "educated" previously was not really helpful: the reality had an angry face, fists and bad temper. Our "teenager" then needed a "short-term boot camp" (the first pledge law reform – Federal Law No. 306-FZ dated 30 December 2008 "On amendments to certain Russian Federation laws in connection with improving the procedure of enforcing pledges of assets") where they tried to teach it to "take a punch". But this "course" was not enough: life knocked our "student" out nonetheless and, after some time, it was taken to the "gym" again (the second pledge law reform – Federal Law No. 405-FZ dated 6 December 2011 "On amendments to certain Russian Federation laws relating to improvements of the procedure of enforcing pledges of assets" ("Federal Law No. 405-FZ")).

This time, the "workout" lasted a little longer, another "coach" appeared who was giving good advice (Decisions adopted at Plenary Sessions of the RF SCC (*the Supreme Commercial Court of the Russian Federation*) No. 58 dated 23 July 2009 "On certain issues in connection with settling a pledgeholder's claims in the event

[1] Колер, Й., 1895. *Шекспир с точки зрения права (Шейлок и Гамлет)*. Перевод с немецкого языка. Санкт-Петербург: Издательство Я. Канторовича, с. 16.

Kohler, J., 1895. *Shekspir s tochki zreniya prava (Sheilok i Gamlet)*. Perevod s nemetskogo yazyka. Saint-Petersburg: Izdatelstvo Ya. Kantorovicha, p. 16.

of a pledgor's bankruptcy" and No. 10 dated 17 February 2011 "On certain issues arising in the course of applying pledge laws" ("RF SCC Plenary Decision No. 10")) – and here are the first results: the "mature adult" gradually started to win. But the "education" did not end with this, there were still some things that had to be done: to revise what has been taught and to teach a few more "special techniques" from fashionable "foreign martial arts". This phase was addressed more thoroughly than before, and for several years (the reform of the RF Civil Code that began in 2008), our "student" was instructed by the best "coaches" including foreign "coaches". The education has now been completed (the third pledge law reform in 2014 – Federal Law No. 367-FZ dated 21 December 2013 "On amending Part One of the Civil Code of the Russian Federation and repealing certain laws (provisions of laws) of the Russian Federation"), the more skilled "youth" is ready for a fight… What results will it achieve?

I had good reasons to come up with all these "martial arts" comparisons relating to the development of pledge law. Having monitored court cases in pledge matters for almost seven years that I was working for the RF SCC, I have indeed got an impression that pledge in Russia is a fight where the main figure is the pledgeholder: a fight between a pledgeholder and a pledgor, a pledgeholder and the pledgor's other creditors, a fight between a pledgeholder and purchasers of the pledged assets, a fight between a pledgeholder and persons organising the sale of the pledged assets, a fight between a pledgeholder and a bankruptcy receiver, a fight between a pledgeholder and fiscal authorities… In a situation involving a pledge, the eternal private law conflict – the conflict between a creditor and a debtor – escalates to a high level. This conflict becomes particularly intense because, after private law was humanised and the practice where a creditor had remedies directly against the person of the debtor (debtors' prison, hostage taking etc.) was discontinued, a pledge remained the principal and the most reliable way for a creditor to ensure that it would receive performance owed to it from the debtor in the end. Naturally, this leads to the extreme escalation of the fight over the pledge.

There is always heated atmosphere in litigation over pledges: in practically every case, pledgors try to challenge the pledge agreement on any small pretence (a slang expression was even born - "shake off the pledge") or throw a spanner into the "pledge machinery" (when they allege that the pledgeholder's claims are incommensurate, that the pledge has terminated due to the change in the pledged assets, that the material terms of a pledge agreement have not been agreed etc.); it

seems to me that no party to a court dispute is more resourceful than pledgors that do not wish to lose pledged assets…

The third phase of the pledge law reform was in many respects the result of studying and summarising tools used in the fight for pledge, not only by pledgors, but also by pledgeholders. I believe that the goal of the third phase of the reform was exactly to secure, on the one hand, the solutions that courts (primarily commercial courts) came up with to resolve certain pledge law problems, and, on the other hand, to lay certain main routes that could be followed in the course of the future development of pledge. And I believe that pledge will not really develop as a result of amendments to statutory documents (it seems to me that pledge has already received a "shocking dose" of this type of regulatory action), but as a result of banks' contractual practices and court cases. Of course, there will still be new pledge laws, at least one – changes to mortgage rules in the relevant section of the RF Civil Code and Federal Law No. 102-FZ dated 16 July 1998 "On mortgage (pledge of immovable property)" (the "Federal Mortgage Law").

With regards to this publication, its goal is not only and not so much a description of the essence of the latest phase of the pledge reform, but a demonstration of a link between the changes that were introduced and earlier solutions that lawmakers themselves and (most importantly) courts developed to tackle pledge law problems. It seems to me that there is such a link, at least I can see it quite clearly. And I will consider the goal of the publication to be achieved if after reading the reader shares the same view.

My other goal was of course to get to the bottom of the new pledge regulations and understand the logic that lawmakers followed when they were phrasing specific new rules of pledge law. And, last but not least, the goal of the publication is to attempt to predict the consequences that the completed reform will have in practice and to assess its practical outcome.

2. PLEDGE RIGHT AND THE BASIS FOR IT

One of the most important theoretical problems of pledge law is how to describe its nature. It is known that there are two approaches to what pledge is. The first approach is that pledge is viewed as a *security contract*, i.e. an obligation between a pledgor and a pledgeholder. The second approach is to consider the pledge to be a *right in rem* whose essence is the creditor's right to appropriate, in priority to other creditors, the value of the pledged asset.

One would think that this theoretical dispute has nothing to do with real life. However, this is not true in reality. We can provide quite a few examples when a pledge dispute is resolved differently depending on which specific approach to the nature of pledge is thought to be correct.

For example, the following case is quite well known. A person mortgaged an unfinished property, but by the time the mortgage was enforced, it turned out that the property had been finished and has been put into operation. If we assume that pledge is a contract (and this contract does not envisage pledge over a changed object), then it seems that we would need to conclude that the pledge was terminated because the object of the pledge contract ceased to exist; a claim to enforce the pledge should be rejected.[1] However, if we do not view pledge as a contract, but rather as a right in rem (a right to the value of an asset) that arises out of a contract (among other things), the answer should be completely different. It is clear that in the case in question, it can be easily seen that the value of the pledged asset promised to the pledgor has not gone anywhere – it just has a different exterior now – a completed building. Therefore, with this approach, judgment should be granted to the claimant and the pledge over the building should be enforced.

Another example. Let's imagine that a pledge provided by a third party secures a debt under a loan in the amount of 100; this debt object is also described in the pledge agreement. Let's assume that the debtor and the creditor executed an agreement increasing the debt under the loan agreement to 150. However, the relevant amendment was not made to the pledge agreement. If enforcement of the pledge is considered by a court, and the court uses the first approach, it would most likely have to reject the claim because obligations under the pledge agreement cannot secure a non-existent obligation and, therefore, they must terminate. The approach to pledge as a right in rem (a right to the value of the asset) will lead to a different answer: the pledge will remain in force because an independent right in rem may not terminate as a result of merely changing a secured obligation; it is required that its holder clearly express its intention to terminate the right in rem.

[1] For example, if parties entered into a sale and purchase arrangement (which, without a doubt, is a contract) in respect of an unfinished property, but by the time performance was due under the contract the property had been built, then the claim to register the transfer of the ownership title would be rejected because of the physical absence of the object of the contract.

Therefore, it is hardly appropriate to think of the question as to whether pledge is in essence a right in rem or an obligation as purely academic: it has serious practical consequences.

For the last 20 years, pledge has been viewed in Russian civil law more often as a contract. I believe that this is exactly the reason for the main problems that courts faced in disputes over pledges: courts did not understand that pledge was in essence a limited right in rem and resolved cases based on approaches relevant for contract law, in a completely unsatisfactory manner (for pledgeholders).

This is not least because of the location of rules regulating pledge. The issue is that, while the existing 1994 RF Civil Code was being drafted, lawmakers unfortunately used the approach applied in the 1964 RSFSR Civil Code and included rules concerning pledge in the section entitled Law of Obligations. The draftsmen of the 1964 RSFSR Civil Code adopted this position most likely because the section Law of Rights in Rem that was included in the 1922 RSFSR Civil Code and included rules regulating pledge was repealed (it was not needed) in the course of adopting the new code, and the rules regulating pledge had to find a "new home" somewhere; the section Law of Obligations probably seemed to the authors of the code to be the most appropriate place (because pledge is indeed a form of security for obligations).[1]

When amendments to the rules of the RF Civil Code regulating pledge were being drafted, one of the questions that was raised was whether pledge-related rules should be moved to the updated section Law of Rights in Rem. However, such a radical change of the system of the RF Civil Code was thought to be unnecessary for reasons that were psychological and practical ("we have already got used to it") rather than systemic. However, the section Law of Rights in Rem of the draft updated version of the RF Civil Code does have chapter 20.4 Mortgage in which rules regulating pledge of immovable property were included.

The draftsmen's logic was in this case as follows. Mortgage is subject to state registration in the register as a right in rem, and for this reason it is logical that the regulations concerning all registrable rights in rem with respect to immovable property should be found in the section Law of Rights in Rem. In addition, draft

[1] For more detail, see: Иоффе, О.С., Толстой, Ю.К., 1965. *Новый Гражданский кодекс РСФСР.* Ленинград: Издательство Ленинградского университета, с. 19–20.

Ioffe, O.S., Tolstoy, Yu.K., 1965. *Novyi Grazhdanskii kodeks RSFSR.* Leningrad: Izdatelstvo Leningradskogo universiteta, pp. 19-20.

chapter 20.4 Mortgage includes rules regulating the so-called "non-accessory" mortgage (see below for more detail).

Going back to the idea that a pledge right is viewed by lawmakers exactly as a right in rem, we should note that it is quite clearly reflected in the text of § 3 of chapter 23 of the RF Civil Code. In cases when pledge is referred to as a right in rem as such, lawmakers use the words "pledge" or "the pledgeholder's right" (cf. clause 1 of Article 334, Article 334.1, clause 2 of Article 335, 335.1, 336, 339.1 (especially) etc. of the RF Civil Code).

The distinction between pledge as a right in rem and a contract of pledge (as a basis for the right in rem) is seen particularly well in the concept of pledge of a future asset (clause 2 of Article 334 and clause 2 of Article 341 of the RF Civil Code) when a person that does not have ownership title to assets representing the object of a contract of pledge can nevertheless act as a pledgor, i.e. assume various obligations arising out of a contract of pledge (the most important obligation is to create the pledge), but the pledge right (as a right in rem) will not arise until the pledgor obtains ownership title to the pledged asset. Therefore, it is possible to have situations where a contract of pledge has been entered into, but the pledge as a right in rem has not yet arisen.[1]

In addition, a correct understanding of the nature of a pledge right is also important in analysing the concept of pledge arising by law. Such pledge, as a right in rem, arises as a result of circumstances set out in the law (clause 1 of Article 334.1 of the RF Civil Code). At the same time, we should remember that pledge by law can be "discretionary" (when parties may by agreement prevent the pledge right from being created; a good example of a "discretionary" pledge arising by law are provisions of clause 5 of Article 488 of the RF Civil Code) and "mandatory" (when the creation of the pledge may not be prevented by an agreement; an example of such pledge is clause 1 of Article 587 of the RF Civil Code, or mortgage by law of parties to an off-plan property development scheme).

In addition to situations where pledge arises out of a contract or by law, which are well known in Russian law, another basis for a pledge right was introduced by new pledge laws – a "court" pledge. This is addressed in clause 5 of Article 334 of the RF Civil Code, pursuant to which a creditor whose claims are

[1] This situation can again be compared to sale and purchase: a sale and purchase contract was entered into, it created the seller's obligation to deliver ownership title over an asset to the purchaser. However, until the delivery of the asset (movable property) or the state registration of the transfer of the right (immovable property), the purchaser does not acquire ownership title to the asset.

secured by an attachment ordered by a court or another authorised body is viewed as the pledgeholder in respect of the attached assets.

The legal regime applicable to a creditor whose claims (arising out of an obligation) are secured by an attachment is very interesting. When a thing is attached, certain assets are singled out of the debtor's property and such assets are in a way specifically intended to settle its, the creditor's, claims. This looks very much like… pledge. And lawmakers' further logic also shows that the rights of a creditor that has successfully obtained an attachment are very similar to a pledgeholder's rights.

One of the most important characteristics of pledge is the fact that pledge follows the asset whose value is intended to be applied towards a creditor's claims. Clause 2 of Article 174.1 of the RF Civil Code introduces exactly this concept to regulate the consequences of the sale of an attached asset.

However, in pledge law, following is just one of elements of the concept of pledge right; the second inevitable element is priority. The following question arises: what will happen to a creditor whose claims are secured by an attachment, if the debtor or the purchaser of the attached assets becomes bankrupt? Should we think that such creditor has priority similar to a creditor whose claims are secured by a pledge? I believe that the answer to this question should be yes. The explanation is the same as in respect of pledge: the law protects active persons, those who are the first to procure better security for their claims over a debtor's or a third party's assets. These include a pledgeholder; these also include a creditor that has obtained an attachment of the debtor's assets. It appears to me that the express statement in clause 5 of Article 334 of the RF Civil Code (that a creditor that has obtained an attachment has the rights of a pledgeholder) means that such priority is given to it by law.

However, the protection of active (and strong) creditors in some cases (primarily when the debtor becomes bankrupt) is secondary to the protection of other groups of creditors – involuntary creditors (torts against life (well-being)); creditors whose claims are socially significant (alimony creditors, bank depositors etc.)). You can see how this balance was drawn in bankruptcy laws. In my view, it would be reasonable if this balance applied in situations involving an attachment to secure a creditor's claims. A reference to pledge law seems to allow us now to resolve this problem, too.

Finally, classifying a creditor's claims secured by an attachment as pledge-related claims allows us to resolve an old issue of the competition between a pledge

creditor and a non-pledge creditor and an issue as to whether a pledged asset can be attached in connection with a claim that is not secured by pledge. Until recently, such attachment has not been allowed, which had to do with a different understanding of the consequences of attachment (everything contradicting the attachment order being null and void). However, if we agree that attachment is a "court" pledge of sorts, there are no obstacles to attaching (following a non-pledge creditor's demand) an asset that has already been pledged. In this case, attachment will constitute a subsequent pledge, and the holder of such pledge must (if no performance is provided under senior pledge) join the senior pledge creditor in the proceedings to enforce the pledge and sell the assets. If this has not happened, the junior pledge (probably including a "court" pledge) must terminate because a junior pledge creditor may not impair a senior creditor's claims. And this is obviously the case if we recognise that a junior pledge (in my example, a "court" pledge) will continue and will "encumber" the assets sold by the senior pledgeholder.

Of course, if attachment is a "court" pledge, pledge law doctrines protecting the person that has acquired the assets not knowing and not being able to know about the "court" pledge (attachment) must apply. This is actually provided for in clause 2 of Article 174.1 of the RF Civil Code (a creditor that has obtained an attachment order retains "rights secured by the attachment" also when the attached assets are transferred to a third person, "unless the acquiror of the assets did not know and should not have known about the prohibition").

The question regarding the attachment of a third party's asset is also interesting. In principle, according to the doctrine of bona fide purchaser's protection (the second and the third paragraphs of clause 2 of Article 335 of the RF Civil Code), security in favour of a creditor that did not know and could not have known that the asset belongs to another person (where the owner did not lose it against its will, for example, where it was leased to the debtor and it did not disclose this fact in the attachment proceedings) must subsist.

In addition, it is worth looking at the issue of the public nature of such "encumbrances" (various categories of attachment) in the context of the reform of the laws regulating the registration of notices of pledge of movable property (see below).

3. SYSTEM OF LAWS REGULATING PLEDGE

After the new version of § 3 of chapter 23 of the RF Civil Code was adopted, the system of Russian laws regulating pledge finally started to look more or less well organised.

Thus, the bulk of rules regulating pledge is now included in that paragraph of the RF Civil Code. It is curious that the structure of the new version of § 3 of chapter 23 of the RF Civil Code is to a certain extent that of a "mini-code" because it now consists of sub-paragraph 1 entitled General Provisions (which is, in a way, the general part of pledge law) and sub-paragraph 2 entitled Certain Categories of Pledge (which is akin to a special part of pledge law).

As the new version of § 3 of chapter 23 of the RF Civil Code has been adopted, the old 1992 Pledge Law has finally been repealed in full. The 1992 Pledge Law and the provisions of the RF Civil Code regulating pledge had competed for almost two decades. This is because, when the RF Civil Code was adopted, it was not formally declared that the 1992 Pledge Law was repealed; in fact, one of the higher courts noticed this back in 1998.[1]

However, the difficulty was that, although in many respects the rules of the 1992 Pledge Law *de facto* replicated the rules of the RF Civil Code regulating pledge, there were nevertheless certain differences between the rules of the RF Civil Code and the rules of the 1992 Pledge Law. Therefore, in order to determine whether a rule of the 1992 Pledge Law applied, practicing lawyers had to assess separately every time whether there was a conflict between such rule and the RF Civil Code, which created a certain ambiguity in the statutory regulation of pledge. In addition, it should be reminded that the 1992 Pledge Law included rules setting out the specifics of the pledge of such asset as property rights, whereas no such rules were included in the RF Civil Code at all. Finally, lawmakers, who began to amend the 1992 Pledge Law actively in the second half of the 2000s, confused practitioners completely (indeed, it cannot be earnestly said that a law is *de facto* repealed, even in part, if lawmakers amend the text of such law from time to time!).[2]

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[1] See para. 1 of Information Letter of the Presidium of the RF SCC No. 26 dated 15 January 1998 "Overview of court cases in which commercial courts apply the rules of the Civil Code of the Russian Federation regulating pledge".

[2] For example, practitioners even expressed the following opinions: given that lawmakers amend the text of the 1992 Pledge Law, this means that all of its rules should be deemed to be effective, including the rules concerning the registration of pledges of motor vehicles with the State Traffic Safety Inspectorate and concerning the notarisation of pledges of railway carriages and marine and river vessels. However, courts did not support this approach (see, for example, para. 15 of RF SCC Plenary Decision No. 10).

The final solution to the issue of the relationship between the rules of the 1992 Pledge Law and pledge law rules of the RF Civil Code meant that all rules of the 1992 Pledge Law applied in practice would be transferred to the text of the RF Civil Code (this applies to procedural rules regulating the enforcement of pledge and the sale of pledged assets, as well as provisions concerning the pledge of property rights) and that the 1992 Pledge Law would be repealed. This is exactly the route that lawmakers followed, when they provided that the 1992 Pledge Law would be repealed from 1 July 2014.

Lawmakers treat the relationship between the rules of the Federal Mortgage Law and rules of the RF Civil Code regulating pledge differently. Pursuant to clause 4 of Article 334 of the RF Civil Code, mortgage is regulated by special rules of the RF Civil Code regulating rights in rem (lawmakers imply here chapter 20.4 (already mentioned by me) of the draft of the section Law of Rights in Rem regulating mortgage), as well as provisions of the special mortgage law.

Therefore, the RF Civil Code itself leaves room for special rules establishing a regime different from the general regime applicable to pledge.[1] Such "two-level" regulation should not as such present any particular difficulties.

However, the pledge law reform has created a rather serious issue, the relationship between old rules of the Federal Mortgage Law and new rules of the RF Civil Code regulating pledge.

The issue is that it was intended that in the course of changing pledge law, rules of the RF Civil Code regulating pledge would be changed first and, after that, the special regime of the pledge of immovable property would be changed. (The change (update) of the Federal Mortgage Law is in fact long overdue; it currently looks rather like a patchwork quilt that hides the central idea). In general, given Russian law-making routines, it is probably a healthy approach. However, there is one "but" – that very preference that the RF Civil Code gives the special mortgage law in mortgage-related matters.

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[1] It should probably be reminded that a special feature of Russian civil law is that, as a general rule, the general law – the RF Civil Code – is superior to special laws. This idea, which turns the RF Civil Code into a certain "economic constitution", is reflected in the second paragraph of clause 2 of Article 3 of the RF Civil Code ("Civil law rules included in other laws must correspond to this Code"). Courts do not view this rule as a "wish" of the draftsmen of the RF Civil Code directed at lawmakers, but view it rather as a rule that applies directly and that allows a court not to apply provisions of special laws if they do not correspond to the RF Civil Code (see, for example, para. 4 of Decision No. 14 dated 23 March 2012 adopted at a Plenary Session of the RF SCC "On the selected questions of the banking guaranties cases").

However, the RF Civil Code still provides for an option that permits special laws to be passed in the civil law realm: these are the cases when the RF Civil Code rule directly states that a law may provide for a different regime.

One of the trends of the new pledge legal provisions is that they are radically de-formalised. This means that formal requirements to the contents of the pledge agreement have become much lighter. Other trends – taking into account that a pledgeholder
or a purchaser of pledged assets acted in good faith etc. – were also reflected in the text of the new draft of § 3 of chapter 23 of the RF Civil Code.

However, lawmakers have so far implemented all these wonderful plans only in the RF Civil Code – the Federal Mortgage Law has not yet been amended. A lot of existing rules of the Federal Mortgage Law (that a pledge agreement must include a detailed description of the secured debt and must specify the pledge value, that a subsequent mortgage may be prohibited by an agreement, that in the discussion concerning a pledge created by a non-owner, the fact that the pledgeholder acted in good faith seems to be taken into account) include provisions that are in sharp contrast to what was adopted as general pledge legal provisions with effect from 1 July 2014.

For this reason, the following question has arisen: how should cases relating to pledges of immovable property be resolved? On the basis of the rules of the RF Civil Code, there would be one solution, but on the basis of the Federal Mortgage Law, there would be another.

The formal approach is that old rules of the Federal Mortgage Law must apply because they fall under the phrase “otherwise as established by the law” (second paragraph of clause 4 of Article 334 of the RF Civil Code). For this reason, the new rules regulating pledge will not apply to mortgages until lawmakers change the Federal Mortgage Law.

However, I am confused by one thing about this formal approach. *Lex specialis* is really a situation when lawmakers knowingly introduce a regime that is different from the general regime. And the rules of the Federal Mortgage Law that I mentioned were at the relevant time simply copied to it from… the previous version of § 3 of chapter 23 of the RF Civil Code. Lawmakers never intended to make these rules of the Federal Mortgage Law *lex specialis*, they became such… accidentally!

But can we then in principle classify them as *lex specialis*? In my view, the history of these rules itself is sufficient proof that they should not be viewed as “knowingly special”, if you will. Yes, they are different from the rules of the existing RF Civil Code, but not because lawmakers intended to make them different for the reason that the general regime is not appropriate in certain cases. One cannot earnestly assume that, in 1996-1997, the draftsmen of the Federal Mortgage Law

anticipated that a pledge law reform would take place in 2014 and created special rules for mortgages in advance. This is absurd, to say the least…

I believe that the conflict between the rules of the RF Civil Code and the Federal Mortgage Law should be resolved based on a different principle of the hierarchy of norms (which by the way is not "weaker" than the above-mentioned *lex specialis* principle[1] in any way): *lex posterior derogat priori*. The rules of § 3 of chapter 23 of the RF Civil Code, as a later law, should be deemed to be superior to the relevant rules of the Federal Mortgage Law. In this case, new, more "advanced", more "pro-creditor" rules set out in that paragraph will prevail over the rules of the Federal Mortgage Law. Until a new version of the Federal Mortgage Law is adopted, this conflict should probably be resolved in this manner.

4. PLEDGOR. CONSEQUENCES OF NON-OWNER CREATING A PLEDGE

The new rules set out in Article 335 of the RF Civil Code are lawmakers' response to courts that, on the one hand, had a very narrow understanding of the phrase "the right to pledge an asset belongs to the owner of the asset" and practically always declared a pledge agreement invalid if it was executed by a non-owner,[2] and, on the other hand, ignored the fact that in many cases a pledgeholder did not know and could not have known that the pledgor was not authorised to create a pledge right.

When a pledge agreement is entered into, the pledgor may well not have ownership title to the pledged assets. This may be because the pledgor has not yet acquired ownership title to the asset that will be pledged from the person disposing of the asset (for example, pledge over goods that the seller has not yet transferred to the pledgor). Another possible situation where a pledgor is not an owner of the pledged asset (and where this should in no way adversely affect the pledge agreement) is when the pledgor is to become the owner of the asset in accordance with the rules regulating the initial acquisition of assets (for example, as a result of creating or converting them), but the relevant legal fact has not yet occurred (for

[1] Although the relationship between the principle of *lex posteriori* and the principle of *lex specialis* has not been exactly defined yet (which to a certain extent makes it more difficult to apply them efficiently (see: Kieninger, E.-M., Linhart, K., 2012. *German Report*. European Review of Private Law, 20(1), pp. 109–110; Lindroos, A., 2005. *Addressing Norm Conflicts in a Fragmented Legal System: The Doctrine of Lex Specialis*. Nordic Journal of International Law, 74, pp. 27, 41). Most likely, when choosing the interpretation principle, practitioners and law enforcement agencies should rely on their interpretative instinct.

[2] It is a serious error and it results from failing to distinguish between a pledge agreement as a basis for a pledge right and a pledge right as such (see above).

example, when a pledgor is a developer and it has not yet finished the construction of a building that will be pledged in the future). In such situations, it should be deemed that the pledge agreement has been executed; it is not invalid and it may not be treated as a preliminary agreement. Such an agreement (a pledge agreement in respect of a future asset) only creates obligations for the pledgor: an obligation to pledge the asset when the pledgor obtains ownership title to it and an implied obligation of the pledgor to exercise necessary and sufficient endeavours to acquire ownership title to the assets to be pledged. In addition, such an agreement may include numerous other obligations relating to the inspection rights of the pledgeholder (which is a party having rights – a creditor under obligations arising out of a pledge agreement in respect of a future asset), an obligation to insure risks relating to the future asset and an obligation to disclose certain information to the creditor. Finally, this same agreement may provide that a breach of obligations thereunder is grounds for accelerating the loan secured by the pledge agreement in respect of a future asset.

However, courts often ignored all these arguments and declared invalid pledge agreements with respect to pledge of assets to be acquired by the pledgor in the future. This approach must now become a thing of the past.

The question as to whether it is possible to pledge a future immovable asset presents certain difficulties. This is because, until recently, a mortgage agreement was subject to state registration; in addition, mortgage as an encumbrance over immovable property was also subject to state registration. In fact, there is no rationale in double state registration of a mortgage because the scope of the legal due diligence investigation in the course of the registration of an agreement and in the course of the registration of a right is the same. In essence, by procuring state registration both of a mortgage agreement and of a mortgage as a right in rem, registration authorities did the same work twice.

However, this doubling is not as innocuous as it may seem initially. The issue is that the Federal Mortgage Law contains quite rigid rules as to the consequences of the situation when a mortgage agreement does not go through state registration: in this case, the agreement is deemed null and void. Accordingly, there were no opportunities even for courts to apply, for example, the doctrine pursuant to which an unregistered agreement has no effect against third parties. Such a doctrine would allow them to declare that the agreement creates legal

consequences for its parties also in cases when it has not gone through state registration.[1]

At the same time, the organisation of the Unified State Register of Rights to Immovable Property and Transactions Therewith (the "USRR") on an asset-by-asset basis and rules and regulations concerning maintenance of the USRR imply that state registration of transactions is carried out by making relevant entries in the section of the register that corresponds to the asset involved in the registrable transaction. However, if a pledged immovable asset is a "future" asset, this either means that the relevant section has not been started in the USRR at all (the asset has not yet been built) or that the asset belongs to another person and making an entry in the section without such person's consent is simply impossible. It may be inferred that the requirement for the state registration of a mortgage agreement *de facto* prevented the execution of mortgage agreements in respect of a future immovable asset.

However, practitioners felt the need for such transactions. It suffices to imagine a situation when a borrower negotiates a credit facility with a bank, but cannot provide the bank with significant collateral in the form of immovable property for the time being (because the relevant buildings have not been finished, or third parties have not yet completed the transfer of ownership to such buildings to the pledgor). However, the bank agrees to provide a credit facility if it is secured by the personal collateral provided by the beneficiaries of the business (for example, suretyship), on condition that security in the form of mortgage will be provided at some point. Until recently, such agreements could either be executed in the form of a preliminary agreement or could exist as "gentlemen's agreements". It is clear that the legal effect of both the former and the latter is quite modest.[2]

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[1] This is precisely the approach that the RF SCC used to resolve the issue of a lease agreement that has not gone through state registration: it cannot be said that such agreement has not been executed or is invalid, it only binds the parties that have signed it; that it has no effect against third parties means that a lessee's rights under an unregistered agreement may not be used against third parties.

[2] And it is unclear in which case it is more modest because a preliminary agreement under Russian law has a reputation of being "as good as headache". This primarily has to do with the completely unsatisfactory rule of the RF CCCP (*the Code of Commercial Courts' Procedure of the Russian Federation*) concerning a court's judgment in a claim regarding the execution of a contract. If it is interpreted literally, it turns out that, in order for a contract (where a court orders to execute it) to be deemed executed it is required that the losing party act in good faith by signing the contract; it is clear that if such party does not act in good faith, enforcement proceedings in respect of the respondent would be completely unsuccessful. The RF SCC tried to correct the situation when it interpreted the rule of the RF CCCP *contra legem* and declared that a contract is deemed executed at the time when the court's judgment ordering the contract to be executed becomes effective (Decision of the Presidium of the RF SCC No. 4408/11 dated 13 October 2011), but it is not obvious that this approach has become popular among practitioners.

However, since 1 July 2014, the requirement for a mortgage agreement to go through state registration has been repealed, and an agreement itself is deemed executed when its parties agree all the material terms of the agreement in the form of a single written document. Therefore, there are currently no serious legal obstacles to parties expressing an intention to create a pledge of a future immovable asset.

Nevertheless, we should clearly understand that creating a pledge right – a mortgage – out of a mortgage agreement in respect of a future immovable asset is only possible if the mortgagor's ownership title to the relevant asset is registered and encumbered by a mortgage on the basis of a mortgage agreement executed by the mortgagor and the mortgageholder earlier.

Another interesting new provision of Article 335 of the RF Civil Code is the statement that the rules of Articles 364-367 of the RF Civil Code regulating the relationship between a debtor, a creditor and a surety apply to the relationship between a debtor, a third party pledgor and a creditor that is also a pledgeholder.

Why were such new rules needed? In Russian contractual practices, a pledge that is provided by a third party pledgor rather than the debtor itself is an extremely popular situation. This is not least because at the heart of domestic corporate governance strategies lies the wish to minimise, as much as possible, a company's risks in connection with seizures of assets in enforcement proceedings. Market players are prompted to do that by an incredibly simple procedure of incorporating legal entities that in Russia borders on complete "corporate irresponsibility". Thus, businessmen have fully mastered the technique of setting up "operating companies", which take part in contractual relationships and fully assume the risks of contractual, tort and public law liability etc., as well "property companies", which do not do business and which task is only to own immovable property, securities, patents and other valuable assets of a business group.

It is clear that such division of assets and potential debts negatively affects not only the enforcement of judicial acts ordering to repay debts,[1] but also the business climate on the whole: the level of creditors' trust in debtors, low as it is, deteriorates even more.

[1] In the absence of a properly formulated doctrine of "piercing a corporate veil", which allows courts to view formally independent legal entities as one unit, and rules regulating bankruptcy of a group of legal entities, for a creditor, recovery of debts turns into a competition that is akin to an obstacle race; the final of this competition is, as a rule, sad for the creditor: according to the statistics, around three fourths of writs of enforcement issued by courts are not actually enforced.

However, this problem only affects involuntary creditors (tort creditors, public authorities, a legal entity's employees) and voluntary creditors that do not have serious leverage in negotiations. Banks, which are probably the strongest negotiators in modern economy that is strongly addicted to credit, resolve this problem successfully by demanding reliable security, primarily a pledge of high-value and liquid assets (immovable property, liquid securities etc.). It is this tough negotiating position that, as a rule, allows the very company holding assets of the business group financed by the bank to become involved in the loan as a security provider.

Thus appears the figure of a third party pledgor that is not the debtor under a secured obligation.[1] Quite a few rather interesting legal issues arise at the same time. For example, let's assume that a pledgeholder files a claim against the pledgor to enforce a pledge; and the debtor is joined in the proceedings as a third party. However, the statute of limitations has expired in respect of the claim to repay the loan secured by the pledge. Hence the question: can the third party pledgor (as a matter of substantive law) rely on the fact that the statute of limitations has expired and the pledgeholder's claim should be rejected? This could be argued by the debtor, but let me remind you that it is a third party in the proceedings,[2] i.e. it cannot argue the expiry of the statute of limitations.

Another situation. Let's imagine that the case relating to the enforcement of a pledge provided by a third party includes the following fact: the debtor notified a set-off against the creditor's claim, the creditor believes, however, that the set-off did not happen for some reason. Can the pledgeholder present arguments against the enforcement claim if such arguments are in fact the debtor's arguments?

Must a debtor that has discharged its obligation notify the pledgeholder thereof? What are the consequences of failing to do so? What happens to a pledge if the pledgeholder has not filed a claim to enforce the debt for a long time and the pledge agreement does not specify the duration of the pledge? Will a pledge

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[1] In theory, a third party pledgor may appear in other cases. For example, a pledgor is a debtor of the debtor under a secured debt and in principle does not care how to repay the debt: either by paying its creditor or by paying its creditor's creditor (although, I must confess, that cash owed by the debtor to the security provider as a basis for creating security rights is more akin to suretyship). Or it may be possible that providing pledges for third parties is the pledgor's business and it charges debtors whose obligations it secures for this (however, this basis is probably purely theoretical; for the 18 years that I have been practicing law, I have never seen such pledgors). Still, other grounds exist pursuant to which a third party can provide a pledge – those arising from human relationships: friendship, love, a wish to support etc. But these cases can hardly be assessed from the legal perspective…

[2] It is not mandatory to join the debtor in such proceedings as a respondent.

terminate if the obligation secured by the pledge changes without the pledgor's consent?[1]

Answers to these and other numerous questions regarding the relationships inside the triangle "creditor – debtor – security provider" can be easily found in the provisions of Articles 364-367 of the RF Civil Code regulating suretyship. In general, it seems to me that there is nothing unusual or extraordinary in this legal technique used by lawmakers: there is no principal difference between pledge and suretyship either from the substantive or the economic perspective. Only two things are different: 1) a surety is liable to the creditor with all its property (except when the surety has negotiated a limitation of liability), whereas a third party pledgor, only to the extent of the value of the pledged asset); 2) a creditor demanding the security provider to repay the debt will have priority over the pledgor's other creditors, but will rank equally to the surety's other creditors.

Another very serious and long-awaited new rule in Article 335 of the RF Civil Code is the introduction in the pledge law of a bona fide pledgeholder, i.e. a person that did not know and was not supposed to know that an asset is pledged by a non-owner.[2]

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[1] Because the problem is so acute, I would not like to treat this question as rhetoric. Of course, the pledge will not terminate: the pledgor will be liable to the pledgeholder in accordance with the original terms and conditions of the secured obligations (para. 13 of RF SCC Plenary Decision No. 10). The reference to clause 1 of Article 367 of the RF Civil Code included in Article 335 of the RF Civil Code in no way changes the solution to the problem, because this suretyship-related rule should be applied to pledge the way it is interpreted by courts: if the obligation changes, suretyship continues in force subject to the original terms and conditions of the secured obligation. Of course, the surety (and, consequently, the pledgor) may agree with the creditor that, if the secured debt changes, the size of the collateral will also increase (to the extent provided in the agreement) (Decision of the Presidium of the RF SCC No. 6977/11 dated 18 October 2011; Ruling of the RF SC (*the Supreme Court of the Russian Federation*) No. 39-V11-5 dated 13 September 2011; para. 37 of Decision No. 42 dated 12 July 2012 adopted at a Plenary Session of the RF SCC; for more detail see: Бевзенко, Р.С., 2013. *Правовые позиции Высшего Арбитражного Суда Российской Федерации по вопросам поручительства и банковской гарантии: Комментарий к Постановлениям Пленума Высшего Арбитражного Суда Российской Федерации от 12 июля 2012 г. № 42 «О некоторых вопросах разрешения споров, связанных с поручительством» и от 23 марта 2012 г. № 14 «Об отдельных вопросах практики разрешения споров, связанных с оспариванием банковских гарантий».* Москва: Статут. Bevzenko, R.S., 2013. *Pravovye pozitsii Vyshchego Arbitrazhnogo Suda Rossiiskoi Federatsii po voprosam poruchitel'stva i bankovskoi garantii: Kommentarii k Postanovleniyam Plenuma Vyshchego Arbitrazhnogo Suda Rossiiskoi Federatsii ot 12 iyulya 2012 g. No. 42 "O nekotorykh voprosakh razresheniya sporov, svyazannykh s poruchitel'stvom" i ot 23 marta 2012 g. No. 14 "Ob otdel'nykh voprosakh praktiki razresheniya sporov, svyazannykh s osparivaniem bankovskikh garantii".* Moscow: Statut.

Therefore, a reference to suretyship rules that is now included in pledge regulations does not affect the solution to the problem of keeping security in force when the secured obligation changes.

[2] The pledge right created by a non-owner in favour of a pledgeholder who knew about this fact (for example, a thief pledged a stolen thing to a person who knew that it was stolen) cannot be recognised and protected by law, because it will be contrary to good morals. However, this situation should not be confused with the concept of pledge of future assets described above, where at the time of the execution

First of all, we should determine whether a pledge right created by a non-owner is supposed to be protected at all, whether there are any compelling policy and legal considerations according to which the pledgeholder in such a situation must be protected.

An affirmative answer to this question may be supported by the following arguments.

Firstly, pledge is inextricably linked to credit: a vast majority of pledge transactions secure specifically the repayment of a credit or a loan. And even the pledge-related concept of the protection of the interests of the seller of assets sold for deferred consideration or consideration paid in instalments referred to in clause 5 of Article 488 of the RF Civil Code also in fact protects credit, but credit in a wide, economic sense of the word – as credit provided by the seller to the purchaser in the form of a time gap between the exchange of performances under a sale and purchase contract.

The risk of a credit not being repaid has a serious (although not crucial) impact on the credit interest rate. This means that the weakness or, conversely, the strength of security instruments directly affects payment for the credit: the more likely it is that the creditor, using security rights, will ultimately receive what is due to it, the cheaper the credit is, and, conversely, the higher the creditor's risks are, the more expensive the credit will be. It appears that, by taking steps to strengthen legal security instruments, lawmakers (or courts) minimise creditors' risks and thereby create conditions for cheaper credit.

Secondly, a refusal to protect a bona fide pledgeholder in a situation when the latter could rely on proof of ownership provided by the pledgor (for example, a USRR record) will compel pledgeholders to carry out a very profound and thorough investigation of the pledgor's title. This would include an investigation of the entire chain of transactions (or other legal actions) as a result of which the potential pledgor obtained ownership title to the pledged asset.[1] Of course, this may not only slow down the provision of credits, but paralyse it completely.

Thirdly, we should not forget about the flip side of defaulting on credits, including those secured by pledge, in the economy. When banks (it is them that in a vast majority of cases act as pledgeholders) provide loans, they do it primarily out

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of a pledge agreement, the pledgeholder is fully cognizant that the pledgor does not yet have ownership title to the asset; but when a pledge right is created in respect of the relevant assets (they are delivered to the pledgeholder's possession, signs are affixed, pledges are registered etc.), the pledgeholder (acting prudently) should believe that the asset *is already owned* by the pledgor.

[1] It is appropriate to remember at this point such exotic legal instrument as *probatio diabolica*.

of money received from depositors. Accordingly, a default on a loan inevitably leads to difficulties for the bank in meeting depositors' demands. As a result, it appears that, by protecting lending banks' interests, lawmakers (or courts) also protect their depositors' interests quite well.

Of course, a person that has information that the apparent holder and the actual holder of the right are not the same person may not rely on the apparent right. This means that a person acting in bad faith may not rely on an apparent right. In addition, if a person that acts reasonably and prudently (as prudently as is acceptable in the course of business) had sufficient grounds to believe that the apparent holder and the actual holder of the right are not the same person; such person may not rely on the apparent right either. At the same time, it is important to consider the circumstances under which the owner has lost possession of the asset. It is generally recognised that a bona fide purchaser does not acquire ownership title to stolen things and things that the owner lost against its will. The logic described above should now also work in cases when the consequences of a pledgeholder relying on the pledgor's apparent right are discussed: if a stolen thing was pledged, the interests of justice demand that (in a situation when none of the parties to the conflict (pledgeholder and owner) did anything for which they can be held responsible) the owner be granted priority protection.

Therefore, the strength of pledge law and the creditor protection ideology are very closely interlinked. It is exactly for this reason that in borderline cases, when there is a defect in the basis of a pledge, but this defect is "cured" by facts of the case that occur subsequently (for example, a pledgor has become the owner, an owner has given consent to the pledge of its asset that has already been executed etc.), the conflict between the owner's and the pledgeholder's interests should be resolved in favour of the pledgeholder.

It is interesting that the concept of protection of a bone fide pledgeholder is not new in the full sense of the word. For example, back in 2011-2012, the Presidium of the RF SCC started to advise courts to both protect a bona fide pledgeholder[1] from owners and owners who have lost possession of pledged assets against their will.[2]

[1] Decisions of the Presidium of the RF SCC No. 2763/11 dated 26 July 2011 and No. 16513/11 dated 7 July 2012.

[2] Decision of the Presidium of the RF SCC No. 9555/11 dated 6 December 2011.

5. CONTENTS OF A PLEDGE AGREEMENT: SECURED DEBT

One of the significant deficiencies of the earlier pledge rules was lawmakers' requirement that secured debt be described (specified) to quite a tough standard. Thus, in accordance with the previous version of Article 339 of the RF Civil Code, a pledge agreement must specify "the essence, size and term of the obligation secured by the pledge".

Unfortunately, courts interpreted this rule too literally and believed that a smallest deviation from these regulations and an ambiguity in the provisions of a pledge agreement relating to the secured debt mean that the agreement must be deemed not to have been executed.

Higher courts tried to correct the situation and provided a restricted interpretation of the rule: in para. 43 of Decision No. 6 adopted at the Plenary Session of the RF SC and No. 8 adopted at the Plenary Session of the RF SCC dated 1 July 1996 "On certain matters in connection with the application of Part One of the Civil Code of the Russian Federation" ("Decision No. 6/8"), it was declared that "[in] cases, when the pledgor is the debtor in the principal obligation, the terms regarding the essence of, the size of, and the term for the performance of, the obligation secured by the pledge should be deemed agreed if the pledge agreement includes a reference to the agreement regulating the principal obligation and containing the relevant terms."[1]

The higher courts' logic was most likely as follows: the purpose of the provisions of Article 339 of the RF Civil Code is to protect a pledgor's right to know for certain which specific debt is secured by the pledge. However, according to the courts, this is necessary only when the pledgor is not a debtor in the secured obligation, because otherwise the debtor-pledgor cannot but know how much it owes the creditor. And it is for this reason that para. 43 of Decision No. 6/8 offers quite an elegant solution to the issue of the excessive rigidity of the rule set out in clause 1 of Article 339 of the RF Civil Code: the standard of description of a secured debt is deemed met if the pledge agreement specifies that it secures repayment of the debt, say, under loan agreement No ____ dated ___ _____ 201__.

[1] However, RF SCC Plenary Decision No. 10 (para. 13) included a legal position that in many respects weakened the progressive approach described in the clarification in question: if an agreement does not describe the size of the loan interest and/or the procedure for paying it, this means that claims secured by the pledge are limited to the amount of the principal debt.

However, I would like to note again that this solution only applies to the situation when a pledgor is a debtor under the secured debt; if a pledgor is a third party, such softer standard of description of secured debt should not apply. It seems that this solution was proposed not least because there was a desire to protect a third party pledgor from a possible conspiracy between a creditor-pledgeholder and a debtor that (in theory) could conspire against the pledgor, replace the genuine text of the agreement and specify a new, significantly larger debt amount in the new text, thereby making the third party pledgor significantly worse off. The most likely reason why it was declared that a softer standard of description of secured debt applies only to the pledge executed by the debtor itself is to rule out such abuses. In other situations, the secured obligation should be described in detail, such that the amount of the secured debt does not come as a surprise to the third party pledgor.

However, although such discussion and theory concerning a possible conspiracy between a creditor and a debtor against a pledgor could exist, they are more hypothetical and have probably no serious foundation in real life. It is of course obvious that the figure of a third party security provider appears only when it (the third party) has a certain relationship (primarily a corporate relationship) with the debtor and, for this reason, provides collateral in respect of such debt. Therefore, the likelihood of a conspiracy of a creditor and a debtor against a pledgor is so small (the debtor has no incentive to do this because the pledgor is always its affiliated party[1]) that it is negligible.

Therefore, the limitation of the scope of the softer standard of description of debt that was developed in practice is excessive – it could be easily dispensed with.

This is exactly what was done during the third phase of the pledge law reform.

Thus, in accordance with the new version of clause 1 of Article 339 of the RF Civil Code, "[t]erms relating to the principal obligation shall be deemed agreed if the pledge agreement includes a reference to the agreement out of which the secured obligation has arisen or will arise in the future." The law does not specify any exceptions for a pledge created by a person other than the debtor in an obligation secured by the pledge.

[1] Although situations when assets are pledged to secure third parties' debts for a fee are possible in theory, they have not been seen in practice.

Therefore, lawmakers have followed the route of softening the standard of description of secured debt in a pledge agreement even further than the courts have.

What are the practical implications of this new rule?

I can name three significant implications.

Firstly, it reduces organisational expenses related to the execution of a pledge agreement. Parties now no longer need to describe terms and conditions of the secured obligation in detail. We can note here that the possibility to specify in a pledge agreement simply that it secures the repayment of a loan provided to the debtor "under agreement No. ____ dated ___ _____ 201__" rules out the risk of errors (typos) that sometimes led to the declaration that the terms concerning the secured debt were not agreed and the pledge agreement was not valid.

Secondly, the new provisions of Article 339 of the RF Civil Code reduce the time and administrative costs that the pledgeholder needs to spend or incur in order to change the secured debt as they no longer require that changes be made to the security transaction (and, most importantly, that the relevant changes be registered). For example, saying in a pledge agreement that the pledge secures the repayment of a loan provided "under agreement No. ____ dated ___ _____ 201__ (as may be amended and supplemented) in the amount not exceeding _____, together with interest not exceeding _____, the maturity date being no later than _____" is sufficient for any changes of the secured obligations within the stated parameters to be also deemed secured by the pledge without making any changes in the registers where the original pledge was registered. In this case, I believe that all third parties' interests will be sufficiently protected by the fact that information may be obtained from the register regarding the maximum size of the encumbrance over the asset and the creditor will not be able to demand that the value of the asset promised to it be extracted from the pledged asset over and above such maximum amount.

Thirdly, the possibility to describe the secured debt in a more general manner protects a pledgeholder against certain significant legal risks, including the risks that the pledge agreement will be deemed not to be valid because the court decides that the description of the secured claim is not sufficiently detailed (whereas such description meets the demands of a specific deal).

However, for situations when a pledgor carries on business, lawmakers went even further and introduced a concept that may provisionally be called "pledge

securing all debts up to a maximum amount": "In a pledge agreement where the pledgor is a person carrying on business the obligation secured by the pledge, including a future obligation, may be described in a manner that allows the obligation to be identified as the obligation secured by the pledge when the pledge is enforced, including by stating that security is granted for all existing and/or future obligations of a debtor owed to a creditor up to a certain amount" (first paragraph of clause 2 of Article 339 of the RF Civil Code). It is easy to see that in this case, lawmakers have provided an even weaker standard of description of secured debt: it is sufficient when it is stated that all (or, of course, a part (for example, all claims arising out of all lease agreements)) of the debtor's obligations owed to the creditor are deemed to be secured by the pledge. The interests of the pledgor's other creditors are also protected in this case because the maximum size of the encumbrance is a mandatory term of the pledge securing all debts. This means that creditors will in any case be able to rely on the value of the asset in excess of such amount.

There is an interesting question as to what will happen to a pledge securing all debts if, after the pledge is created and, accordingly, after some time passes (during which there is a debt relationship between the creditor and the debtor), all of the debtor's obligations are terminated and then arise again. Will they be deemed to be secured by the pledge or will the pledge be deemed to be terminated under sub-clause 1 of clause 1 of Article 352 of the RF Civil Code? It appears to me that the suggestion that the pledge continues until the expiry of the term for which it was created (if such term is specified in the pledge agreement) or for two years from the creation of the pledge (clause 4 of Article 367 of the RF Civil Code) is true. Of course, parties may agree to rely on any other solution in the pledge agreement.

It is obvious that keeping a pledge as an eternal encumbrance is hardly appropriate because there are no eternal obligations (and security is still the dominating element of this legal concept).

In general, the fact that legal requirements applicable to the description of secured obligations have become much more flexible ultimately gives parties to security transactions freedom in creating such security within such a scope that they (the parties) would like to see.

6. CONTENTS OF A PLEDGE AGREEMENT: PLEDGED ASSETS. ELASTICITY PRINCIPLE

Pledge law has gone through changes that addressed various unusual situations relating to the regime of pledged assets. Such changes are quite interesting and will be of some use to practitioners.

The first notable change is that the standard of description of pledged assets in a pledge agreement where a pledgor is a person carrying on business has become much softer. Thus, according to the second paragraph of clause 2 of Article 339 of the RF Civil Code, "…pledged assets may be described in any manner that allows an asset to be identified as a pledged asset when the pledge is enforced, including by stating that a pledge is created over all of the pledgor's assets or a certain part of its assets or a pledge of assets of a certain category or type".[1]

In general, the purpose of this rule is to increase the significance of the intentions of parties in pledge transactions, allowing them to describe assets provided as collateral as they see fit for this specific transaction. Nevertheless, it is also clear that pledge, as a right in rem, is subject to the requirement that the object of such right be specified (identified) in some detail; the description of pledged assets may not be totally abstract.

However, from a practical perspective in modern Russia, it could be seen that any minor defects or ambiguities in the description of pledged assets led to the declaration that the pledge has not been created at all. This all dealt a serious blow to the strength of pledge as a form of security for obligations.

It may also be inferred from this rule that Russian legal system has recognised a form of security that may provisionally be called a *"total pledge"*, i.e. a pledge of all (or a part) of the pledgor's assets.

Our pledge law already has a security instrument that allows assets to be pledged without specifying pledged assets, by including a reference to property owned by the person that has created the pledge: this is a pledge of goods in circulation (cf. Article 357 of the RF Civil Code). However, a total pledge and a pledge of goods in circulation should not be confused. This is because, in a pledge of goods in circulation, assets provided as collateral become unencumbered when they are no longer part of the pledged goods (clause 2 of Article 357 of the RF Civil Code).

In a total pledge, the encumbrance over assets that were pledged and disposed of by a pledgor is not lifted and the acquiror receives them subject to the encumbrance. This is explained by the fact that, for a total pledge, lawmakers do

[1] The rule became effective on 1 January 2015 (clause 2 of Article 3 of Federal Law No. 367-FZ dated 21 December 2013).

not make an exception from the rule that a pledge follows the asset in the case of an acquisition; Article 352 of the RF Civil Code listing grounds for the termination of a pledge does not provide for this either.[1]

A total pledge looks to a certain extent like a well-known security instrument called a *floating charge* that has become quite popular in western jurisdictions. However, there are quite significant differences between a total pledge and a floating charge.

Firstly, floating charge manifests itself as security not when it is created, but when the so-called crystallisation occurs, normally when the debtor delays a payment. With a total pledge, the idea is completely different: when the pledge is created, assets are deemed to be encumbered.

Secondly, floating charge does not give full priority to the creditor that has negotiated such security. Thus, if a fixed charge is subsequently granted in respect of certain assets, it will have priority over an earlier floating charge even though it was created later. There is nothing like this in a total pledge: no exceptions have been made in the pledge ranking rules for a total pledge.[2]

When a total pledge is registered in a register, it is effective against third parties – the pledgor's creditors – by giving the pledgeholder priority when its claims are satisfied out of the value of *all (or a part)* of the pledgor's assets and when third parties acquire assets of the pledgor that has created a total pledge. This is because any third party may learn from the notarial register of notices of pledge that its counterparty has created a pledge over *all* of its assets;[3] for this reason, every acquiror of assets from a pledgor should be deemed to be aware that it is acquiring pledged assets. Accordingly, the pledge will continue in effect. For this reason, a total pledge can be easily seen as a sort of "umbrella" that in a way covers the pledgor's assets, and all of the assets that have been covered or will be covered by that "umbrella" are automatically pledged; they also remain encumbered when they leave the "umbrella".

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[1] Of course, when a pledgeholder and a pledgor create a total pledge, they may establish a different regime: for example, that the pledge will terminate when certain assets are sold.

[2] For more detail regarding the concept of a floating charge, see, for example: Bütter, M., 2002. *Recognition of English Fixed and Floating Charges in German Insolvency Proceedings under the New European Regulation on Insolvency Proceedings*. Journal of Corporate Law Studies, 2, p. 213; Ferran, E., 1988. *Floating Charges: The Nature of the Security*. The Cambridge Law Journal, 47(2); Pennington, R.R. *The Genesis of the Floating Charge*. The Modern Law Review, 23(6); Worthington, S., 1994. *Floating Charges: An Alternative Theory*. The Cambridge Law Journal, 53(1).

[3] See below.

It seems to me however that such solution proposed by lawmakers (for which lawmakers have made no exceptions) is too rigid and does not take into account the specifics of certain transactions, primarily transactions made by individual consumers. Of course, they are also able to review the register of notices of pledge when they enter into transactions relating to the acquisition of expensive[1] furniture, appliances etc. However, it is difficult to imagine, in all seriousness, that consumers will do this. And the issue here is not really that a consumer is a party with weak leverage in negotiations, but rather that standard consumer behaviour preceding a transaction has never included (and, I believe, will never include) an investigation of any third-party sources of information. Consumers obtain all information relevant for the transaction from their counterparty. Moreover, the seller's obligations to provide information to a consumer, which are heavily regulated, are among the fundamental, seminal principles at the core of consumer rights law. It is impossible to imagine that the seller's obligation would not include an obligation to provide to a purchaser (who is a consumer) information that it is acquiring a pledged asset. For this reason, it appears that a purchaser's reliance on the information provided by the seller concerning the goods is usually so great that it is simply impossible to imagine a consumer who is independently searching for information regarding encumbrances.

I am convinced that, even though lawmakers have not made exceptions for individual consumers from the total pledge regime, courts will independently provide protection to purchasers of pledged assets in such a situation.[2]

Of course, even when a total pledge is registered in the notarial register of notices of pledge, it cannot create pledge rights when special, constitutive registration is required to create a pledge (for example, a mortgage, pledge of securities etc. (see below)). This is because, in order for such pledges to be created, pledged assets are required to be specified (a pledged immovable asset is required to be described etc.), which of course is not the case and cannot happen in a total pledge. For this reason, for example, even when such an agreement is submitted to

[1] It is obvious that this issue will only be relevant when expensive movable assets are acquired. A pledgeholder's costs to search for acquirors and enforce pledges of assets of insignificant value will be too high, which means that enforcement proceedings are themselves unlikely to be initiated.

[2] Which has in fact already happened once (cf. para. 25 of RF SCC Plenary Decision No. 10 regarding protection of a bona fide purchaser of pledged assets).

an authority carrying out state registration of rights to immovable property, such agreement may not serve as a basis for the state registration of a mortgage.

The second quite significant new rule in relation to pledged assets is the recognition by lawmakers that a pledge has a certain quality, which I believe is appropriate to call "*elasticity* of pledge".

The nature of this characteristic of a pledge may be described as follows: given that pledge is a right to the value of pledged assets regardless of the changes in the external form that such value had when the pledge was created, pledge will continue in effect until a *de facto* or *de jure* substitute of such value exists. The idea of the elasticity of pledged assets was partially implemented in certain pledge law rules and in court cases; during the reform, the implementation of the idea was completed.

I will explain this using an example.

Let's imagine that a pledged land plot was seized for government needs and a public body became liable to pay compensation. Based on the elasticity principle, pledge as an encumbrance will automatically extend to this compensation. Moreover, under clause 2 of Article 334 of the RF Civil Code, the pledgeholder has the right to demand directly that such amount be paid to it. Another example: a pledged car was destroyed and an insurance company has to pay compensation under the terms of the insurance policy. In this case, the pledgeholder will also have the pledge right in respect of the relevant amount and the right to demand that the insurer pay such amount directly to it. The third example where the elasticity principle applies:
the right to demand the transfer of an immovable property arising out of a contract of sale and purchase of a future immovable asset (investment contract) was pledged. The developer discharged its obligation owed to the pledgor and delivered ownership title to the property. It will be deemed to be pledged to the pledgeholder holding the pledge over the right, because the latter terminated following proper performance and this property became its economic "substitute"; for this reason, the pledge must automatically extend to this new value.

We can provide examples of a different kind, where the "substitute" of the pledged value appears as a result of actual steps taken by the pledgor – when it changed the pledged asset (both legally and physically). Such examples may include changes made to a land plot (division, merger etc.), division of a building into rooms and, conversely, creation of a single building from a number of rooms, conversion of a movable asset, restoration of an immovable asset etc. In all of the

above situations, pledge will continue in effect and will encumber the physical "substitute" of the original pledge (cf. clause 2 of Article 334 and clause 2 of Article 345 of the RF Civil Code).

We would like to note two features of a pledge that continues in effect on the basis of the "elasticity" principle in respect of economic or legal "substitutes" of the originally pledged assets.

This pledge is not a new (a newly created) pledge, it retains the same rank as the one that it had when the pledge was originally created. This is emphasised in two last paragraphs of clause 5 of Article 345 of the RF Civil Code: "The terms of a pledge agreement, as well as other agreements entered into by parties in respect of the previously pledged asset shall apply to parties' rights and obligations in respect of the newly pledged asset to the extent that they are not in conflict with the nature (properties) of this pledged asset.

If a pledged asset is substituted, the seniority of pledgeholders' rights, including those created before the asset was provided to substitute the previously pledged asset, shall not change."

This is correct because a pledge is "switched" from one value to another based on a legal regulation rather than intentions expressed by parties. Therefore, neither the rank of the pledge should change, nor the terms and conditions of the pledge. And, of course, such pledge may not and should not be viewed as a pledge created by law. In the latter case, this would be a new pledge (and not the previous, contractual pledge) with a new rank and new terms and conditions. However, this will contradict an unambiguous legal rule.

Another quite important practical conclusion follows from the conclusion that a pledge that continues pursuant to the elasticity principle is not a pledge created by law: if the newly pledged asset is an immovable asset (a new land plot instead of the divided plot; a new building instead of rooms pledged earlier; new rooms instead of a divided building; a property delivered under an investment contract), then mortgage in respect of such asset will not be registered pursuant to the rules of the Federal Mortgage Law regulating the registration of a mortgage created by law (when the mortgageholder files the relevant application etc.), but by the authority registering rights to immovable assets *ex officio*. This means that the authority responsible for the registration of rights will be obliged to transfer to the file of the newly mortgaged asset all entries concerning the encumbrances that were made in the register in respect of the previously mortgaged assets (for example, with regards to a newly created land plot, all encumbrances over land

plots from which it was created should be transferred to such newly created land plot).

One last thing. It appears to me that clause 2 of Article 345 of the RF Civil Code could be a solution to one of the most difficult problems of Russian immovable property law – concentrating in the same hands the rights to two assets: a land plot and a building constructed upon it.

It is known that the Federal Mortgage Law currently includes rules (Articles 64 and 69) that are not very clear and do not explain properly how we can follow the principle that rights to a land plot and a building thereon have the same fate if a land plot was pledged initially and a building was constructed on it later.

The prevailing view is that a mortgage is created over the building by law. I believe that this view is mistaken: firstly, it means that mortgages with different ranks will be created in respect of what is in essence a single asset; secondly, such solution will also mean that the mortgageholder has to monitor on a daily basis and keep abreast of all of the actions of the mortgagor that has been developing the land plot, so as not to miss the time when a state registration application must be filed.

At the same time, clause 2 of Article 345 of the RF Civil Code mentions that "a new asset that is owned by the pledgor and has been created or has arisen as a result of conversion or another type of change of a pledged asset" is deemed to be pledged to the pledgeholder to which the original asset was pledged. Strictly speaking, this rule allows the elasticity principle to be applied to the construction of a building on a pledged land plot. In this case, encumbrance with the same rank and subject to the same terms and conditions will be created in respect of the building as the encumbrance in respect of the pledged land plot. Moreover, it will not be a mortgage created by law, but an "extension" of the original contractual mortgage over the land plot.

7. CREATION OF A PLEDGE, PUBLIC NATURE AND EFFECT AGAINST THIRD PARTIES: FOLLOWING AND PRIORITY

A pledge right has two "cornerstones" on which it, as a security instrument, is based. The first one is the tracing principle according to which the pledgeholder is able to enforce its rights over the pledged assets, even when the assets have been sold or transferred by the pledgor

The second “cornerstone” is the priority of the pledge, which means that the pledgeholder may have its claims settled out of the value of the pledged property in priority to the pledgor’s other creditors.

It is easy to see that each of these two pledge law “cornerstones” is meant to be effective not only, and not so much, against the pledgor, but rather against *any third party*: new owner of pledged assets, the pledgor’s creditors, etc. It seems that pledge is a concept generally intended to allow a creditor to have impact over third parties.

However, there is a well-known maxim in private law that relates to the scope of the so-called absolute rights (rights that have the *erga omnes* effect, i.e. effective against everyone). This maxim goes as follows: rights can have effect against third parties only if third parties knew or could have known about the existence of such rights. It would be contrary to the law and justice to give a pledgeholder the opportunity to use against third parties (the purchaser of the pledged asset, its other pledgeholders, and the pledgor’s unsecured creditors) a pledge right that these persons did not know and could not have known about when they transacted with the pledgor.

Therefore, one of the tasks of pledge law is to create a system of rules that would ensure that pledge is *public information*, i.e. would make it “visible” to third parties.

There are several ways in which a pledge right can become public information.

The first one (and probably the oldest of them all) is delivery of a pledged asset to the pledgeholder’s possession. Indeed, one and the same person normally possesses and owns assets; a person that does not possess the assets that it owns looks quite suspicious in normal economic situations: it means that it has lost the asset or has disposed of it (and, for this reason, it is not in its possession). Therefore, when a pledgeholder seizes possession of the pledged asset the pledgeholder, in a way, deprives the pledgor of the most important “token of ownership” – possession of the asset. Accordingly, in possessory pledges, the fact that the pledged asset is partly in the pledgor’s or a third party’s possession is sufficient for all third parties to be deemed aware that ownership title to the asset is not free from encumbrances, and is sufficient to consider the delivery of the asset to the pledgeholder’s or a third party’s possession to be an act that makes such pledge public information.

However, in modern economy, possessory pledge is an extremely inefficient type of security: in order to repay a loan, the debtor needs to use its assets (equipment, technical tools etc.) and derive profits from it. However, when a pledgeholder deprives the debtor of possession of the pledged asset, the pledgeholder deprives it of the sources of funds for repaying the debt. Therefore, another, the so-called non-possessory form of pledge emerged quite quickly in practice. In such a pledge, the pledged asset remains in the pledgor's possession.

But how can we ensure that the pledge is public information? There are two possible ways of making a pledge public information. The first one is the so-called hard pledge, i.e. a pledge where marks are added to the pledged asset to show that the relevant asset is pledged. Third parties that transact with the pledgor are deemed to be able to examine their counterparty's assets and are deemed to be aware of the pledge.

However, in practice, the application of the concept of hard pledge demonstrates that this form cannot be efficiently used to make a pledge public information. This primarily has to do with the fact that pledge marks may be removed by a pledgor acting in bad faith. Therefore, a different method of "publicising" pledges (reader, forgive me for this term!) has gained the most popularity – registering them in special registers open to the public, where every interested party may obtain information that certain asset of a certain person is pledged. Historically, pledges became public information through registration for the first time in situations involving pledge of immovable assets called a mortgage.[1]

For quite a long time, Russian pledge law did not have rules that could form a more or less organised system of legal doctrines regarding 1) the moment when a pledge right is created and 2) the link between this moment and certain registration procedures envisaged in pledge laws. Such problems are not only theoretical, but have quite a serious practical impact. For example, without answers to these questions it is impossible to understand, for example, when mortgage over immovable assets is created by law or how to determine the seniority of pledges of movable property etc.

[1] It is interesting that the Russian term for "mortgage" – ipoteka – originates from the ancient Greek word "ὑποθήκη" which meant a stone pillar where an inscription was carved stating that the land plot on which the pillar was located was pledged. It is absolutely clear that this pillar was also intended to "publicise" the pledge of the immovable asset: every third party that examined the land plot for the purposes of entering into a transaction with respect to it would see the pillar and would be deemed to be aware of the pledge.

In the new version of § 3 of chapter 23 of the RF Civil Code, a new Article 339.1, which was not included in the RF Civil Code previously, deals, among others, with these issues. What does it address?

It can already be seen on the first reading that there are two types of registration of pledges (and probably two types of all other registrations of civil law rights).

The first type of registration is the so-called constitutive (right-conferring) registration that can be very easily described as follows: if there is a record, there is a pledge right, if there is no record, there is no pledge right. In the real estate industry, this principle is sometimes called *the entry principle*. As a general idea applicable to the state registration of rights to assets (and a pledge right is also a right to an asset!) this principle is codified in clause 2 of Article 8.1 of the RF Civil Code.

With respect to pledge, there are four situations where lawmakers link the creation of a pledge right to the registration thereof.

The first situation is a pledge of immovable property (mortgage) that is created when a record is made in the USRR (see also Article 11 of the Federal Mortgage Law), and this applies not only to contractual mortgage, but also to mortgage created by law.[1]

The second situation is a pledge of participation interests in charter capitals of limited liability companies; such pledge is created when it is registered in the Unified State Register of Legal Entities.[2]

The third situation is a pledge of securities recorded in an account in the register of holders of uncertificated registered securities or in depository accounts; such pledge is created when it is reflected in the register or the depository account.

As already mentioned, such rules apply both to a contractual pledge and a pledge created pursuant to provisions of law.

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[1] I would remind you that until recent changes were introduced to the Federal Mortgage Law (Federal Law No. 405-FZ), mortgage created by law was not subject to mandatory registration and was created when *the pledgor's ownership title went through state registration*, i.e. it was a so-called "secret mortgage". This of course dealt quite a serious blow to the economy because it created a burden for purchasers and other mortgageholders not only to investigate the counterparty's right to mortgaged assets, but also to find out whether there were any grounds in the past for a mortgage to be created by law.

[2] It is notable that this decision is in stark conflict with lawmakers' decision as to when a participation interest is deemed to have passed to its acquiror. Pursuant to Article 21 of Federal Law No. 14-FZ dated 8 February 1998 "On Limited Liability Companies", it happens when the transaction whose purpose is to dispose
of a participation interest is notarised; registering this fact in the register only has evidentiary value and does not create the right.

In addition to constitutive registration, Article 339.1 of the RF Civil Code includes rules relating to evidentiary registration of pledges[1] (declaratory registration of pledges, registration of pledges for record-keeping purposes) (clause 3 of Article 339.1). The main difference between this registration and the constitutive registration of pledges is that the "no record, no pledge right" rule does not apply to the former; a pledge is created when certain grounds exist for it to be created (a contract, a law or an attachment) and exists only because the pledgeholder and the pledgor have expressed relevant intentions. However, this pledge becomes public information (and, therefore, is effective against third parties) only when the fact that the pledge has been created was disclosed (recorded) in a special public register. This system, which ensures that a pledge is made public information (it may provisionally be called a "system ensuring effect against third parties", was not invented in Russian law, it exists in many jurisdictions.[2]

In addition to the evidentiary value of such registration of pledge, its other characteristic is also fundamental: it is *voluntary.* In other words, lawmakers do not require pledge holders to disclose information concerning pledges and do not provide that non-disclosure would result in the right or agreement being deemed to be invalid, not to have been created, not to have been executed or would lead to other negative consequences. This is because mandatory registration of a pledge would inevitably entail an investigation of the pledgor's title, and it seems to be completely impossible to organise a more or less workable system of registration of rights to movable assets. And because mandatory registration of ownership title

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[1] It is obvious that a creditor cannot rely on its pledge right only on the basis of such registration. If it did not agree with the pledgeholder that a pledge would be created, such registration *per se* does not create a pledge and does not evidence the existence of a pledge.

[2] It probably originates from the US where, due to the introduction of the Uniform Commercial Code (UCC), a filing system (for registering notices of security granted) was created. The essence of this system is that information concerning the person that has provided the security, the secured creditor and the asset provided as security is recorded in a special register. This information is set out in a special notice called a "financial statement", which is the main source of data for the register (Hamwijk, D., 2011. *Public Filing with Regard to Non-Possessory Security Rights in Tangible Assets as Contemplated by the DCFR: Of No Benefit to Unsecured (Trade) Creditors*. European Review of Private Law, 19(5), pp. 613–614). However, there are exceptions from this principle: for example, if security has effect against third parties or if the asset provided as security is in the creditor's possession (Montague, W., 1963-1964. *Uniform Commercial Code's Article 9: When Filing is Not Required to Perfect a Security Interest*. Kentucky Law Journal, 52, p. 422).

A similar system of registration of notices of pledge currently exists in many European jurisdictions (other than, we would say, Germany and the Netherlands). This system, which makes pledges effective against third parties, was used as a basis in a recent attempt to create an academic code of European private law (Draft Common Frame of Reference (the "DCFR")).

(the principal right in rem) is impossible, mandatory registration of limited rights in rem will also be impossible.

However, in this case, a question inevitably arises: how can we ensure the flow of data to such a register if creation of pledges has nothing to do with a record in the register? A pledgeholder will then no longer have a powerful incentive to register pledges, won't it?...[1]

We can see here quite an interesting legislative approach. Lawmakers rather "softly" push creditors to disclose information about pledges: according to the third paragraph of clause 4 of Article 339.1 of the RF Civil Code, "[i]n relationships with third parties, a pledgeholder may rely on its pledge right only after a record of pledge is made, unless the third party already knew or should have known about the existence of a pledge." Therefore, it seems that a pledgeholder can rely on the two "cornerstones of pledge" that I have mentioned only if a notice of its pledge was registered in the register. Absence of such notice does not mean that there is no pledge at all – it exists, but only in the relationship among the pledgeholder, the pledgor and persons that definitely knew about the pledge. For example, a pledgeholder's creditors may not argue that the pledge in favour of another creditor has no effect against them under the pretext that the relevant notice has not been registered in the register, if it is proven that they had information about pledge agreements entered into by the debtor.

The procedure of the registration of notices of pledge is described in chapter XX.1 of the Principal Regulations in Relation to Notarial Procedures in the Russian Federation (approved by the Supreme Council of the Russian Federation No. 4462-I dated 11 February 1993) (the "Principal Notarial Regulations"); it is quite simple.[2]

Either the pledgor or the pledgeholder can apply to register the pledge.

A notary who has received the relevant notice of pledge (both in writing and electronically) must identify the person that has filed the application, verify that the notice has been completed correctly and the tariff has been paid. At the same time, the notary does not verify whether the pledgor has given consent to the registration of the notice of creation of a pledge, the accuracy of the information concerning the

[1] It is known that the principle of making a mandatory record upon the owner's application (i.e. a requirement to make a record in the register in order to create a right (Antragsprinzip) broke the resistance of German land owners against registration of their rights to land plots (Vliet, L. van., 2012. *The German Grundschuld*. Edinburgh Law Review, 16(2), p. 150 [online], Available at: <http://papers.ssrn.com/abstract_id=2071814>).

[2] I believe that the same procedure should apply to a "court" pledge, which will be effective against third parties only if it is public.

pledged asset and the creation, change and termination of the pledge included in the notice, or the accuracy of the information concerning persons referred to in the notice of pledge. For this reason, the notary is not liable for the inaccuracy of information provided in the notice (Part Two of Article 103.2 of the Principal Notarial Regulations). In general, such approach seems reasonable as a different approach (giving verification powers to the notary) would have created quite a heavy, expensive and inefficient system of registration of notices. Conversely, the adopted approach created a quick and cheap mechanism to make pledges public information.

The register of notices of pledge is open to public: every person has the right to search this database freely.[1] In addition, the Principal Notarial Regulations provide that any interested party may request any notary in the Russian Federation to issue an excerpt from the register of notices of pledge (Article 103.7). Such an excerpt is authentic evidence that, on a certain date, there was no notice of pledge in the register or that the pledge was registered subject to certain terms and conditions, Therefore, such an excerpt protects creditors against surprises of any kind. Of course, relevant persons may fully rely on the results of an independent search in the database of notices of pledge.

However, there is a fine point here that persons searching the register should take into account.

The issue is that the notice database may be searched by two criteria: the object (pledged assets) and the subject (pledgor).

You can search by object either using the unique car number (VIN)[2] or another identification number containing letters and digits.[3] However, not many movable assets (let alone other, intangible assets, pledges of which may also be recorded in the register of notices) have such numbers; therefore, in this case, searching the register by object will be simply impossible.

But this does not mean that it will be impossible to find information about such pledges in the register, given that interested parties may use a different

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[1] The database is available online at: http://reestr-zalogov.ru.

[2] In fact, the idea of an open register of pledges was the government's reaction to an absolutely hideous practice of creating non-public pledges in respect of cars as security for personal car loans. Stories about unsuspecting people buying pledged cars and finding out subsequently that pledges had to be enforced to recover third party debts are well known.

[3] This presents a certain difficulty. For example, there can be several numbers (factory number, inventory number etc.); therefore, there are certain risks that a pledgeholder submitting information to the register will specify one number, whereas a person searching the information will search a different number. However, I believe that the latter should not be viewed as a bona fide purchaser.

search criterion – search by pledgeholder. In order to do this, information about an individual or a legal entity that is a potential counterparty will need to be entered in the relevant fields of the search form. The system will show notices that have been registered in respect of the relevant pledgor.[1]

The date of the registration of the notice affects the seniority of pledge rights. This can be inferred from the last paragraph of clause 4 of Article 339.1 of the RF Civil Code: subsequent and preceding pledgeholders are the third parties mentioned in this rule, and for this reason the seniority of pledges recorded in the register of notices is not calculated from the date of execution of the pledge agreement, but from the date of registration of the relevant notice. Clause 10 of Article 342.1 of the RF Civil Code states this unambiguously: "If pledged assets pledges over which are recorded in accordance with clause 4 of Article 339.1 of this Code are subject to several pledges, a pledgeholder's claims that are secured by a pledge recorded earlier shall be settled in priority to a pledgeholder's claims that are secured by a pledge of the same assets where such pledge was not recorded in accordance with the procedure established by law or was recorded later, regardless of which pledge was created earlier. Securities laws may provide for a different procedure of settling pledgeholders' claims."

If the contents of the pledge (for example, the term of the pledge) change, the relevant information must be included in the register of notices: "If a pledge in respect of which a notice of pledge has been recorded changes… the pledgeholder must send a pledge change notice or a notice of removal of information concerning the pledge in accordance with the procedure set out in the laws regulating notarial procedures within three business days after it learned or should have learned about the change or termination of the pledge" (second paragraph of clause 4 of Article 339.1 of the RF Civil Code). It should be noted that only the pledgeholder has the right to change the contents of the notice of pledge. The purpose of this rule is to protect the contents of the notice from actions that the pledgor may take in bad faith, as a different regime might have made it possible for the pledgor to change the notice unlawfully.

Even though lawmakers use the expression "the pledgeholder must", it should not be interpreted literally. This is because a pledgeholder is a person most

[1] Such assets (apart from assets without identification numbers) include groups of movable assets (for example, "all assets", "all trade equipment", "goods in circulation"). In general, search "by pledgor" is more flexible and comprehensive, because there are many different ways of describing one and the same asset: for example, "desk", "furniture", "work station", "executive office" etc. But all of this relates to one and the same thing – an office desk.

interested in making sure that the register adequately reflects the actual status of the pledge (otherwise it will not be able to exercise its pledge right against third parties). Strictly speaking, for a pledgeholder, the only consequence of failing to discharge the obligation to change a notice is the impossibility for it (in situations involving third parties acting in good faith) to argue that the contents of the pledge are different from how they were described in the register, but not more than that. If no changes are made to the notice, the pledge does not terminate, but continues to exist subject to original terms and conditions.

There is a logical link between the rules we have commented on and a new ground for the termination of a pledge provided in sub-clause 2 of clause 1 of Article 352 of the RF Civil Code: "Pledge shall terminate… if pledged assets have been acquired for value by a person that did not know and should not have known that these assets are pledged."

This rule marks the end of an old dispute between the RF SC and the RF SCC as to how the fact that the purchaser of a pledged asset acted in good faith affects the pledge.

The RF SC quite consistently defended the view that pledge does not terminate.[1] Against this, in para. 25 of RF SCC Plenary Decision No. 10, the RF SCC stated that when the purchaser of a pledged asset acted in good faith, the pledge may not be enforced. Even the RF CS (*the Constitutional Court of the Russian Federation*) distanced itself from this dispute back then.[2] We can now say that the issue has been resolved in favour of the approach that the RF SCC proposed previously.

However, para. 25 of RF SCC Plenary Decision No. 10 included a rather fine point relating to a bona fide purchaser of pledged assets that were subject to a possessory pledge, i.e. were in the pledgeholder's possession. Thus, the RF SCC clarified that if a pledged asset was in the pledgeholder's possession in accordance with the pledge agreement, but ceased to be in its possession against its will, then, *in a claim to enforce the pledge over the asset, the judgment shall be granted in favour of the claimant regardless of the fact that the purchaser did not know and should not have known that the asset acquired by it was pledged.* In this case, Article 302 of the RF Civil Code is, in a way, "projected" onto the regime of the

[1] Rulings of the RF SC No. 11V07-12 dated 10 April 2007, No. 74-V11-4 dated 12 July 2011, No. 16-V11-24 dated 20 March 2012, No. 18-KG12-39 dated 9 October 2012.

[2] Rulings of the RF CS No. 215-O-O dated 20 March 2007, No. 323-O-O dated 15 April 2008, No. 942-O-O dated 15 July 2010, No. 498-O-O dated 22 March 2012, No. 754-O dated 22 April 2014, No. 1142-O dated 5 June 2014.

acquisition of pledged assets. Let me remind you that pursuant to Article 302 of the RF Civil Code, a bona fide purchaser is not protected from an owner's vindication claim if the owner lost possession of the asset against its will.

Something similar was also proposed at a Plenary Session of the RF SCC, in para. 25 of RF SCC Plenary Decision No. 10. If a pledgeholder has lost the external sign of a pledge (possession of the asset subject to possessory pledge) against its will, it can hardly be held responsible for the fact that the pledge is not public. Therefore, the circumstances under which a pledged asset was lost can exonerate the pledgeholder. And from the perspective of the "concept of the lesser evil" (which, by the way, was also developed in connection with a vindication claim against a bona fide purchaser[1]), in a similar situation, the interests of the actual holder of the right (in this case, the pledge right) are given greater protection than the acquiror's interests.

If this approach is "transferred" onto the system of registration of notices of pledge of assets introduced in the course of the reform of the RF Civil Code, we can come to the following conclusion: if a pledge termination notice was registered in the register and this notice was sent to a notary against the pledgeholder's will, a bona fide purchaser of the pledged asset should not be protected – the pledge will continue in effect and should be enforced.

8. MULTIPLE PLEDGEHOLDERS: CO-PLEDGE

The most common situation is when there is only one pledge in respect of an asset or when only one person, the pledgeholder, has the pledge right.

There may however be exceptions from this rule when two or more pledge rights have been created in respect of one asset or when several persons share the pledge right.

[1] The concept, in essence, is understanding which person's claim should be rejected, such that it is the lesser evil from the perspective of distribution of risks in the economy and taking into account actions taken in good faith. An excellent article by a judge A.A. Makovskaya published in the book *Current Private Law Issues* discusses the distribution of risks among a pledgeholder, a pledgor and an acquiror (see: Маковская, А.А., *Добросовестность участников залогового правоотношения и распределение рисков между ними*. Опубликовано в: В.В. Витрянский и Е.А. Суханов, ред. 2010. Актуальные проблемы частного права: Сборник статей к юбилею доктора юридических наук, профессора Александра Львовича Маковского. Москва: Статут, с. 130-150. Makovskaya , A.A., 2010. *Dobrosovestnost' uchastnikov zalogovogo pravootnosheniya i raspredelenie riskov mezhdu nimi.* In: V.V. Vitryansky and E.A. Sukhanov, eds. 2010. Aktualnye problemy chastnogo prava: Sbornik statey k yubileyu doktora yuridicheskikh nauk, professora Aleksandra L'vovicha Makovskogo. Moscow: Statut, pp. 130-150).

In the first situation, there can either be vertical multiple pledges (when pledges are ranked according to their seniority depending on the date of the registration of the pledge right or the notice of pledge (see below)) or horizontal multiple pledges (when all pledges have the same seniority).

In the second situation, pledgeholders can also in principle be ranked by seniority (for example, one of the holders of the pledge right, based on an agreement with another pledgeholder, may be entitled to have its claims settled first), although such situation will most likely be rather exotic: joint pledgeholders holding a pledge right in shares will be ranked equally by default.

The concept of horizontal multiple pledgeholders (co-pledge) is based on the following idea. If two co-pledgeholders have a claim against the pledgor in the amount of 50 each and the pledged assets are sold for 80, their claims will be settled pro rata: each will receive 40. (In the case of vertical multiple pledgeholders, the senior pledgeholder would get 50, and the junior, 30).

The settlement of claims of joint co-pledgeholders is based on the same principle: claims of each of them will be settled pro rata to their share in the pledge right. I will further describe the concept of horizontal multiple pledges and the concept of horizontal multiple pledgeholders holding a pledge right in shares as the same regime (unless I say otherwise) and will call it a “co-pledge”; I will describe separately the specific features of each of them, if need be.

The RF Civil Code provides that the rule regarding the pro rata distribution among co-pledgeholders of proceeds of the sale of the pledged assets is discretionary and may be changed by an agreement among co-pledgeholders unless the nature of the relationship among them dictates otherwise (see below regarding this exception). Therefore, it is possible to subordinate co-pledgeholders having the same rank in an agreement. Of course, such subordination will be strictly personal in nature and will only affect parties to the subordination agreement. The pledgor will be bound by such subordination only if it was party to the relevant agreement and had agreed to comply in accordance with the claim subordination provisions agreed among the co-pledgeholders.

Co-pledge may be created by contract, or by law, or as a result of a pledge right passing in part to another creditor.

Co-pledge will be created if several creditors have a joint claim against a debtor and a pledgor has provided security for the loan in the form of pledges in

favour of all of the banks as a whole (in this case, there will be one pledge right that the pledgeholders will hold in shares) or in favour of each of the creditors (in this case, there will be several pledges based on the number of the creditors).

A co-pledge is created by law if a developer raised funds from investors in off-plan development schemes to finance construction (Articles 13 and 15 of Federal Law No. 214-FZ dated 30 December 2014 "On participating in off-plan development schemes in respect of apartment houses and other immovable assets and amendments to certain Russian Federation laws", Article 201.9 of Federal Law No. 127-FZ dated 26 October 2002 "On insolvency (bankruptcy)"). If a developer becomes bankrupt, this will mean that investors' claims will not be settled first for those of them who were the first to enter into an "off-the-plan" purchase agreement (and, accordingly, the first to become a pledgeholder). They will be settled pro rata, i.e. in proportion to the amount of claims against the developer.

Another situation when a co-pledge is created is an assignment of a part of a claim secured by a pledge when the pledged asset cannot be divided. For example, a bank provides a loan in the amount of 100, obtains security for it in the form of a mortgage of a building, assigns a part of the claim, in the amount of 50, to another person and does not specify in the assignment that the pledge right is not transferred. In this case, the assignee will become a co-pledgeholder holding the same share in the pledge right as the assignor.

Finally, another situation when co-pledge is created is subrogation. For example, let's imagine that a loan in the amount of 100 was provided and it was secured by a pledge of the debtor's assets and a suretyship. The debtor was in arrears, and the creditor presented a payment demand to the surety, which paid the creditor some of the amount, say, 50. The relevant portion of the creditor's rights passed to the surety pursuant to Article 387 of the RF Civil Code, includes half share in the pledge right. Therefore, the creditor and the surety have become co-pledgeholders holding the pledge right in equal shares. The pledged asset was subsequently sold for 80. A question arises: how should the surety's and the original creditor's claims be settled?

If we follow the general approach, each of the co-pledgeholders should receive 40, i.e. creditors' claims should be settled pro rata. However, such an approach may materially affect the interests of the creditor for the sake of which the security was really provided: we can anticipate that the debtor's default will quite likely occur at the same time as the default on the part of the surety (which, as a rule, are affiliated parties and, from experience, usually declare bankruptcy

simultaneously). It turns out that the creditor, which had sufficient security (80 from the pledgeholder + 50 from the surety = 130, given the debt of 100) in the end will be 10 short.

In principle, the issue may be resolved if we assume that in some cases, the seniority principle, rather than the pro rata principle, will apply even among co-pledgeholders. It follows from the provisions of Article 335 of the RF Civil Code that this is possible if the pro rata principle is disapplied in the co-pledgeholders' agreement (and this can be easily inferred from the general principle of the freedom of contract) or if the consistent application of the pro rata principle is not in line with the nature of the relationship among the co-pledgeholders.

In the example in question, we are dealing with the second situation: a surety that is also a co-pledgeholder, being a security provider, cannot act to the detriment of the original creditor. This means, among other things, that it is impossible to prevent the enforcement of the pledge or to prevent the surety that is also a co-pledgeholder from taking part in the distribution of proceeds from the sale of the pledged assets (before the creditors' claims are discharged in full).[1]

Co-pledgeholders cannot act to the detriment of each other. Each of them independently exercises a pledgeholder's rights (second paragraph of clause 1 of Article 335.1 of the RF Civil Code). This is quite an important rule, which avoids the application by analogy of rules relating to another situation, well known in the law, when rights are held jointly – joint ownership. According to the provisions of the RF Civil Code regulating joint ownership, when determining the fate of the jointly owned asset or the regime pursuant to which it will be used, co-owners shall act jointly based on the unanimity principle.

However, this approach is not suitable at all in a situation where there are multiple holders of another right in rem – the pledge right. If the unanimity principle is followed when the fate of an asset pledged to several persons is determined, it is much more likely that it will be impossible to enforce the pledge over the asset because of disagreements among the co-pledgeholders. This, in turn, will significantly reduce the importance of pledge as a form of security, because in this case, the creditor that is also a co-pledgeholder will simply no longer be able to

[1] For more detail, see para. 30 of Decision No. 42 dated 12 July 2012 adopted at the Plenary Session of the RF SCC "On the selected questions of the suretyship cases": "… courts should take into account the fact that the surety's obligation is, in essence, to provide security. Therefore, a surety may not exercise a right that has passed to it to the detriment of a creditor whose claims have only been partially discharged (for example, to prevent the enforcement of a pledge over pledged assets etc.). Conversely, the creditor may independently exercise its rights in respect of the remaining part of its claim in priority to the surety."

use the advantages of a pledgeholder's status. And this is exactly the reason why, when drafting the rules regulating joint pledge, lawmakers did not support the unanimity principle (or even the majority principle, although, of course, co-pledgeholders may also agree to use it to manage affairs among them) to resolve matters affecting all co-pledgeholders and gave them the right to decide the fate of their pledge right as they see fit.

Neither of the arguments set out above prevents co-pledgeholders from executing an agreement setting out that their pledge rights will be exercised based on the unanimity principle or on a majority principle.

At the same time, it is notable that, when one of co-pledgeholders enforces a pledge, other co-pledgeholders are given the right to enforce the pledge (clause 2 of Article 342.1 of the RF Civil Code). However, if a co-pledgeholder does not exercise this right, its co-pledge continues in effect and the asset passes to the acquiror thereof encumbered (clause 6 of Article 342.1 of the RF Civil Code). Of course, co-pledgeholders may execute an agreement setting out other rules and consequences of one of the co-pledgeholders enforcing the pledge.

9. ENFORCEMENT

Enforcement is the first stage of a forced settlement of a creditor's claim secured by pledge out of the value of pledged assets. During this stage, a an authority entrusted with this power confirms that the debtor has defaulted on the secured debt and the pledgeholder has the right to settle its claims out of the value of the pledged asset by selling the pledged asset in the manner specified in the law or a contract.

Lawmakers have kept three forms of enforcement of pledges: enforcement through court, out-of-court enforcement by the creditor and out-of court enforcement by a notary. Accordingly, the entrusted authorities that may enforce a pledge[1] are the court, the creditor itself or a notary.

What changes were made to enforcement rules during the pledge law reform in question?

As a general rule, pledges are enforced through court (clause 1 of Article 349 of the RF Civil Code), provided that the debtor has defaulted on the secured debt

[1] We need to distinguish here between enforcement of a pledge in the sense used by me and enforcement in the sense used in laws regulating enforcement proceedings: the latter define enforcement as listing, seizing and selling the debtor's assets.

(clause 1 of Article 348 of the RF Civil Code). However, it is not required that the debtor be responsible for the default (see the previous version of clause 1 of Article 348 of the RF Civil Code). In other words, there is no link between a pledgeholder's right to enforce a pledge and to obtain the value of the pledged asset promised to it and the defaulting debtor's behaviour (fault or no fault). This solution is absolutely correct because fault is discussed only when the debtor is subject to civil law liability (damages, penalties etc.) The primary role of pledge, however, is to secure a contractual debt that is ordered to be paid to the creditor regardless of whether there is any fault on the debtor's part in breaching the obligation.

Even if parties in their agreement provided for out-of-court enforcement of a pledge, the pledgeholder may still enforce the pledge through court, i.e. file a claim with the court to enforce the pledge. However, in this case, additional expenses relating to the enforcement of the pledge through court are borne by the pledgeholder regardless of the outcome of the proceedings. An exception from this rule is a situation when the pledgeholder proves that the pledgor's or third parties' actions were the reason why the pledge was not enforced (or the pledged assets were not sold) in accordance with the agreement providing for out-of-court enforcement (second paragraph of clause 1 of Article 349 of the RF Civil Code).

Another interesting new rule is introduced in the third paragraph of clause 1 of Article 349 of the RF Civil Code: lawmakers provide that, in the course of enforcement of a pledge and sale of pledged assets, the pledgeholder and other persons are required to take steps to receive the biggest price from the sale of the pledged assets. A person that has suffered damages as a result of the breach of this obligation may claim such damages. This rule is a manifestation of the general principle of good faith (clause 3 of Article 1 of the RF Civil Code), including the obligation to act in good faith in the course of exercising civil rights.[1]

The rules concerning the criteria for determining whether the value of the pledged assets is commensurate to the size of the debt and the duration of the arrears have been kept in the RF Civil Code (although it was initially proposed during the reform that these provisions should be deleted): clause 2 of Article 348 still provides that the creditor's claim to enforce the pledge has to be rejected as

[1] Cf. clause (4) of Article IX. – 7:103 ("Enforcement is to be undertaken in the most commercially reasonable way and as far as possible in cooperation with the security provider and, where applicable, any third person involved") and clause (1) of Article IX. – 7:112 of the DCFR ("The creditor must realise a commercially reasonable price for the encumbered asset").

incommensurate if the debt is less than 5% of the value of the pledged assets and the duration of the arrears is less than three months. Although these rules reek of primitivism somewhat, in modern Russia they do more good than harm. This is because absolutely hideous practice existed in the past, when courts rejected pledgeholders' claims to enforce pledges due to security being incommensurate, although the excess of the value of the security over the amount of the debt was insignificant; in addition, there were quite unusual references to the concept of incommensurability of pledge: for example, it was discussed whether pledge was incommensurable in light of the social significance of the pledged asset etc.

Incommensurability rules are not rigid – they just set presumptions that may be rebutted in court (cf. the second sentence of clause 2 of Article 348 of the RF Civil Code: "Unless otherwise proven, it is presumed that the breach of the obligation secured by a pledge is insignificant and the size of the pledgeholder's claims is clearly incommensurate to the value of the pledged assets provided that…").

Another rule has been kept – a rule that, in relation to a claim discharged in instalments, the pledgeholder may enforce the pledge if payments have been delayed on four occasions in the course of the preceding 12 months (clause 3 of Article 348 of the RF Civil Code). It is important to note that this rule is discretionary and parties to a pledge agreement can always agree otherwise.

In order to use one of the two out-of-court enforcement routes (enforcement by the creditor or by a notary), the pledgeholder and the pledgor must execute a special agreement to that effect that may be a part of the pledge agreement (clause 4 of Article 349 of the RF Civil Code), or may exist as a separate document executed in the same form as the pledge agreement (clause 5 of Article 349 of the RF Civil Code).

If parties want to have the pledge enforced by a notary the pledge agreement must be notarised (clause 6 of Article 349 of the RF Civil Code). The advantage is that a pledge will be enforced as soon as the notary places an enforcement inscription on the pledge agreement and a bailiff subsequently starts enforcement proceedings)

. However, if a pledge agreement provides that the pledge is enforced by the creditor (when the creditor itself sends the pledgor an enforcement notice), we should remember that enforcement of the pledgeholder's rights to get satisfaction out of the value of the pledged assets will not be possible because only a notary's enforcement inscription constitutes a writ of enforcement. Accordingly, a

pledgeholder may safely choose this type of enforcement only if it knows that it will not need help from public authorities in the course of the sale of the pledged assets, for example, in the case of a possessory pledge (i.e. when pledged assets are in the pledgeholder's possession and it does not need a bailiff to seize the pledged assets from the pledgor) or substantially similar situations.[1]

An agreement to enforce a pledge out of court must specify one or more methods of selling the pledged assets listed in the RF Civil Code, as well as the value (the initial purchase price) of the pledged assets or the procedure pursuant to which it will be determined.

If a pledge enforcement agreement provides for several methods of selling the pledged assets, the pledgeholder has the right to choose the sale method unless the agreement provides otherwise (clause 7 of Article 349 of the RF Civil Code).

Lawmakers have changed the list of situations when out-of-court enforcement is not permitted (clause 3 of Article 349 of the RF Civil Code):

a) the pledge was granted by an *individual* over their *sole* residential property, unless the agreement to enforce the pledge out of court is executed after the grounds to enforce the pledge have arisen;[2]

b) the pledged assets are subject to a preceding and a subsequent pledge that provide for different methods of enforcement of pledge or different methods of selling the pledged assets, *unless an agreement between the preceding and the subsequent pledgeholder provides otherwise*;

c) assets are pledged to secure different obligations owed to several pledgeholders, *unless an agreement among all of the co-pledgeholders and the pledgor provides for out-of-court enforcement.*

Other situations when out-of-court enforcement of pledge is not permitted may be provided by law. Such limits to out-of-court enforcement are mandatory, which is emphasised by a clause stating that agreements breaching them are void. However, it does not of course apply to situations when an agreement between the preceding and the subsequent pledgeholder, as well as the co-pledgeholders, allows out-of-court enforcement and sets out details of the relevant procedures.

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[1] Courts have recognised that a pledge of non-certificated shares to a bank that simultaneously maintained a depository account recording the pledgor's rights to such securities was similar in its effect to a possessory pledge (see Decision of the Presidium of the RF SCC No. 15085/11 dated 10 April 2012).

[2] There is a new element here: this limitation was broader previously – no pledge of any residential property could be enforced.

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