As financing for commercial and infrastructure projects is currently scarce, legal advisers are trying to improve the security packages given to lenders. This article examines the latest developments in Kazakhstan law regarding pledges, bankruptcy and other procedures to protect creditor rights.
Introduction

In the midst of a difficult post-crisis environment for infrastructure development, the legal implications of financing both public and private infrastructure projects are being tested. Government financing and private financing previously offered by commercial lenders is no longer easily available. Nevertheless, the last two decades of infrastructure in most former Soviet countries, including Kazakhstan, suffered from under-investment and significant deterioration, calling for a need for capital intensive refurbishment and new developments.

The existing concession and secured lending laws do not provide the necessary protection for investors and lenders or allow financiers sufficient control over projects. For example, if public infrastructure is involved (normally considered strategic), heightened government scrutiny affects matters like the creation of security over project assets and the investment approval process, where foreign investors’ or concessionaires’ projects can be rejected on the grounds of national security, as well as restricted transferability of project assets, where the government may reject the proposed transferee or exercise its pre-emption rights.

Certain infrastructure like public roads (including bridges) might be designated as “strategic” and within the exclusive domain of Kazakhstan. Investors and operators may acquire an interest in such assets only by the grant of a concession. Such assets are exclusively owned by the government so no security over them may be created; but one may pledge concession rights. Other ways of acquiring an interest in project assets could be privatisation, an investment agreement...
These types of legal constraints often make it more viable to structure the majority of projects outside of local concession financing frameworks and instead as long-term secured lending transactions with conditions similar to those used in project finance.

Security

Most project finance lenders will have a full security package, including:

- a pledge over the project assets
- a pledge over the holding company’s shares in the project company
- a direct agreement between the lenders, the special purpose vehicle (SPV), the sponsors (including the state or local authority), the major suppliers and the major off-takers
- an assignment and/or pledge of receivables and other rights under project agreements (with major suppliers and off-takers)
- an assignment of insurance
- a project support agreement with the owner of the assets (such as a local municipality).

As a result, upon a default the lenders will have the following options available to them:

- transferring the ownership of shares in the project company to the lenders if attempts at selling the shares to the public fail
- appointing an agent to take control of the project company and/or realise its assets to pay back the debt
- exercising “step-in” rights under the direct agreement to either run the project or transfer it to a new operator (SPV) or the lenders.

The law does not limit the types of security available to lenders and allows them to agree on a security structure that best suits the needs of financing. However, the Civil Code\(^1\) contains special rules on certain classic security types like pawns, pledges, mortgages, guarantees and surety.

Guarantees and surety may be governed by foreign law and allow flexibility when structuring any cross border or international financings, but are not always available due to the quality of potential guarantors or their willingness to provide guarantees. Any mortgage is governed by Kazakhstan law.\(^2\)

Pledge of future property

Under Kazakhstan law security interest may be established with respect to property that will be created or acquired in the future. For particular property to be used as security, a detailed identification is required. There are several court cases\(^3\) that established a requirement that an asset must be described so as to be unequivocally identified among any other property a pledgor may own.

The law requires identifying pledged property in reasonable detail in the security documents at signing.\(^4\) The courts will not uphold an arrangement where the pledgee is allowed to identify pledged property at the enforcement stage. If it is difficult to identify future assets to be secured, lenders may contractually agree that the borrower has to execute an additional instrument to create a security interest over such future property as soon as it becomes available.

Unlike other type of assets, uncompleted buildings are treated as movables (that is, as a combination of construction materials) and are subject to a similar reasonable identification requirement, which is often cumbersome, time consuming and expensive.

Registration of movables pledge

To create a pledge over movable property it is normally sufficient to execute a written agreement. Under the Law on Movables Pledge Registration\(^5\) lenders may opt for voluntary
In project finance it is common to have assignment of such receivables in addition to a receivables pledge. Registration of a movables pledge. However, registration gives the lender a set priority in time when enforcing the pledge and any registered pledge prevails over any unregistered pledge. Mortgages need to be in writing and registered in an immovables register. Failure to comply with these requirements would render the mortgage void.

If a project involves the construction of immovables, lenders should first consider having both a movables pledge over the building under construction and a mortgage over the construction site (the land). Once the construction is completed and duly registered, a mortgage over the site/land and the building shall be executed. The mechanics of such a transition need to be negotiated and confirmed in advance in the facility agreement.

Pledge of receivables
To comply with the identification requirement mentioned above, the pledge should contain a list of receivables, including their description by reference to particular contracts, the date of repayment and the names of relevant parties. If a particular contract is replaced and receivables are substituted during the life of the financing, such a change would have to be documented by amending the receivables pledge.

The receivables pledge is perfected by notifying the receivable payer. Failure to notify such payers would not invalidate the pledge, but create the risk of it not being enforceable.

In project finance it is common to have assignment of such receivables in addition to a receivables pledge. The advantage of this dual structure is in the flexibility of exploiting the benefits of both security instruments. A pledge has a higher ranking in the case of the bankruptcy of the borrower, whereas assignment is much easier and faster to enforce, that is, there is no need to have cumbersome enforcement proceedings including court hearings and public sale procedures.

However, Kazakhstan law does not expressly recognise the assignment of contract rights or the use of a conditional assignment as a security if it is aimed at taking receivables out of the reach of a liquidator. In a non-bankruptcy scenario of enforcement a pledge-holder becomes an assignee of the receivables, which would allow them to avoid the requirement of a public sale during enforcement. In bankruptcy the position of the pledge-holder might become subject to dispute, but it is most likely that the pledgee claims will rank equally with other secured creditors. Despite widespread use, the application of the receivables assignment in Kazakhstan is still uncertain. The view of most practitioners is that the assignment of receivables should be enforceable under the general principles of contract law, including the concept of an assignment and the rule that a contract may be subject to a condition subsequent.

Pledge of enterprise
The law specifically states that an enterprise or business as a going concern may be pledged. Security over the enterprise would extend to all movable property, receivables, intellectual property as well as any property acquired later. It is created by written agreement and registration in the immovables register.

Alternatively, lenders may consider obtaining security over separate elements of the enterprise, for example, through the mortgage of land, equipment, intellectual property (IP) rights and such like. The choice between the two options depends on several factors: the value of the enterprise as a whole substantially exceeds the aggregate value of its constituent parts (for example, whether splitting and selling each asset separately would diminish the price of enterprise) and flexibility in enforcing the particular transaction or type of enterprise (for example, whether it is easier to enforce against assets which can be easily split and sold separately without significant reduction of the value).

Subordination
As a general rule the priority of secured interests, like pledges, is determined by the time of their creation. The first overrides anything subsequently created. Hence, there is uncertainty as to whether creditors can determine a different priority by contract. The most common view is that such an arrangement would be unenforceable in Kazakhstan courts. In addition, all claims of secured creditors against a debtor in liquidation rank pari passu.
In practice international lenders tend to have security sharing/intercreditor and subordination agreements that are governed by foreign law – usually English law. Normally one of the lenders may first register their security documents than have priority under Kazakhstan law. The other lenders take their subsequent ranking in security. However, the lenders would have an intercreditor agreement under foreign law where the first lender contractually agrees with subsequent lenders on pari passu ranking of security and share the proceeds irrespective of their priority under Kazakhstan law.

Subordination agreements governed by foreign law, where, for example a senior lender agrees that shareholder loans rank junior, would not be honoured in Kazakhstan bankruptcy proceedings. Nevertheless, in practice lenders tend to use such agreements as a negotiation tool. Such agreements might be reinforced, for example, by getting assignment or a pledge of shareholder loans to the senior lenders under a separate instrument governed by Kazakhstan law. This combination of subordination and assignment/pledge may effectively give advantage to senior lenders with respect to subordination of shareholder loans, however, such a structure has not been tested in Kazakhstan courts and if tested the outcome is uncertain.

### Step in rights and direct agreements: issues in the context of Kazakhstan law

In the classic project finance structure various forms of “security like” instruments are often used in addition to the traditional forms of security. One of the key types is direct agreements containing step-in rights. A lender’s step-in right would mean that in certain cases the lender (or a lender’s designee) will be able to assume the project company’s rights under project agreement(s) for a specified period of time, with a view to getting better control over the project cash flows and then have the opportunity to improve and/or complete the project. The step-in rights are documented by a combination of security assignments over the project agreements and a series of direct agreements between the lender, the sponsor (the owner of the asset or local authority), the project company and relevant companies.

Kazakhstan law does not have the concept of “step-in rights” or “direct agreements”. Although we are aware that in certain projects such types of agreements are being entered into, from the perspective of Kazakhstan law the following considerations will be relevant (among others).

- **Conditionality of assignment**: the closest equivalent of a step-in mechanism in Kazakhstan law would be a conditional assignment, that is, the substitution of a party after a certain event has occurred. However, conditional transactions are permitted only if the occurrence of a trigger event does not depend on the will or actions of any party to the agreement. An event of default may be viewed as a condition ultimately dependent on the borrower’s action, which raises enforceability issues for such an arrangement. As noted above a conditional assignment is not a security instrument under Kazakhstan law (compared with a pledge of rights, the assignment does not take priority in bankruptcy), and it is not always advisable to apply both a conditional assignment and the pledge of rights simultaneously – as the courts may interpret such an arrangement as the absence of parties’ agreement on the substance.

- **Consideration for assignment**: given that assignment under the Civil Code is viewed as a payment or transfer mechanism rather than as a security instrument, there is some court practice suggesting that assignment should be for consideration. However, where the assignment is intended to be made to a designee having no other contractual link with the relevant project company, for example, there is a risk that the assignment will be classified as a gratuitous transaction which is generally prohibited for legal entities.

- **Assignability of rights generally**: there remains a general concern with respect to the assignment of rights under Kazakhstan law contracts, particularly if the lenders only want to receive a portion of the rights of the project company without incurring all or part of its obligations. Until recently there was debate about whether Kazakhstan law...
Until recently there was debate about whether Kazakhstan law allowed a party to a contract to transfer its rights to a third party, while at the same time remaining liable for and obliged to perform its obligations thereunder.

The following instruments give lenders some degree of comfort with respect to taking control of a project in a problematic scenario.

- Naturally, control over the project can also be achieved through share security, such as at an offshore level, which can be a more efficient way of taking control of the holding company. However, the above direct sale enforcement procedures could be applied to the security of a Kazakhstan holding company.

- Project agreements should not contain provisions allowing unilateral termination by either party. Although even in such a case statutory grounds for termination will remain, an absence of unilateral termination clauses adds comfort in problematic scenarios.

- In principle it is possible to enter into direct agreements with counterparties to project agreements under English law – which contains certain comforting undertakings, for example, not to terminate contracts or to inform about a borrower’s attempts to terminate – but that would require extensive negotiations. Any multiparty negotiations would be expensive and time-consuming for lenders and naturally incur additional costs.

### Chart 1
The key stages of bankruptcy in Kazakhstan

<table>
<thead>
<tr>
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<th>External supervision</th>
<th>Rehabilitation</th>
<th>Liquidation</th>
</tr>
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<tbody>
<tr>
<td><strong>Key players</strong></td>
<td>Administrator</td>
<td>Rehabilitation Manager</td>
<td>Liquidation Manager</td>
</tr>
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<td></td>
<td>State Committee (Ministry of Finance)</td>
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<td>State Committee (Ministry of Finance)</td>
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<td>Creditors’ Committee</td>
<td>Creditors’ Committee</td>
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<td></td>
<td>Company Management</td>
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<td>Bankrupted Company</td>
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<td></td>
<td></td>
<td>Court</td>
</tr>
<tr>
<td><strong>Timing</strong></td>
<td>3-12 months</td>
<td>up to 36 months (+ 6 or 24 months)</td>
<td>up to 9 months (+ 3 or 12 months)</td>
</tr>
</tbody>
</table>
| **Powers of**
| administration      | approval for transfer of assets (10 per cent and more) | submission of plan | drafting a plan of assets sale |
|                      |                      | current management | acts on behalf of company |
|                      |                      | procurement of services/assets up to 25 per cent of current debt | terminates employment contracts, liquidates company |
|                      |                      |                      | initiates court proceedings in relation to owners of the company |
| **Key points**       | no transfer of assets | no enforcement of awards | creditors can submit claims within two months once the procedure is initiated |
|                      | no enforcement of awards | no enforcement of awards | assets are to be used for repayment of debts only |
|                      | no withdrawals from bank account | no withdrawals from bank account | no loan interests and penalties occur |
|                      | no equity transfers   | no equity transfers | no compensation of creditors’ expenses |
|                      |                      | transfer of assets through public sale only | settlement should be part of plan |
|                      |                      | freeze for loan interests and penalties | creditors can submit claims within two months once the procedure is initiated |
|                      |                      | assignment of receivables through public sale only | assets are to be used for repayment of debts only |
|                      |                      | settlement should be part of plan | no loan interests and penalties occur |
|                      |                      |                      | no compensation of creditors’ expenses |
Bankruptcy: lender’s perspectives

The Kazakhstan legislature has developed a registration system which effectively allows avoiding most unpermitted transfers of pledged assets in bankruptcy. Secured creditors enjoy the third ranking (after employees and IP right owners, but before tax creditors and other creditors) and are covered by the value of the pledged property. If proceeds from enforcing security are not sufficient to repay the debt in full, then the rest of the debt would rank fifth with the unsecured creditors.

Currently Kazakhstan authorities are working to integrate several databases, including the registration of legal entities (run by the Ministry of Justice), private registrars (maintaining shareholders registers) and vehicles registers (maintained by the Ministry of Interior). This will allow creditors, courts and banks quick access to information with respect to companies’ assets and liabilities, including any encumbrances. The Ministry of Finance has recently launched a web site listing all insolvent entities and those subject to insolvency procedures: see www.minfin.kz.

In general, Kazakhstan bankruptcy laws are favourable to creditors. In practice however, the qualifications and experience of the administrator and the presence of proactive creditors are the crucial elements to maximising the value of the bankrupt estate for the benefit of all creditors.

Procedures

Once the bankruptcy procedure is initiated, the existing management and shareholders are restricted and any asset transfers, execution of all court or arbitration awards is suspended, no withdrawals from bank accounts are allowed and no equity transfers shall occur. Chart 1 provides a summary of the common types of bankruptcy proceedings and the key features of each.

Conclusion

The new draft law on project finance has been widely discussed in recent years and its adoption is aimed at bringing local Kazakhstan laws in line with international standards. As such, the current draft allows companies to: assign their rights (including any obtained in the future) under contract; segregate assets project by project and use project assets as security for debt raised for project implementation; and SPVs will have a special legal regime, where the powers of shareholders and management are restricted and specific reorganisation and liquidation rules apply. Hopefully, the new law will achieve its aim and resolve at least some of the above issues so that international financiers can participate in Kazakhstan’s large infrastructure projects with confidence.
1 The Civil Code of the Republic of Kazakhstan, dated 27 December 1994 (the "Civil Code").

2 Article 1107 of the Civil Code.

3 Kazakhstan law is not precedent law, so court cases do not have ultimate authority, however, decisions of the Supreme Court or specialised economic courts are often referred to and can be said to have persuasive authority.

4 Art. 307(1) of the Civil Code.


6 Art. 8(1), the Movables Pledge Law.

7 Art. 310 of the Civil Code and Art. 5(3), Art. 7(1) and Art. 48 of Law of the Republic of Kazakhstan, "On state registration of immovable property and transactions relating to it".

8 Art. 319(1-1) of the Civil Code.

9 Other parties may argue that the true agreement was by assignment and pledge, hence such a creditor shall be ranked behind other secured creditors.

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