Notes

Secured Financing in Russia: Risks, Legal Incentives, and Policy Concerns†

I. Introduction

Secured financing plays a crucial role in a market economy.[1] In the context of Russia's nascent and struggling market economy, the importance of secured financing is greatly augmented.[2] Investing in Russia involves significant economic and legal risks for both foreign and domestic investors. The role of secured credit laws is to mitigate these risks.

This Note explores the risks, legal incentives, and policy concerns created by Russia's secured credit laws. Part Two provides a brief overview of the legislative history behind the sections of the Russian Civil Code dealing with security interests, which for the most part have been positively received by Western commentators. Although Russia's secured credit laws are clearly an improvement over those that existed in the Soviet Union, commentators' praise may be overly generous, and at the very least should be clearly qualified. Therefore, Part Three describes the process for acquiring and enforcing a valid security interest in Russia and concurrently identifies several shortcomings and ambiguities by way of comparison to Article 9 of the Uniform Commercial Code (UCC) and the Model Law on

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† The list of individuals who made important contributions to this Note is simply too lengthy to enumerate here. Nonetheless, I am tremendously grateful to each of them for their generous investment of time and ideas. Additionally, and most importantly, I would like to thank my wife, Olga, without whom this Note and much more would not have been possible.

1. *See, e.g.*, ROBERT L. JORDAN & WILLIAM D. WARREN, SECURED TRANSACTIONS IN PERSONAL PROPERTY 1 (3d ed. 1992) (noting that "[i]t is fair to conclude that if secured credit had not developed, mass distribution of goods and services might never have occurred").

2. The successful transition of former communist economies will in large part depend on the availability of adequate credit from a variety of sources. *See* Ulrich Drobnig, *Secured Credit in International Insolvency Proceedings*, 33 TEX. INT'L L.J. 53, 54 (1998) (commenting that the "vast financial means" necessary for the economic development of the emerging markets must be obtained in the form of credit "granted by business partners, commercial banks, foreign states, and international financial institutions").

Secured Transactions (Model Law) developed by the European Bank for Reconstruction and Development (EBRD).

The UCC and the Model Law are particularly useful references by which to critique Russia's secured credit laws. Article 9 of the UCC is widely regarded as one of the best secured credit laws in the world.[3] A proposal submitted to the Council of Europe by the Service de Recherches Juridiques Comparatives of the CNRS of Paris suggested using Article 9 as the basis for the creation of a uniform secured credit system for international transactions.[4] In the context of Russia's transitional economy, the UCC can be a particularly valuable resource in further development of a commercial legal structure.[5] The EBRD developed the Model Law to serve as a guide to the former Soviet bloc countries, which possessed either severely antiquated secured credit laws or none at all.[6] The Model Law was intended to provide a comprehensive basis for legislation, while at the same time affording the flexibility necessary to accommodate local characteristics.[7] A guiding principle of the Model Law was to design a model that was compatible with the civil law systems prevalent in Eastern Europe, yet also incorporated features of common law systems more accommodating to modern financing.[8] The Model Law has been influential in several countries in the region.[9]

Part Four discusses related legal and economic factors that directly affect secured financing and without consideration of which the value of a

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3. *See, e.g.*, *Report of the Secretary-General: Study on Security Interests*, 8 Y.B. UNCITRAL 171, 211, U.N. Doc. A/CN.9/SER.A/1977 [hereinafter *Report of the Secretary-General*] ("[Article 9 of the UCC] may indeed be considered as the most modernized, rational and comprehensive system of security interests in the present world.").

4. *See id.* at 211.

5. *See* Alexander S. Komarov, *The Uniform Commercial Code: A Russian Point of View*, 29 LOY. L.A. L. REV. 1085, 1092-93 (1996) (suggesting that the "descriptive character" of the UCC's rules and commentary, which include "a wide variety of examples for business transactions," could positively influence the development of commercially sound business practices in Russia). Komarov, a Professor at the Russian Academy of Foreign Trade, anticipates that "further progressive development of business practices . . . will certainly play an important role in the regulation of commercial transactions." *Id.* at 1091. Komarov believes that one goal of the Russian Civil Code "is to assist with the formation of commercial practices." *Id.*

It should be noted that the bulk of Komarov's article discusses why the UCC could not be transplanted in its entirety into Russian law. Among other concerns, Komarov warns that the importance of business customs and usages in the UCC is not wholly compatible with a transitional economy where customs and usages have yet to take root. *Id.*

6. John L. Simpson & Jan-Hendrik M. Röver, *Introduction* to MODEL LAW ON SECURED TRANSACTIONS, at v (1994).

7. *Id.*

8. *Id.*

9. *See Better Security for Eastern Europe*, LAWYER INT'L, Apr. 1, 1996, at 1, 5, *available in* 1996 WL 9610727. The EBRD Secured Transactions Project has received formal requests from seven countries to assist with reforming secured credit laws and is working with others informally. *Id.* at 3. In particular, the EBRD participated in the drafting or review of the secured transactions laws in Hungary, Kyrgystan, Moldova, Azerbaijan, Slovakia, and Bulgaria. *Id.* at 5.

security interest in Russia cannot be accurately measured. As is true in well-established legal systems, Russia's secured credit laws do not operate entirely in a vacuum, independent of other elements of the legal structure. In particular, banking, tax, and bankruptcy laws impose limitations and incentives that significantly influence secured financing. Similarly, economic factors intrinsic to Russia, such as pervasive tax evasion, create additional risks that necessarily affect the value of security interests. Part Four illustrates that these related elements augment the risk and cost of secured lending and highlights the resulting need for reform of Russia's secured credit laws.

Part Five explains that the shortcomings and ambiguities in Russia's secured credit laws, coupled with the related legal incentives and economic factors, substantially limit the utility and ultimate value of security interests in Russia, which in turn makes credit more expensive and thus less available. Part Five then discusses the policy concerns created by this conclusion, namely a stifling effect on the growth of entrepreneurs and small businesses, and a delayed development of a large middle class and its corresponding tax base.

II. Legislative Background and Western Commentary: Russia's Progress

Whatever its shortcomings, Russia's current law is certainly an improvement over the near absence of secured financing law in that country prior to the dissolution of the Soviet Union.[10] With ubiquitous state ownership in the Soviet economy there was little need for secured transactions. Recognizing the importance of secured credit in its emerging market economy, Russia enacted the Law on Pledge,[11] on May 29, 1992, providing an initial mechanism for creating and enforcing security interests.[12] Western commentators were quick to declare that the Law on

10. During the period of cautious economic reform initiated by Gorbachev that preceded the dissolution of the Soviet Union there were some efforts at establishing a legal basis for secured lending, as well as other features of a market economy. *See* On Securing by Pledge Obligations Which Arise when Effectuating Foreign Investments in the USSR, Edict of the President of the USSR, Aug. 17, 1991, *Vedomosti SND SSSR*, No. 34, item 979 (1991), *translated in* COLLECTED LEGISLATION OF RUSSIA, Booklet XII.A.3, at 31 (W.E. Butler trans., 1993) (authorizing, until legislation was passed, security interests in any property legally alienable when effectuating foreign investments in the USSR).

11. Zakon Rossiiskoi Federatsyi o Zaloge [Law of the Russian Federation on Pledge], No. 2871 of May 29, ROSS. GAZETA, June 6, 1992, at 5, *translated in* COLLECTED LEGISLATION OF RUSSIA, *supra* note 10, Booklet III.4, at 1. The Russian word "*zalog*" translates literally into English as "pledge." *See* A.I. SMIRNITSKY ET AL., RUSSIAN-ENGLISH DICTIONARY 192 (O.S. Akhmanova ed., 14th ed. 1987). However, as is self-evident from this statute and the related sections of the Civil Code, the legal interest more closely represents "security interest" as within the UCC. This Note uses "security interest" instead of "pledge," in keeping with U.S. commercial parlance.

12. *See* William G. Frenkel, *New Russian Secured Transactions Regime: Analysis of the Law on Pledge*, SEEL, Mar. 1993, at 1 (characterizing the Law on Pledge as an important development and critiquing it in general). Frenkel is a frequent and respected commentator on Russian legal affairs. His perspective has been very helpful in writing this Note.

Pledge promised "significant improvement" in facilitating foreign investment[13] and provided a "strong incentive . . . to make loans which could now be" adequately secured.[14]

The Law on Pledge was one of an uncoordinated and often contradictory myriad of statutes and presidential decrees concerning various aspects of commercial activity.[15] Western investors frequently cited "mutually contradictory rules, Soviet-era anachronisms, and yawning gaps in Russian legislation on commercial relations" as significant sources of frustration.[16] This "completely unacceptable state of civil legislation" provided important motivation for the creation of Russia's Civil Code.[17] Part One of Russia's Civil Code[18] took effect on January 1, 1995, after a rather tumultuous origin.[19] The enactment of the Civil Code prompted further confidence and optimism for business in general, and secured financing in particular.[20] Security interests are covered in Chapter 23, "Securing Performance of Obligations," which includes Articles 329-358, within the section dealing generally with the Law of Obligations. The Civil Code codified much, but not all, of the Law on Pledge without changes.[21] Numerous laws and presidential decrees enacted subsequent to the introduction of the Civil Code supplement its general provisions.[22]

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13. *Id.*

14. Christopher Osakwe, *Modern Russian Law of Banking and Security Transactions: A Biopsy of Post-Soviet Russian Commercial Law*, 14 WHITTIER L. REV. 301, 378 (1993).

15. *See* E.A. Sukhanov, *Russia's New Civil Code*, 1 PARKER SCH. J. E. EUR. L. 619, 621-22 (1994) (discussing the Russian civil code in general and describing in detail the confusing and incompatible system of Russian legislation prior to the Civil Code).

16. Edward H. Lieberman et al., *New Russian Civil Code Bodes Well for Business*, NAT'L L.J., Nov. 14, 1994, at C10.

17. Sukhanov, *supra* note 15, at 621.

18. Grazhdanskii Kodeks Rossiiskoi Federatsyi, Chasti Pervoi [Civil Code of the Russian Federation, Part One], Sobr. Zakonod. RF, 1994, No. 32, Item 3301 [hereinafter GK RF], *translated in* CIVIL CODE OF THE RUSSIAN FEDERATION: PART ONE (W.E. Butler trans., 1994), *in* RUSSIA & THE REPUBLICS LEGAL MATERIALS: RUSSIAN FEDERATION (John N. Hazard & Vratislav Pechota eds., 1998).

19. *See* Sukhanov, *supra* note 15, at 619-20 (recounting the legislative history of, and opposition to, the adoption of Part One of the Civil Code).

20. *See, e.g.*, Lieberman, *supra* note 16, at C10 (characterizing the Civil Code as important legal support for a market economy and expressing optimism that the Code would address particular inadequacies in pre-Code secured transactions law).

21. Disparity between the two is resolved in favor of the Civil Code, but the Law on Pledge does remain in effect to the extent that it does not contradict the Civil Code. *See* GK RF, *supra* note 18, art. 3(2) ("[L]egislation shall consist of the present Code and other federal laws. . . . Norms of civil law contained in other laws must conform to the present Code.").

22. Later sections of this Note discuss several such legal enactments that supplement the Civil Code. It is important to note that the elements of the laws and decrees mentioned herein do not represent the full extent of legal modification to the Civil Code sections dealing with secured transactions, especially in the context of immovable property. Furthermore, Russia's legal environment is still evolving, and significant changes in the relevant laws are quite possible.

III. Acquiring and Enforcing a Security Interest

Despite the praise and optimism of Western commentary,[23] there are several shortcomings and ambiguities in key areas of Russia's secured credit laws. First, particular requirements of security agreements (namely specification of the value of the collateral and notarization) impose burdensome transaction costs.[24] Second, the Civil Code does not require filing or registration to perfect security interests in personal property, thus depriving creditors of a reliable mechanism of ensuring priority status in their particular collateral.[25] Third, although the Civil Code contemplates registration of security interests in real property, a national, unified registry has only recently been initiated and will not be operational for some time.[26] Finally, enforcement rights are limited, ambiguous, and subject to delay, and disposition of collateral is limited to public auction.[27] These elements create significant risks for secured creditors and consequently raise the price of capital in the Russian economy.

A. Acquiring A Security Interest

1. General Characteristics.—The basic elements and overall structure of Russia's secured credit laws resemble those contained in Article 9 of the UCC and the Model Law. Article 329(1) of the Civil Code authorizes security interests as a means of securing the performance of an obligation.[28] The rules for acquiring and enforcing a security interest, whether arising by contract or by law, reside in Articles 334-358.[29] As a general rule, a security interest entitles a secured creditor, in the event of nonperformance of the obligation giving rise to the security interest, to receive satisfaction from the value of the collateral, with priority over the debtor's "other" creditors.[30] Subsequent security interests are subordinate

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23. *See generally* Frenkel, *supra* note 12; Osakwe, *supra* note 14; Jason J. Kilborn, Note, *Securing Russia's Future: A Plea for Reform in Russian Secured Transactions Law*, 95 MICH. L. REV. 255 (1996). Each of these sources describes in varying detail the process for acquiring a security interest in Russia and provided useful perspective and corroboration. Kilborn's Note was helpful in providing numerous sources and useful critique. Kilborn focuses on the drawbacks of requiring creditors to dispose of collateral through public auction. *See* Kilborn, *supra*, at 257, 261-63 (explaining how the public auction limitation may "seriously undermine creditor comfort . . . in Russia").

24. *See* discussion *infra* section III(A)(3).

25. *See* discussion *infra* subsection III(A)(4)(a).

26. *See* discussion *infra* subsection III(A)(4)(b).

27. *See* discussion *infra* subpart III(B).

28. *See* GK RF, *supra* note 18, art. 329(1). Because security interests can be used to secure the performance of many different types of obligations, not just monetary debt, the party issuing the security interest (called the pledgor in Russian) will not always be a "debtor" in the strict sense. However, in keeping with U.S. commercial parlance this Note uses "debtor" when referring to the party issuing the security interest.

29. *See id.* arts. 334-358.

30. *See id.* art. 334(1).

to prior security interests. The demands of a subsequent creditor are satisfied from the value remaining after the demands of the prior creditor have been satisfied.[31]

2. *Property Subject to Security Interest.*—"Any property, including things and property rights (or demands) may be the subject of" a security interest, with the exception of "property withdrawn from turnover,"[32] and certain personal rights, such as alimony or personal injury compensation.[33] Future acquired property is expressly mentioned as subject to security interests.[34] Commentators have uniformly assumed that "any property" includes all personal property, intangible property rights (*e.g.*, intellectual property and accounts), inventory, and securities.[35] Most types of immovable property may also be used as collateral in secured lending.[36] The Law on Mortgage specifies what types of immovable property may be mortgaged and what special limitations apply.[37] Commercial buildings and structures, enterprises, and residential housing (including apartments) may be mortgaged relatively freely.[38] The mortgaging of certain types of land, however, is severely limited or even prohibited.[39] In general terms, land essential to the

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31. *See id.* art. 342(1).

32. *Id.* art. 336(1). "Goods in turnover," which include inventory as defined in UCC § 9-109 and more, are subject to security interests. *Id.* art. 357. Goods withdrawn from turnover are described as exempt because a transferee of goods in turnover takes free of security interests. *See id.* art. 357(2). For further details, see *id.* art. 357.

33. *Id.* art. 336(1). Article 9 of the UCC also excludes similar claims which are not typically used as commercial collateral. *See* U.C.C. § 9-104 & cmt. 8 (1995) (including rights represented by a judgment, rights of set-off, and transfers of tort claims "as claims which do not customarily serve as commercial claims"). The Model Law excludes all nonbusiness-related rights. *See* MODEL LAW ON SECURED TRANSACTIONS art. 2 (1994) (declaring that "a natural person may grant a charge only as part of his business activity").

34. *See* GK RF, *supra* note 18, art. 340(6).

35. *See, e.g.*, Frenkel, *supra* note 12, at 11 ("[A]ll movable property, intellectual property, securities, and present and future rights may now be pledged."); Osakwe, *supra* note 14, at 355 (claiming that property that can be mortgaged under the new Russian mortgage law includes "a thing or right," such as "the right to use land, a piece of land or intellectual property right"); Kilborn, *supra* note 23, at 260, 260 & n.16 (noting that the laws on pledge have the potential to affect "a broad range of tangible and intangible property rights").

36. The concept of immovable property under the Russian Civil Code is more inclusive than real property or real estate in common law legal systems. Immovable property includes land, buildings, the subsurface, solitary bodies of water, forests, and other fixtures. *See* GK RF, *supra* note 18, art. 130(1). Additionally, immovable property encompasses aircraft, water vessels, and space objects. *See id.* Typically, real estate consists of "[l]and and anything permanently affixed to the land, such as buildings, fences, and those things attached to the buildings, such as light fixtures . . . ." BLACK'S LAW DICTIONARY 1263 (6th ed. 1990).

37. *See* Federal Law No. 102-FZ of July 16, 1998 On Mortgage (Pledge of Real Estate) art. 5 [hereinafter Law on Mortgage].

38. *See id.* art. 5(2), (3).

39. *See id.* arts. 5, 62, 63.

"functional maintenance" of buildings or structures located thereon may be mortgaged, as well as land allotted for individual housing, gardening, and the construction of garages or summer cottages.[40] In contrast, land under state or municipal ownership and agricultural land are not subject to mortgages.[41]

On its face, then, the Civil Code defines property subject to security interests more broadly than either Article 9 of the UCC or the Model Law. Article 9 does not govern real property mortgages.[42] Real property is, of course, subject to mortgaging in the United States, but as determined by the nonuniform real property laws of the various states.[43] The Model Law authorizes security interests in all property and rights, except the nonbusiness property and rights of individuals.[44] Consumer goods are excluded in recognition of the consumer protection issues incident to consumer financing.[45] However, the Model Law commentary indicates that adequate consumer protection laws would make it possible to extend the Model Law to consumer financing.[46]

3. Security Agreement.—As in Article 9 of the UCC and the Model Law,[47] security agreements under Russian law must be in writing[48] and describe the collateral.[49] Failure to comply with the writing requirement renders a security agreement invalid and unenforceable against the debtor.[50] Like the Civil Code, Article 9 and the Model Law require a written agreement in order to create a security interest good against the debtor.[51] Russian security agreements are also governed by the Civil

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40. *Id.* art. 62(1).

41. *See id.* art. 63(1).

42. *See* U.C.C. § 9-102(1)(a) (1995) (limiting the application of Article 9 to transactions intended to create a security interest in personal property or fixtures).

43. *See generally* JESSE DUKEMINIER & JAMES E. KRIER, PROPERTY 632-36 (4th ed. 1998) (describing in general terms the mortgaging of real estate in the United States and noting the variations in the law among the states).

44. MODEL LAW ON SECURED TRANSACTIONS art. 2 (1994).

45. *Id.* art. 2 & cmt.

46. *Id.* art. 2 cmt. Article 9 of the UCC implicitly assumes that adequate consumer protection laws are in place. *See* U.C.C. § 9-203(4) (1995) (acknowledging the important supplementary role of existing consumer-related regulatory legislation).

47. U.C.C. § 9-203(1)(a) & cmt. 1 (1995); MODEL LAW ON SECURED TRANSACTIONS arts. 7.1 & cmt., 7.3.4 (1994).

48. *See* GK RF, *supra* note 18, art. 339(2).

49. *See id.* art. 339(1).

50. *See id.* art. 339(4).

51. *See* U.C.C. § 9-203(1)(a) (1995) (requiring a written security agreement unless the creditor is in possession of the collateral); MODEL LAW ON SECURED TRANSACTIONS art. 7.3 (1994). It should be noted that the Model Law, in the case of an "unpaid vendor's charge," does not insist on a formal security agreement, but rather allows a written agreement between the vendor and purchaser to the effect that the vendor retains title or obtains a security right to the goods until the purchase price is paid. *Id.* art. 7.1 & cmt. An "unpaid vendor's charge" is substantially similar to a purchase money

Code provisions concerning written transactions in general, which require the signature of both parties to the agreement.[52] The UCC requires only the signature of the debtor for a security agreement to be valid, whereas the Model Law requires the signature of both debtor and creditor.[53]

Additionally, Russian security agreements must indicate the amount or essence of the obligation secured by the collateral.[54] The UCC has no comparable provision, instead merely requiring that "value" be given for the security agreement to become effective against the debtor.[55] The Model Law, however, does have similar provisions concerning identification of the debt secured. According to the Model Law, the debt secured must be identified in the security agreement, but may be described specifically or generally.[56] In the context of the Model Law, a general description would only need to refer to the category or categories of debts, or even to a changing pool of present and future debts.[57] Keeping in mind the Civil Code's broad concept of collateral, a description of the debt secured similar to the Model Law's general description would presumably satisfy the Civil Code requirement to specify the essence of the obligation secured.

Unique to the Civil Code, however, Russian security agreements must also specify the value of the collateral, the period for performance, and which party is in possession of the collateral.[58] Even in the absence of this requirement, the period for performance and possession of the collateral are fundamental elements that parties will most likely identify expressly in their security agreements. However, the requirement to specify the value of the collateral offers little in regulatory benefit and is potentially problematic for two reasons.

First, independent valuation of the collateral would add an additional cost to the transaction and therefore increase the cost of the loan to the

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security interest under the UCC in that both involve a security interest retained by the vendor of collateral in order to secure payment of the purchase price. *See id.* art. 9.1 (defining unpaid vendor's charge); U.C.C. § 9-107 (1995) (defining purchase money security interest).

52. GK RF, *supra* note 18, art. 160(1). A written agreement must also conform to other requirements established by law concerning the "form" of the agreement. *Id.* Most notably, Russian companies and foreign companies registered to operate in Russia are typically required to design and acquire an official company stamp (*i.e.*, an inkpad-type stamp) that is required on written agreements in addition to the actual signature of the responsible individual.

53. *Compare* U.C.C. § 9-203(1)(a) (1995), *with* MODEL LAW ON SECURED TRANSACTIONS art. 7.3.5 (1994).

54. GK RF, *supra* note 18, art. 339(1).

55. U.C.C. § 9-203(1)(b) (1995).

56. MODEL LAW ON SECURED TRANSACTIONS art. 7.3.2 (1994). If the collateral is in the possession of the creditor, the Model Law requires the security agreement (or registration statement) to indicate in monetary units the maximum amount of the secured debt. *Id.* art. 7.3.3 & cmt.

57. *Id.* art. 4.1 & cmt.

58. GK RF, *supra* note 18, art. 339(1).

debtor in the form of a higher interest rate. Second, even assuming the parties are permitted to determine the value of the collateral by agreement, the interests of the parties may diverge. The legal implications of specifying a value for collateral are unclear and could result in tax liability or limit the amount recovered from collateral.[59] Consequently, the debtor may be interested in minimizing the recorded value of the collateral in order to avoid increasing his tax liability. In contrast, the creditor may seek to maximize the recorded value of the collateral in order not to limit his allowed recovery in the event of default.[60]

An additional requirement unique to the Civil Code is notarization of security agreements. Security agreements must be notarized if the underlying contract must be notarized.[61] Notarization of a contract is required if specified by law, or when any party to the agreement insists upon notarization.[62] In particular, security agreements involving immovable property (*e.g.*, mortgages) must be notarized.[63] Failure to comply with the notarization requirement renders the security agreement invalid and unenforceable against the debtor.[64] Notarization is another feature that may create more costs than regulatory benefit. At the very least, the notarization fee, usually between 1.5% and 2.5%,[65] represents a significant

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59. Telephone Interview with William D. Morris, Partner, Akin, Gump, Strauss, Hauer & Feld, L.L.P. (Jan. 9, 1998) (suggesting that many investors are concerned that specifying a value for collateral would (1) create tax liability if a tax based on the value of the collateral were to be imposed; or (2) limit the recovery of a secured creditor in the foreclosure process to the stated value of the collateral).

60. For instance, if a creditor involved in foreclosure proceedings, which the Civil Code anticipates will be judicially managed, *see infra* subpart III(B), is undercollateralized as to the debt owed, collection and enforcement costs, and interest, he might be concerned that his recovery would be limited by the court to that specified in the security agreement, rather than the potentially higher amount realized in the actual sale of the collateral.

61. GK RF, *supra* note 18, art. 339(2).

62. *Id.* art. 163(2).

63. *Id.* art. 339(2); Law on Mortgage, *supra* note 37, art. 10.1.

64. *Id.* art. 339(4). The invalidity of a security agreement does not invalidate the underlying obligation. *Id.* art. 329(2). It should be noted, however, that if the underlying agreement (*i.e.*, the debt obligation, not the security agreement) must be notarized, then the agreement itself is void if it is not notarized. *Id.* art. 165(1). Furthermore, Article 165(1) applies retrospectively. The failure to meet notarization requirements is grounds for the invalidity of transactions conducted before the Civil Code took effect in January 1995. *See* Federal Law on the Introduction into Operation of Part One of the Civil Code of the Russian Federation, Oct. 21, 1994, art. 9, Sobr. Zakonod. RF, 1994, No. 32, Item 3302, *translated in* CIVIL CODE OF THE RUSSIAN FEDERATION: PART ONE (W.E. Butler trans., 1994), *in* RUSSIA & THE REPUBLICS LEGAL MATERIALS: RUSSIAN FEDERATION (John N. Hazard & Vratislav Pechota eds., 1998). However, when only one party is culpable for evading notarization, Article 165 does provide protection for a party having concluded an otherwise valid contract and for a party having already performed under an otherwise valid contract. *See* GK RF, *supra* note 18, art. 165(2)-(3).

65. *See* Andrei Pobukovsky, *Pledges, a First Step to Mortgages*, MOSCOW TIMES, Jan. 28, 1997, *available at* <http://www.moscowtimes.ru/archives/issues/1997/Jan/28/story82.html> (characterizing notarization fees of 1.5% to 2.5% as a "substantial additional transaction expense").

significant additional cost, and often may make acquiring a security interest "prohibitively expensive," as suggested by the EBRD.[66]

4. Registration and Perfection.—For the purpose of registration, the Civil Code distinguishes between movable property (*i.e.*, personal property) and immovable property (*i.e.*, real property).[67] Immovable property includes land, buildings, the subsurface, solitary bodies of water, forests, and other fixtures as would be expected, but also encompasses aircraft, water vessels, and space objects.[68] Security agreements involving immovable property must be registered in order to be valid.[69] However, in stark contrast to Article 9 of the UCC and the Model Law,[70] the Civil Code does not require a filing or registration to perfect a security interest in personal property.[71] Movable property includes any property that is not considered immovable, specifically including money and securities.[72]

a. Movable property.—The sections of the Civil Code dealing specifically with security interests do not require, or even contemplate, registration of security interests in movable property.[73] In contrast, such registration is a fundamental feature of both Article 9 of the UCC and the Model Law.[74] Under the Civil Code, a security interest in movable property becomes effective upon execution of the security agreement, or upon transfer of the collateral to the creditor, unless the security agreement provides otherwise.[75] Therefore, except for creditor possession, a security interest becomes automatically perfected upon execution (and notarization if required) of a valid security agreement, and thus simultaneously effective against the debtor and subsequent creditors.

In contrast, the UCC distinguishes between attachment and perfection of security interests. A security interest attaches, or becomes good against the debtor, once there is a valid security agreement.[76] However, as a

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66. EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT, TRANSITION REPORT: ENTERPRISE PERFORMANCE AND GROWTH 18 (1997) [hereinafter TRANSITION REPORT 1997].

67. GK RF, *supra* note 18, art. 130.

68. *Id.* art. 130(1).

69. *Id.* art. 339(4).

70. *See infra* notes 74, 76-83 and accompanying text.

71. GK RF, *supra* note 18, art. 339.

72. *Id.* art. 130(2).

73. In the sections dealing with transactions in general, however, the Civil Code does specify that state registration of movable property may be established by law. *Id.* art. 164(2).

74. *See* U.C.C. § 9-302 cmt. 1 (1995) (noting that "the general rule [is] that to perfect a security interest under this Article a financing statement must be filed"); John L. Simpson & Jan-Hendrik M. Röver, *Introduction* to MODEL LAW ON SECURED TRANSACTIONS, at vi (1994) (explaining that to fulfill its public notice objective, the Model Law relies primarily on the registration of charges).

75. GK RF, *supra* note 18, art. 341(1).

76. *See* U.C.C. § 9-203(1)-(2) (1995). For a security interest to attach, the UCC requires that value has been given and that the debtor has rights in the collateral. *See id.* § 9-203(1)(b)-(c).

general rule, the security interest created by the security agreement will not have priority over subsequent, perfected security interests unless and until it is perfected by filing a financing statement with the appropriate state organ.[77] Under the UCC, requiring a filing for perfection is considered crucial in guarding against debtor fraud and secret liens, thus significantly enhancing the commercial viability and availability of secured financing.[78] The UCC filing must be signed by the debtor, and must include a description of the collateral by type or item, as well as the addresses of both the creditor and debtor.[79] The filing system thus provides a means by which a potential creditor can ensure that collateral proposed for a loan under consideration is not subject to any prior interests (or if so, to what extent), and therefore eliminates a key source of risk. Equally important, by filing a proper financing statement the creditor secures his priority in the collateral. Therefore, having confidence in the value of his security interest, the creditor is able to offer credit at a lower price than he otherwise would.

Similarly, registration is a fundamental feature of the Model Law. Except in special circumstances, the Model Law requires security interests to be registered in order to be valid.[80] A registration statement must be filed within thirty days of the debtor signing the security agreement in order to preserve the validity of the security interest.[81] The Model Law

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77. Due to the structure of Article 9, this general rule is an implicit result, as opposed to an express provision. *See id.* § 9-301 (listing the parties to which an unperfected security interest is subordinate); *id.* § 9-302 (requiring filing for perfection of a security interest except in limited circumstances); *id.* § 9-312 (reconciling priorities among conflicting security interests in the same collateral).

There are important exceptions and modifications to the general rule. For example, when a seller extends credit to a buyer and retains a purchase money security agreement, the security interest is automatically perfected without a filing in the case of consumer goods, or temporarily perfected for 21 days without filing in other instances. *Id.* §§ 9-302(1)(d); 9-304(4). Also, a creditor can perfect a security interest without filing by possessing the collateral. *Id.* § 9-305.

78. *See* JOHN O. HONNOLD ET AL., SECURITY INTERESTS IN PERSONAL PROPERTY 137-45 (2d ed. 1992) (describing the problems of fraud and ostensible ownership as motivations for the imposition of a filing system).

79. *Id.* § 9-402(1). The UCC filing is intended to serve as a notice filing. *Id.* § 9-402 cmt. 2. The Official Comment to Section 9-402 explains that further inquiry will be necessary to disclose additional information. *See id.* § 9-402 cmt. 2. Section 9-208 contains a statutory procedure to facilitate disclosure. *See id.* § 9-208. The UCC requires notice filing, as opposed to a filing containing details of the particular transaction, in order to obviate the need to submit filings daily where the details of the security arrangement change frequently, such as in inventory financing. *Id.* § 9-402 cmt. 2.

80. *See* MODEL LAW ON SECURED TRANSACTIONS art. 6.1 (1994). Similar to the UCC, registration is not required by the Model Law when the creditor is in possession of the collateral or the security interest is created by an "unpaid vendor's charge." *Id.* art. 6.1. An "unpaid vendor's charge" is the functional equivalent of a purchase money security interest in Article 9 of the UCC. *See id.* art. 9.1 & cmt. (defining an unpaid vendor's charge); U.C.C. § 9-107 (1995) (defining purchase money security interest). Under the UCC, if a seller retains a purchase money security agreement, his security interest is automatically perfected without a filing in the case of consumer goods, or temporarily perfected for 21 days without filing in other instances. *See id.* §§ 9-302(1)(d); 9-304(4).

81. MODEL LAW ON SECURED TRANSACTIONS art. 8.1 (1994).

registration statement is more comprehensive than the UCC notice filing. The registration statement must include identification of the creditor and debtor, description of the debt, specific or general description of the collateral, the debtor's signature, and the "maximum amount" of secured debt expressed in monetary terms.[82] The Model Law registration system, designed to prevent the creation of secret liens,[83] performs the same important functions as does the UCC filing system. The registry provides information that creditors need in order to assess the value of property under consideration for use as collateral, and serves as a mechanism to ensure priority status.

The Civil Code gives priority to the secured creditor first in time, as the UCC and the Model Law generally reward the first creditor to perfect his security interest. However, the Civil Code fails to provide a system by which secured creditors can verify their first-in-time status, thus creating uncertainty about whether, or how much, they may ultimately recover from their collateral. As a result, creditors have a strong incentive to over-collateralize or lend at higher interest rates to accommodate for the risk, consequently making sorely needed capital less available and more expensive. The secured credit laws of other civil law countries also lack systems allowing creditors to check for prior interests in movable property.[84] However, this is the exception; the majority of secured credit systems require registration of a security interest in order for the creditor's rights to be fully effective.[85] Furthermore, in those systems without a registration system enabling verification of priority status, commercial creditors rely on "general knowledge . . . of which goods usually are bought on credit and which debtors are most likely to do so."[86] Russia's minimal exposure to capitalism historically and its limited recent experience with a developing market economy have provided little opportunity for Russia to

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82. *Id.* art. 8.4. As mentioned, the Model Law registration statement requires more than the UCC notice filing. The particular requirements for the registration statement in the Model Law are motivated by commercial utility, as in the UCC. See *supra* note 79 for a description of the UCC policy reasons. Specifically, the Model Law justifies disclosure of the "maximum amount" secured, which does not include interest, maintenance, and enforcement costs, in order to give subsequent creditors meaningful information about the full extent of a security interest, which may in turn facilitate further lending based upon the collateral. *See* MODEL LAW ON SECURED TRANSACTIONS art. 4.5 & cmt. (1994). (Interest, maintenance, and enforcement costs are automatically secured by the collateral and need not be specifically included in the "maximum amount" shown on the registration statement. *See id.* art. 4.6 & cmt.; *infra* note 133 and accompanying text. A discussion of the merits of notice filing versus detailed filing is beyond the scope of this Note. The relevant point is that both the UCC and the Model Law utilize a registration system.

83. *See* MODEL LAW ON SECURED TRANSACTIONS art. 8.1 & cmt. (1994) (stating that the cited section avoids the creation of "secret" charges); *id.* at vi (noting the Model Law's use of a public registry to prevent secret rights in assets).

84. *See* Frenkel, *supra* note 12, at 13.

85. *See Report of the Secretary-General*, *supra* note 3, at 182.

86. *Id.* at 186.

develop well-established commercial practices that would create such "general knowledge" upon which creditors could confidently rely.[87]

Russia's struggling market economy would greatly benefit from the increased availability of capital that a reliable registration system could achieve. The Model Law was specifically designed to be compatible with civil law systems, like Russia, yet incorporate the advantages of common law systems,[88] such as Article 9 of the UCC. In its present form, the Russian Civil Code deprives creditors of the ability to be confident in taking a security interest in particular collateral. Without the ability to assess and protect the value of their security interests, creditors will be compelled to raise the price of credit. Even worse, as the resident director of the IRIS-Russia Project in 1994 observed, "[T]his hole in the legal structure deters commercial lending institutions from making credit and capital available . . . ."[89]

In lieu of a filing system, the Civil Code obligates the debtor to inform each subsequent secured creditor about existing security interests in the relevant collateral. Specifically, the debtor should disclose to subsequent creditors the collateral subject to the interest, the essence and amount of the obligation, the period for performance, and who is in possession of the collateral.[90] The debtor is liable for loss to subsequent secured creditors resulting from the debtor's failure to inform them of prior interests.[91] This approach is naive and likely to be ineffective for two reasons. First, debtors have a strong incentive not to disclose prior interests in collateral. Disclosure will frequently result in rejected loan applications or demands for different or additional collateral. Such encounters will likely convince many debtors that disclosure is not in their immediate self-interest. As implicitly recognized in the filing systems created by Article 9 of the UCC and the Model Law, debtors should not

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87. *See generally* Komarov, *supra* note 5, at 1091 (noting that in Russia's transitioning economy "customs or usages are not yet established in commercial transactions"); DANIEL YERGIN & THANE GUSTAFSON, RUSSIA 2010, at 59 (1995) ("Russia is still far from a modern market economy. . . . [P]roperty and contracts have only the weakest basis in the law or in practice."); PAUL KENNEDY, THE RISE AND FALL OF GREAT POWERS 234 (1987) (describing Russia's economy in the late nineteenth century and early twentieth century before the Bolshevik revolution as "'immature'" and "underdeveloped").

88. *See supra* text accompanying note 8.

89. Lane H. Blumenfeld, *A Hole in the Bucket: The Unavailability of Financial Credit Due to the Lack of a Registry in Russian Collateral Law*, *in* LAW IN TRANSITION, Winter/Spring 1994 at 14, 14. The IRIS-Russia project is sponsored by the U.S. Agency for International Development (AID) and operated by the Center for Institutional Reform and the Informal Sector (IRIS), which is an affiliate of the University of Maryland at College Park. *See The IRIS-Russia Project and Its Commercial Law Reform Initiative*, *in* LAW IN TRANSITION, Winter/Spring 1994, at 12, 12. The project is designed to "assist and train Russian law-makers, judges and legal practitioners" in developing a commercial legal system. *Id.*

90. GK RF, *supra* note 18, arts. 339(1), 342(3).

91. *Id.*

be trusted to disclose prior interests. Second, debtor liability for the failure to disclose prior interests promises little, if any, remedy.[92] Loss will arise when a debtor defaults and a junior secured creditor, uninformed of a prior interest, cannot recover from the collateral. A defaulted debtor will often be insolvent and therefore offer little hope of compensation to the junior creditor.

Creditors are not inherently trusting; nor are they indifferent to risk. The Civil Code leaves creditors without any realistic means of verifying prior interests in potential collateral or meaningful recourse for losses suffered due to a debtor's failure to disclose. Consequently, creditors' logical response would be to lend elsewhere or increase their rates, which means very expensive or often unavailable credit in Russia.

b. Immovable property.—All rights of ownership and use in immovable property are subject to registration in a "unified" state registry.[93] Security interests involving immovable property must be registered according to the procedure established by law.[94] The failure to do so renders the security agreement invalid.[95] On the surface, the Civil Code appears to contemplate a system of registration of real property similar to that in Western countries.[96] The Civil Code, however, leaves the registration process to be further defined and established by subsequent legislation,[97] requiring specifically that the registry of rights in immovable property should be accessible by "any person."[98] Further, the Civil Code authorizes special registration or recording of particular types of

92. *See* Frenkel, *supra* note 12, at 13 (asserting that often the secured creditor will have "no actual recourse" for losses suffered as a result of a debtor's failure to provide complete information).

93. GK RF, *supra* note 18, arts. 131(1), 164(1).

94. *Id.* art. 339(3).

95. *Id.* art. 339(4).

96. The Model Law requires registration of immovable property in the same manner as movable property. *See* MODEL LAW ON SECURED TRANSACTIONS art. 2 (1994). Article 9 of the UCC does not govern registration of interests in real property. *See* U.C.C. § 9-102 (1995) (limiting the application of Article 9 to transactions intended to create a security interest in personal property or fixtures). However, each U.S. state has established by statute a system for recording interests in real property. *See* DUKEMINIER & KRIER, *supra* note 43, at 652. Such recording statutes create government-maintained records in each county, in which instruments "creating or affecting an interest in land" are filed. *Id.* The public real estate records serve two important functions. First, interested parties, such as potential buyers or creditors, can search the public records to authenticate ownership and identify existing interests for a particular piece of property. *Id.* Second, the recording statutes protect purchasers and creditors from prior interests that were not filed in the public records. *Id.* at 652-53. Additionally, in many areas of the United States, private title insurance companies have used the public records to create and improve their own records detailing interests in real property. *See id.* at 651.

97. GK RF, *supra* note 18, art. 131(6).

98. *Id.* art. 131(4).

immovable property as established by law.[99] Until a law concerning registration is established, "prevailing procedure for the registration of juridical persons and the registration of immovable property and transactions with them shall apply."[100]

Russia has been slow to develop the additional legal structure necessary for implementation of a registration system. In February of 1996, President Yeltsin decreed additional measures designed to facilitate mortgaging.[101] In particular, the decree ordered the creation of an executive body called the Federal Commission for Real Property and Appraisal of Realty to "ensure the keeping" of a unified registry of locally registered interests.[102] The decree was considered a "disappointment,"[103] and accomplished little more than did the Civil Code provisions in actually establishing a registration process. In November of 1997, the Russian government issued a resolution assigning to the Ministry of Justice oversight responsibility for a new registration system.[104]

Finally, in February of 1998, a federal law establishing a national registry for immovable property went into effect.[105] Initial comments by the legal community in Moscow have been positive.[106] However, the

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99. *Id.* art. 131(2).

100. Federal Law on the Introduction into Operation of Part One of the Civil Code of the Russian Federation, Oct. 21, 1994, art. 8, Sobr. Zakonod. RF, 1994, No. 32, Item 3302, *translated in* CIVIL CODE OF THE RUSSIAN FEDERATION: PART ONE (W.E. Butler trans., 1994), *in* RUSSIA & THE REPUBLICS LEGAL MATERIALS: RUSSIAN FEDERATION (John N. Hazard & Vratislav Pechota eds., 1998).

101. Decree on Additional Measure to Develop Hypothecation (Mortgage) Crediting, Russian Federation President's Decree No. 93 of Feb. 28, 1996, Sobr. Zakonod. RF, 1996, *in* RUSSIA & THE REPUBLICS LEGAL MATERIALS: RUSSIAN FEDERATION (John N. Hazard & Vratislav Pechota eds., 1998).

102. *Id.* § 16.

103. Alfred Evans, *Mortgage Decree Fails to Clarify*, MOSCOW TIMES, Mar. 26, 1996, *available at* <http://www.moscowtimes.ru/archives/issues/1996/Mar/26/story79.html>. Evans, a real estate attorney with Clifford Chance in Moscow, suggested that the decree actually complicated the registration process and furthermore ignored the primary obstacles to mortgage financing. *See id.*

104. *See* Decision of the Government of the Russian Federation, No. 1378 of Nov. 1, 1997, On the Measures for Implementing the Federal Law On the State Registration of Rights to Real Property and Deals with It.

105. *See* Federal Law No. 122-FZ of July 21, 1997, On the State Registration of Rights to Real Estate and Transactions with It [hereinafter Law on Registration]. The Law on Registration provided that the law would be effective six months after its official publication. *See id.* art. 33.1. The law went into effect on February 1, 1998. *See* Boris Aliabyev, *Owners, Officials Hail New Property Registry*, MOSCOW TIMES, Feb. 10, 1998, *available at* <http://www.moscowtimes.ru/archives/issues/1997/Feb/10/story47.html>.

106. Adrian Moore, partner at Baker & McKenzie Moscow, characterized the new law as "an exciting development." *Id.* Jack Kelleher, director at Noble Gibbons, called the law a "necessary step." *Id.* Cameron Sawyer, president of Sawyer & Co., described the law as a "very good thing." *Id.*

legislation has been criticized for being "very vague" in places,[107] and for failing to recognize rights in buildings under construction until they have been completed.[108]

Under the new law, registration constitutes "the acknowledgment by the State of the origin, limitation (encumbrance), transfer and termination of rights" in immovable property.[109] Rights of ownership, lease, mortgage, and servitudes are expressly subject to registration.[110] Prior laws required that interests in immovable property be registered at one of several local government offices, depending on the type of immovable property involved.[111] In contrast, the new registration law institutes a single registry for almost all rights in immovable property.[112] Parties to a transaction still register their rights locally, *i.e.*, where the immovable property is located.[113] However, under the new law, they will register their rights at a single, newly established entity, regardless of the type of immovable property. The required registration fee varies by the type of registrant.[114] Rights in immovable property that arose before the new law became effective are recognized as legally valid even if they are not registered under the new system.[115] Such rights must be registered with the new registry if the property is involved in a transaction that takes place subsequent to the new law becoming effective.[116]

Importantly, the Law on Registration provides for public access to the registry.[117] Upon submitting an application, providing identification, and paying the required fee,[118] a party is entitled to receive, within five days, information concerning particular immovable property, including a legal description of the property and rights in and encumbrances on the property.[119]

Three particular elements of the new registration law may cause concern for creditors seeking security interests in immovable property.

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107. *Id.* (reporting criticism by Alexei Safanov, a member of the Federal Notary Chamber board).

108. *See id.* (citing Cameron Sawyer, President, Sawyer & Co.).

109. Law on Registration, *supra* note 105, art. 2.1.

110. *Id.* art. 4.1; GK RF, *supra* note 18, art. 131.

111. *See* Olga von Recum, *Registration of Real Estate Rights in Russia*, EAST EUROPEAN BUS. L., Mar. 1, 1998, at 4. For instance, prior laws required that rights in residential property, raw land, and "production facilities" were each registered with a different local government entity. *Id.*

112. Law on Registration, *supra* note 105, art. 2.2. The law does not govern registration of rights in aircraft, seagoing and inland water vessels, and space objects. *Id.* art. 4.1.

113. *Id.* art. 2.4.

114. *See* Decision of the Government of the Russian Federation, No. 248 of Feb. 26, 1998, On Establishment of a Cap on the Fee Payable for the State Registration of Rights to Real Property and Deals with It and for Providing Information on the Registered Rights [hereinafter Decision No. 248] (establishing registration fees that vary by the legal identity and the income level of the registrant).

115. Law on Registration, *supra* note 105, art. 6.1.

116. *Id.* art. 6.2.

117. *Id.* art. 7.1.

118. *See* Decision No. 248, *supra* note 114.

119. Law on Registration, *supra* note 105, arts. 7.1, 7.2.

First, the unified registry is not likely to be fully implemented for some time. The Law on Registration and Ministry of Justice officials acknowledge that the new system will not be operational until January of 2000 at the earliest.[120] However, even this date seems ambitious considering the current financial strain and significant economic problems facing the Russian government. Consequently, uncertainty arising from transactions involving immovable property located in areas where the new system is not yet operational will likely create a substantial disincentive to use immovable property as collateral.

Second, there can be a delay of up to two months between the time a creditor submits the required documentation and the point at which his interest in collateral is registered and thus effective. Under normal circumstances, registration may not be completed for up to one month from the time the required documentation is filed with the registry.[121] If the registrar has "doubts as to the grounds" for registration, it has up to one month to take steps to obtain additional information, including informing the party that submitted the application.[122] In addition to being generally inconvenient, such a delay would effectively suspend a creditor's rights in the collateral against the debtor; recall that under the Civil Code a security interest in immovable collateral is invalid unless registered as required by law.[123]

Third, although the registry is designed to be available to the public, access can be denied by the government entity operating the registry.[124] Although presumably access would be denied only in very limited circumstances, the law fails to specify any grounds for denial, thus allowing for the possibility of abuse and creating an additional frustration involved in secured financing.

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120. *Id.* art. 33.2; Aliabyev, *supra* note 105 (reporting a statement by Pavel Krasheninnikov, Russia's First Deputy Justice Minister, that the nationwide system is "scheduled to be up and running by January 1, 2000").

121. *See* Law on Registration, *supra* note 105, art. 13.3 ("[R]egistration of rights shall be carried out not later than one month [from submission of the necessary documents].").

122. *Id.* art. 19.1.

123. *See* GK RF, *supra* note 18, art. 339(4); *supra* text accompanying notes 94-95. Under the Law on Registration, an interest in immovable collateral is not deemed registered until the information is verified and entered into the registry. *See* Law on Registration art. 16.7. Consequently, simply submitting the application and required documentation does not make a security interest effective against the debtor. One commentator has suggested using an escrow account in connection with the purchase of real estate in Russia, whereby the purchase price would be released to the seller only upon the completed registration of the buyer's ownership rights. *See* von Recum, *supra* note 111, at 4. A similar arrangement would also be helpful in providing some protection to a secured lender in a mortgage transaction.

124. Law on Registration, *supra* note 105, arts. 7.1, 7.2.

B. *Enforcing a Security Interest*

Enforcement of security interests in Russia poses additional problems. The Civil Code grants courts broad discretion to excuse default[125] and stay enforcement proceedings.[126] A creditor's right to take possession of movable goods upon default is ambiguous.[127] Foreclosure of immovable property is essentially limited to court action, which is subject to deferral.[128] Until the time of disposition of collateral, a debtor retains the right to terminate enforcement proceedings by fulfilling just the overdue portion of the obligation.[129] Finally, disposition of collateral is limited to public auction.[130]

1. Secured Claim.—Unless the underlying contract provides otherwise, a security interest secures the underlying debt, interest, the cost of maintaining the collateral, the cost of recovering the collateral, liquidated damages, and compensation for loss caused by delayed performance (consequential damages).[131] The first four elements (underlying debt, interest contractually owed, and maintenance and recovery costs) are likewise elements of a secured claim under Article 9 of the UCC and the Model Law.[132] By automatically including liquidated and consequential damages in the secured claim, the Civil Code is more generous to the creditor than either the UCC or the Model Law.[133]

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125. *See* GK RF, *supra* note 18, art. 348(1) (qualifying a creditor's right to foreclosure as default by the debtor "under circumstances for which he is liable").

126. *See id.* art. 350(2) (allowing courts to stay proceedings for up to a year on a debtor's request).

127. *See id.* art. 349(2); *infra* text accompanying notes 138-47.

128. *See id.* art. 349(1) (permitting extrajudicial foreclosure of immovable property only upon notarized, post-default agreement with the debtor, but subject to court decision invalidating the agreement upon suit of a person whose rights were violated by the agreement).

129. *See id.* art. 350(7).

130. *See id.* art. 350(1).

131. *Id.* art. 337.

132. U.C.C. § 9-504(1) (1995); MODEL LAW ON SECURED TRANSACTIONS arts. 4.5, 4.6 (1994).

133. Under the UCC, the proceeds of collateral are disbursed to satisfy the "indebtedness" secured by the security interest, in addition to expenses incurred in recovering, holding, and preparing for sale the collateral. U.C.C. § 9-504(1) (1995). The UCC, therefore, refers to the security agreement to determine the extent of the debtor's liability to the creditor that is secured by the collateral. A UCC creditor who did not negotiate the inclusion of liquidated or consequential damages in the security agreement would be unable to recover them from the collateral, whereas the Civil Code automatically includes these liabilities, unless the security agreement says otherwise. In practice, however, UCC creditors commonly include a broad provision in the security agreement to the effect that the security interest secures all obligations and damages arising from the transaction. *See* Interview with Jay L. Westbrook, Benno C. Schmidt Chair in Business Law, University of Texas School of Law, in Austin, Tex. (Mar. 3, 1998).

The Model Law secured claim, as in the Civil Code, automatically includes damages for breach of the underlying contract, in addition to reasonable maintenance and enforcement costs, unless the security agreement provides otherwise. MODEL LAW ON SECURED TRANSACTIONS art. 4.6 (1994).

2. *Default.*—A creditor may exercise his enforcement rights upon default on the underlying obligation or particular statutory grounds for demanding accelerated performance.[134] Similar to the UCC and the Model Law, the Civil Code uses a general concept of default, leaving it to be further defined in the security agreement.[135] "Execution may be levied against" secured property in order to satisfy a creditor's claim, upon the debtor's failure to perform or his improper performance of an obligation secured by the collateral "under circumstances for which he is liable."[136] This qualifying phrase, "under circumstances for which he is liable," is potentially troubling. Neither the UCC nor the Model Law contains any similar qualification. Additionally, levy of execution may be refused when the violation is "extremely insignificant" and the amount of the demand resulting from the violation is "incommensurate" with the value of the collateral.[137] This is also potentially troubling for secured creditors. Each of these provisions creates an opportunity for a debtor to challenge enforcement proceedings, thus diminishing the ultimate value of a security interest. The extent to which security interests are devalued by these provisions will depend on judicial interpretation.

3. *Levy of Execution/Foreclosure.*—As mentioned above, a creditor may exercise his enforcement rights upon default or under the circumstances allowing accelerated performance. The enforcement rights a creditor possesses under the Civil Code depend on the nature of the security interest, *i.e.*, whether it covers immovable property, movable property, or movable property in the possession of the creditor.

The creditor may recover these in addition to the underlying debt, or more precisely, the amount indicated in the registration statement as the maximum amount of debt secured. *Id.* art. 4.5. However, the Model Law significantly limits the amount a creditor can recover from the collateral as damage for breach of the underlying contract. Recovery of breach of contract damages is limited to 20% of the maximum amount of debt secured, as indicated in the registration statement, or in the case of an "unpaid vendor's charge" to 20% of the unpaid purchase price. *Id.* art. 4.6.4. For an explanation of an "unpaid vendor's charge," see *supra* note 80; MODEL LAW ON SECURED TRANSACTIONS art. 9.1 (1994). Interestingly, the Model Law commentary does not explain the policy concerns that motivated this limitation.

134. *See infra* note 192.

135. *See* U.C.C. § 9-501 (1995) (endowing a secured party with enforcement rights and remedies upon the debtor's "default," without providing specific explanation of the term); MODEL LAW ON SECURED TRANSACTIONS art. 22.1 & cmt. (1994) (explaining that default events are usually specified by agreement, upon which a security interest becomes enforceable when there is a failure to pay).

136. GK RF, *supra* note 18, art. 348(1).

137. *Id.* art. 348(2). The Law on Mortgage allows foreclosure of immovable property under such circumstances if the debtor has persistently violated payment terms of the obligation, which is defined as "more than three times over twelve months." *See* Law on Mortgage, *supra* note 37, art. 54.1.

a. Movable property.—A secured creditor's claim against movable property shall be satisfied by decision of a court, "unless provided otherwise by agreement" between the debtor and the creditor.[138] The particular wording of this provision creates a possible concern. It is unclear from the text whether the agreement authorizing repossession by a creditor can be in the security agreement, or whether it must be a post-default agreement. Arguably, this article of the Civil Code is subject to the latter interpretation for two reasons.

First, the language used creates ambiguity because it varies from explicit language used in a related provision. Specifically, the provision concerning collateral in the possession of the creditor, located in the same article, specifies that execution may be levied against the collateral as established by the "contract on pledge" unless a different procedure has been established by law.[139] Strangely, the language used in the provision concerning nonpossessory interests on movable property fails to specify that such an agreement can be included in the security agreement, thus creating support for an argument that such an agreement can only be made after default. The failure to specify, especially in such close proximity to a specific reference, might provide enough ambiguity to compel a court to give a debtor the benefit of the doubt.

Second, the Civil Code neglects to address the means by which a creditor can take possession of collateral after default. Compared to the UCC and the Model Law, the absence of any qualification in the Civil Code is rather conspicuous. The UCC authorizes taking possession of collateral upon default only when it can be done without a breach of the peace.[140] Similarly, the Model Law makes creditors liable in damages for using enforcement measures they are not entitled to, specifically in order to discourage "wrongful or reckless enforcement."[141] Additionally, the Model Law provides a mechanism by which a secured creditor can acquire the assistance of an official "bailiff," without the delay of a court proceeding, when he does not have right of entry to the location of the collateral, or if such right is refused to him.[142] In contrast, the provision of the Civil Code dealing with enforcement of security interests fails to limit creditor seizure to peaceable means, or to provide an official enforcement mechanism other than a lengthy court proceeding.[143] Considering the prevalence of business-related violence in Russia,[144] the drafters of

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138. *Id.* art. 349(2).
139. *Id.*
140. U.C.C. § 9-503 (1995).
141. MODEL LAW ON SECURED TRANSACTIONS art. 30.1 & cmt. (1994).
142. *See id.* art. 23.7 & cmt.
143. *See* GK RF, *supra* note 18, art. 349(2).
144. *See* Michael Newcity, *Russian Legal Tradition and the Rule of Law*, *in* THE RULE OF LAW AND ECONOMIC REFORM IN RUSSIA 41 (Jeffrey D. Sachs & Katharina Pistor eds., 1997) (characterizing

the Civil Code would likely have been very sensitive to potential abuse of an unqualified self-help remedy. Therefore it is quite plausible that the drafters may have intended to require a post-default agreement to authorize seizure without court action. Possession would presumably take place peaceably if the debtor cooperated. In contrast, because an uncooperative debtor might compel a creditor to use reckless or dangerous seizure tactics, court supervision would be required in the absence of a post-default agreement.[145]

However, the *Kommentarii*, an authoritative Russian commentary on the Civil Code, has interpreted the provision to allow security agreements to include repossession agreements. Article 349 of the Civil Code does not limit the procedure for levying execution of movable property, and therefore, "suitable terms may be included in the contract on pledge itself."[146] Although this is not official commentary, it may be persuasive to a court. Furthermore, at least some secured creditors in Russia have not hesitated to help themselves to collateral.[147] To minimize the possible risk created by the ambiguous wording, a creditor might want to specify expressly in the security agreement not only the right of self-help repossession, but also an obligation to the debtor to provide such permission post-default if necessary. Ultimately, however, even this precaution is no guarantee that the debtor will cooperate.

In Article 9 of the UCC and the Model Law, the right to take possession of the collateral upon default is an important feature. As recognized by the Model Law commentary, having the right to seize collateral without

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crime in Russia as "pandemic" and reporting a Russian study indicating the extensive presence of organized crime in the economy); Christian Lowe, *Russian Crime Report Draws Scorn, Apathy*, MOSCOW TIMES, Oct. 2, 1997, *available at* <http://www.moscowtimes.ru/archives/issues/1997/Oct/02/story9.html> (citing official figures indicating a rise in economic crime and reporting a study by a U.S. think tank suggesting that crime syndicates exert significant control in the Russian economy).

145. If the Civil Code drafters did not so intend, then the failure to qualify the creditor's self-help seizure remedy gives rise to another criticism. As mentioned above, the use of violence in the commercial sector is very prevalent in Russia. This fact aside, it would seem to be unwise public policy to give creditors carte blanche over the manner of seizure.

146. M. E. BRAGOMSKAYA ET AL., KOMMENTARII DLA PREDRINIMATELEY [COMMENTARY FOR BUSINESSMEN] 552 (V. Kuznetzov & T. Braginskaya eds., 1996) [hereinafter KOMMENTARII]. Translation of this commentary, and therefore any errors, are that of the author of this Note. Each of the authors of the Kommentarii participated in the preparation of the Russian Civil Code. *See id.* at [i]. V.V. Vitryanskii, who authored the sections of the Kommentarii pertaining to Articles 307-453 of the Russian Civil Code, is the Deputy Chief of Russia's Supreme Arbitrage Court, which adjudicates disputes between enterprises. *See id.* at [ii].

147. For example, MOST-Bank, one of Russia's largest and most prominent banks, boldly seized inventory off the shelves of a popular Moscow supermarket when the controlling joint venture failed to make its loan payments due to a dispute between the partners. *See* Erin Arvedlund, *Bank Seizes Supermarket's Inventory*, MOSCOW TIMES, Oct. 8, 1996, *available at* <http://www.moscowtimes.ru/archives/issues/1996/Oct/08/story17.html>. The bank even sealed off the store in order to facilitate the seizure. *Id.* A source within MOST-Bank characterized the seizure as "'completely legal under Russian law and not at all unusual.'" *Id.* Curiously, however, the source refused to be identified. *Id.*

delay upon default is fundamentally related to the value of the security interest.[148] The UCC provides secured creditors with the right to take possession of collateral upon default without judicial process, unless there is an agreement to the contrary.[149] Therefore, if a security agreement is silent as to the right to seize collateral upon default, the UCC implied term is opposite that of the Civil Code. In practice this difference is probably unimportant: presumably parties will specify in their security agreement whether the secured creditor has the right to repossess.

The Model Law also grants broad self-help enforcement rights to secured creditors. Upon default, a creditor has the right to take possession of the collateral[150] or take action necessary to "immobilise" the collateral or prevent its use or transfer.[151] In order to exercise these rights, a creditor need only deliver an "enforcement notice" to the debtor, at which point the creditor's enforcement rights "arise immediately."[152] The enforcement notice requirement, which is unique to the Model Law, serves two functions. First, it provides notice to the debtor, although not necessarily far in advance, that enforcement proceedings have been initiated. A creditor concerned about seizing or protecting his collateral upon default will likely deliver the enforcement notice simultaneously with the seizure.[153] Second, and more important from the perspective of the Model Law, the enforcement notice is a means by which third parties are informed of the enforcement proceedings. In order to continue enforcement of a security interest, a secured creditor must supplement his security agreement registration by registering the enforcement notice within seven days of its delivery to the debtor.[154] The enforcement notice must identify the debt and the collateral, contain a statement that enforcement

148. *See* MODEL LAW ON SECURED TRANSACTIONS art. 23.1 cmt. 23.1/2 (1994) ("[I]t is essential that the [secured creditor] has effective rights to protect the charged property without delay."); *id.* at vii ("Without a clear right to enforce, the [secured creditor] is deprived of his remedy and a [security interest] becomes valueless.").

149. U.C.C. § 9-503 (1995).

150. MODEL LAW ON SECURED TRANSACTIONS art. 23.1 (1994). The Model Law does not expressly provide that this provision is subject to agreement. *See id.* However, in the section dealing with the formation of security agreements, the Model Law does acknowledge freedom of contract in general, which is subject only to limited exceptions. *See id.* art. 7.5 & cmt. (authorizing parties to include provisions in their security agreement in addition to those required).

151. *Id.* art. 23.2.

152. *Id.* art. 23.1 & cmt.

153. The Model Law recognizes that it is important to the creditor to be able to protect his collateral without delay. *See id.* art. 23.1 & cmt. (stating that "in practice it is essential that the chargeholder has effective rights to protect the charged property without delay"). Therefore, enforcement rights arise "immediately" upon delivery of the enforcement notice, seemingly permitting, if not encouraging, delivery simultaneous to seizure. *See id.* The particular manner in which the enforcement notice must be delivered is to be determined by the appropriate local law. *Id.* art. 22.7 cmt.

154. *Id.* art. 22.4. This requirement is applicable to all security interests, even an unpaid vendor's charge or collateral in the creditor's possession. *Id.* art. 22.4 & cmt.

proceedings have been initiated, and make reference to the security interest's registration information.[155] Registration of the enforcement notice thus makes important information available to interested third parties, such as potential secured creditors and existing secured creditors with an interest in the collateral subject to the enforcement proceeding, or other collateral owned by the debtor.

b. Immovable property.—Foreclosure of immovable property must involve a judicial proceeding, with one limited exception.[156] Foreclosure without recourse to a court is permissible only if the creditor acquires and notarizes a post-default agreement with the debtor authorizing such foreclosure.[157] However, a court can invalidate this agreement "upon the suit of the person whose rights were violated by such agreement."[158] Although the Civil Code provides no further detail, Russian commentary suggests the provision is designed to enable a court to "mitigate undesirable consequences" resulting from the narrowing of the court's supervisory role.[159] Further, the *Kommentarii* indicates that "any party" whose rights are violated may petition the court to invalidate a post-default agreement that allows a creditor to commence enforcement without court supervision.[160]

Article 9 of the UCC does not govern mortgages of real property.[161] Foreclosure of real property in the United States is governed by non-uniform state law. Although foreclosure laws vary from state to state, mortgage holders typically may choose whether to pursue court action or a self-help remedy provided for in the mortgage agreement.[162] Foreclosure by judicial proceeding typically involves filing a complaint with the appropriate court, summons of the debtor and others who may have an interest in the property, and a public auction of the collateral conducted by a public official authorized by the court.[163] Substantial

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155. *See id.* art. 22.7.

156. GK RF, *supra* note 18, art. 349(1) ("The demands of the [creditor] shall be satisfied from the value of the pledged immovable property by decision of a court.").

157. *Id.* The Civil Code and the Law on Mortgage prohibit such agreements in certain circumstances. *See* GK RF, *supra* note 18, art. 349(3); Law on Mortgage, *supra* note 37, art. 55.2.

158. *Id.* Consequently, a court might very well be inclined to invalidate such an agreement made pursuant to a provision in the security agreement that obligated a debtor to make such a post-default agreement.

159. KOMMENTARII, *supra* note 146, at 552.

160. *Id.*

161. U.C.C. § 9-104 cmt. 4 (1995) ("Except for fixtures . . . the Article applies only to security interests in personal property.").

162. *See* William C. Prather, *Foreclosure of the Security Interest*, 1957 UNIV. ILL. L.F. 420, 427 (asserting that these two options are the "most prevalent methods" of foreclosure).

163. *See id.* at 428-29 (describing the entire process from the original petition to foreclose until judgment is entered).

delays, inconvenience, and significant fees and costs are characteristic of judicial foreclosure and sale.[164]

In contrast, self-help remedies permitted by state law provide a more efficient enforcement mechanism. A significant number of states allow foreclosure without judicial proceeding, typically in the form of a "power of sale" provision, the terms of which are agreed to by the creditor and debtor in the instrument granting the mortgage.[165] The power of sale provision provides the creditor with the right to arrange the public sale of the property and specifies the notice requirements with which the creditor must comply.[166] Foreclosure through a power of sale provision is generally considered a more effective enforcement remedy because it is less expensive, less complicated, and more expeditious than judicial foreclosure.[167] Additionally, in the vast majority of states the mortgage agreement may provide the creditor with the right to take possession of the secured property upon default by the debtor, thus significantly enhancing the creditor's ability to protect the value of the collateral and the possibility of generating income from the property.[168]

The Model Law does not explicitly distinguish enforcement rights on the basis of movable and immovable property. The traditional concepts of a mortgage in real property and a secured lien in personal property are merged into a single concept.[169] The self-help enforcement measures are essentially the same for movable and immovable property.[170] However,

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164. *See id.* at 429 (describing the formalities that must be followed in a judicial foreclosure and sale); *see also* Robert K. Lifton, *Real Estate in Trouble: Lender's Remedies Need an Overhaul*, 31 BUS. LAW. 1927, 1937 (1976) (attributing these drawbacks to an excessive concern for the owner).

165. *See* Prather, *supra* note 162, at 429. The mortgage agreement must expressly authorize the creditor's power of sale. *See id.* Typically, the power of sale provision specifies what constitutes default and thus triggers the creditor's self-help enforcement rights. *See id.* at 429-30.

166. *See* Lifton, *supra* note 164, at 1937 (noting that a power of sale provision is usually accomplished by an advertisement); Prather, *supra* note 162, at 430 ("Ordinarily personal notice of the proposed sale to the borrower is necessary, but certain states permit notice by advertisement.").

167. *See* Lifton, *supra* note 164, at 1937 (noting that a power of sale provision "sharply reduces foreclosure time and costs" because it avoids court action); Prather, *supra* note 162, at 429 (characterizing foreclosure by power of sale as "a less expensive as well as more convenient and expeditious mode of foreclosure" relative to a judicial proceeding).

168. *See* CURTIS J. BERGER & QUINTIN JOHNSTONE, LAND TRANSFER AND FINANCE 308 (4th ed. 1993).

169. *See* John L. Simpson & Jan-Hendrik M. Röver, *Introduction* to MODEL LAW ON SECURED TRANSACTIONS, at vi (1994) ("The distinction between various traditional types of security rights, such as pledges of movables, pledges of rights, and mortgages is merged into one right."); *id.* art. 5.2 ("Charged property may comprise anything capable of being owned, . . . whether rights or movable or immovable things . . . .").

170. A secured creditor has the "right to possession" when the collateral is movable property. *See* MODEL LAW ON SECURED TRANSACTIONS art. 23.1 (1994). Possession here is meant literally. When physical possession of the collateral is impracticable, as in the case of immovable property, the creditor may prevent transfer of title and use of the property, typically through a lien on the title and eviction. *See id.* art. 23.2.

recall that the Model Law applies only in the business context:[171] security interests in noncommercial property—such as occupied residential housing, which may invoke public policy justifications to limit seizure and eviction rights—are not covered by the Model Law.

The absence of a viable self-help remedy in the Civil Code is problematic for a creditor with a security interest in immovable property and for real estate financing in general. Secured creditors will likely find it difficult to obtain post-default agreements in which debtors authorize creditor foreclosure. Furthermore, as mentioned above, the Civil Code gives Russian courts wide discretion to declare post-default agreements invalid.[172] Therefore, in most cases, a secured creditor will face the delay and expense of a court proceeding in order to enforce his rights in immovable collateral. These elements significantly diminish the value of a security interest in immovable property. Consequently, residential and commercial real estate financing has been difficult to acquire. Commercial building projects often must be financed out-of-pocket,[173] which substantially limits the number of economically viable projects. Likewise, consumers find it necessary to save thirty to sixty thousand dollars to pay up front in order to buy a one-bedroom apartment.[174] It is generally believed that the weak enforcement rights pose a serious obstacle to real estate financing in Russia.[175]

4. Delay of Foreclosure Proceedings.—In general, a defaulted debtor is likely to be unwilling to help a creditor seize his property. Under the

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171. *See supra* note 44 and accompanying text.

172. *See supra* notes 158-60 and accompanying text.

173. *See* Sujata Rao, *Moscow Seeks Western Help to Develop Mortgage System*, MOSCOW TIMES, Jan. 13, 1998, *available at* <http://www.moscowtimes.ru/archives/issues/1998/Jan/13/story30.html> (asserting that "[m]ost commercial building projects" are financed by the developer).

174. *See id.* (quoting a partner in the Moscow office of real estate group Jones Lang Wootton). The alternative, for those who can afford it, is paying over 20 percent in interest to acquire a mortgage. *See* Lena Berezanskaya, *Fund Gives Lower-Rate Mortgages*, MOSCOW TIMES, Apr. 8, 1998, *available at* <http://www.moscowtimes.ru/archives/issues/1998/Apr/08/story16.html>.

175. *See id.* (quoting Gerald Gaige, director of real estate services at Arthur Anderson in Moscow, as asserting that until enforcement rights are strengthened, "no mortgage program is going anywhere"); *id.* (quoting a western expert as characterizing the inability to eject defaulted residents as "fatal"); Stephen Sumpton, *Proposed Mortgage Law Lays Foundation for Russian Realty*, MOSCOW TIMES, July 29, 1997, *available at* <http://www.moscowtimes.ru/archives/issues/1997/Jul/29/story51.html> (noting a consensus that the limited remedies available to mortgage holders in Russia, such as the lack of self-help foreclosure, have been a "major impediment" to real estate financing).

Stephen Sumpton, an associate in the real estate section of Baker & McKenzie, Moscow, characterized a draft of the Law on Mortgage as a "major step forward." *See id.* One improvement made by the Law on Mortgage is that it grants eventual eviction rights to mortgage holders whose lending enabled the acquisition or construction of apartments or residential housing securing the debt. *See* Law on Mortgage, *supra* note 37, art. 78.2. *See also* Sumpton, *supra* (predicting that eviction rights will ultimately increase the availability of financing for home purchases and construction).

Civil Code, a debtor has even less incentive to cooperate because he has recourse to significant protection in court. At the request of the debtor, courts have the prerogative to defer the sale of collateral for up to one year.[176] Neither the UCC nor the Model Law provides judicial discretion to delay enforcement so drastically.[177] The particular circumstances under which a court can grant a deferral are not specified in the Civil Code. To the extent that courts use the authority liberally, the value of security interests diminishes. As recognized in the Model Law commentary, "[i]f the [security interest] is to be of value . . . there must be some real assurance that any proceedings will be dealt with quickly."[178] The *Kommentarii* is critical of the provision,[179] characterizing the length of the delay as "inappropriately great" and suggesting that in inflationary conditions the delay provision generally calls into question the "security function" of security interests.[180] In practice, secured creditors often require the debtor to expressly waive this right in the security agreement.[181] However, the enforceability of such a waiver is uncertain.[182]

Under a court-imposed deferral, the creditor does retain his rights against the collateral, and the debtor remains liable for the underlying

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176. GK RF, *supra* note 18, art. 350(2).

177. In order to protect the interests of the debtor and other creditors, Article 9 of the UCC authorizes courts to enjoin a secured creditor from disposing of collateral in a manner not in good faith and not commercially reasonable. *See* U.C.C. § 9-507(1) & cmt. 1 (1995). However, this authority is not intended to facilitate a lengthy stay of the enforcement process. Rather, the UCC anticipates that a secured creditor could be ordered to proceed "under specified terms and conditions," or that a representative for all the creditors be authorized to dispose of the collateral. *Id.* § 9-507 cmt. 1. The Model Law also recognizes the need for appropriate safeguards against abuse of self-help enforcement, but explicitly acknowledges that the value of a security interest is largely dependent on the ability to enforce the interest without the risk of lengthy court proceedings. *See* MODEL LAW ON SECURED TRANSACTIONS art. 29 cmt. (1994) ("Against [the need to prevent abuse] enforcement must remain a real remedy which cannot be defeated or rendered meaningless by use of court procedures."); *id.* art. 29.1 cmt. ("If the charge is to be of value to the chargeholder there must be some real assurance that any proceedings will be dealt with quickly."). Therefore, when enforcement of a security interest is challenged in court, the secured creditor's enforcement rights are not automatically stayed. *See id.* art. 29.1.2 (authorizing the secured creditor to continue with enforcement measures notwithstanding initiation of court proceedings). A court can temporarily suspend enforcement only in limited circumstances. *See id.* art 29.3 (detailing the findings that a court must make in order to stay enforcement proceedings). Under the real property laws of some states of the United States, the debtor's statutory or common-law redemption rights may result in some delay of either the foreclosure sale or, in some instances, the final transfer of title following the foreclosure sale. *See generally* Lifton, *supra* note 164, at 1941; Prather, *supra* note 162, at 428 (both discussing the application of a defaulted debtor's redemption rights in real property).

178. MODEL LAW ON SECURED TRANSACTIONS art. 29.1 & cmt. (1994).

179. *See* KOMMENTARII, *supra* note 146, at 554 (observing that this is yet another instance in which the Civil Code takes a position against the interests of secured creditors).

180. *Id.*

181. *See* Telephone Interview with William D. Morris, *supra* note 59.

182. *See id.*

obligation as well as any losses suffered by the creditor as a result of the deferral.[183] Even assuming the deferral is designed as a quasi-workout, however, there is significant additional risk in assuming that the defaulted debtor will have additional resources in a year's time with which to pay the underlying obligation, interest, and any other related loss, such as depreciation due to inflation. Furthermore, with enforcement proceedings stayed, the debtor has little incentive to limit his use and disposition of the collateral according to the terms of the security agreement or those provided in the Civil Code.

5. Redemption Rights and Acceleration Clauses.—Even without the one-year deferral, the delay intrinsic to the court system benefits the debtor. Until the time of the actual sale of collateral, the debtor may terminate the levy of execution (redeem the collateral) by performing the obligation in full, or fulfilling only that part which is overdue.[184] Any agreement limiting this right is invalid.[185] Both the UCC and the Model Law also provide redemption rights. However, in contrast to the Civil Code, the UCC and the Model Law enable a creditor in effect to require that a debtor fulfill the obligation in full, not just an overdue installment, in order to redeem collateral.[186]

This disparity is particularly important when a secured debt is due in installments and the agreement contains an acceleration clause. In the secured financing context, acceleration clauses afford creditors protection when circumstances develop that cast serious doubt on a debtor's ability to meet his obligations. For example, to redeem collateral under the UCC, a debtor must tender "all obligations secured by the collateral," which include any amount due under an acceleration clause.[187] Therefore, if a security agreement contains a provision accelerating the balance of a loan upon default of one installment, a defaulting debtor would have to tender the entire balance in order to redeem the collateral.[188]

For two reasons, the Civil Code appears to prohibit such use of acceleration clauses. First, as mentioned above, any agreements "limiting" redemption rights are invalid.[189] If given full effect, an acceleration clause would effectively deprive the debtor of his statutory right to pay

183. *See* GK RF, *supra* note 18, art. 350(2).

184. *Id.* art. 350(7).

185. *Id.*

186. Article 9 of the UCC requires a defaulted debtor to tender "fulfillment of all obligations secured by the collateral" in order to redeem collateral. U.C.C. § 9-506 (1995). Likewise, under the Model Law, a debtor must satisfy the secured debt "in full" in order to terminate enforcement proceedings against the collateral. MODEL LAW ON SECURED TRANSACTIONS art. 22.1.2 (1994).

187. U.C.C. § 9-506 & cmt. (1995).

188. *See id.* § 9-506 cmt.

189. *See* GK RF, *supra* note 18, art. 350(7).

only the overdue portion of the obligation. This would seem to directly contradict the provision nullifying any agreement limiting this right.[190] Based on the substantially similar provision in the Law on Pledge, William Frenkel, an attorney involved with work in Russia and a frequent commentator on the Russian legal environment, concluded that the contractual right to accelerate payment in installment obligations might also be limited.[191]

Second, unlike the Law on Pledge, the Civil Code provides specific statutory grounds for acceleration, none of which authorizes accelerating the full obligation on the basis of default on installments.[192] The Civil Code does not expressly provide that these grounds are exclusive; nor does it mention whether they may be supplemented or altered by the parties. In other sections of the Civil Code, certain provisions expressly defer to agreements of the parties.[193] In doing so, the drafters of the Civil Code imply that when an article does not expressly defer to private agreements, the parties cannot contract around the Civil Code provisions. Furthermore, in two pages of discussion of the statutory acceleration rights, the *Kommentarii* does not indicate that parties may provide other grounds for acceleration.[194] Rather, the language used by the Russian commentary suggests the statutory grounds are exclusive.[195] The Law on Mortgage

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190. Theoretically, one could argue that the effect of an acceleration clause under the Civil Code is simply to make the entire debt become the "portion overdue." This argument would suggest that the Civil Code describes redemption rights both in the context of fulfilling the entire debt as well as the overdue portion, simply in order to represent that when only a portion of the debt is contractually due, the debtor need not tender the entire amount. The prohibition against agreements limiting this right should be construed as protecting redemption rights in general, which is not inconsistent with the UCC's insistence that waiver of redemption rights occur post default only. *See* U.C.C. § 9-506 (1995). However, the Civil Code's specific treatment of acceleration rights ostensibly limits their use and effectively counters the above argument. *See infra* notes 192-95 and accompanying text.

191. *See* Frenkel, *supra* note 12, at 13. Frenkel suggests including a liquidated damages clause in the security agreement, which would be triggered if the debtor were to exercise this right. *See id.* at 14. (Recall that collateral automatically covers liquidated damages under the Civil Code. *See supra* note 131 and accompanying text.) However, since any agreement limiting the right to pay only the overdue portion is invalid, a liquidated damages clause may not be enforceable in this context. Such a clause would impose additional obligations to be satisfied by the collateral and would effectively limit a debtor's ability to stay enforcement by paying only that part which is overdue.

192. A creditor may "demand the performance" of the underlying obligation before due, if: (1) in a way contrary to the security agreement, the collateral is not in the possession of the debtor; (2) the debtor has impermissibly substituted other collateral; or (3) there is loss of the collateral and the debtor has not replaced it. GK RF, *supra* note 18, art. 351(1).

A creditor may "demand the performance" of the underlying obligation before it is due, and if not satisfied, he may levy execution against the collateral if: (1) the debtor violates the Articles concerning subsequent security interests; (2) the debtor violates the Articles concerning proper maintenance of the collateral; or (3) the debtor violates the Articles concerning use and disposition of the collateral. *Id.* art. 351(2).

193. *See, e.g.*, *id.* arts. 337, 338, 340, 341, 345, 346, 355.

194. *See* KOMMENTARII, *supra* note 146, at 556-57.

195. "[Article 351(1)] gives the [secured creditor] the right to demand early performance of primary obligations in three different situations." *Id.* at 556. "[Article 351(2)] gives the [secured

reinforces the impression that acceleration rights are limited to those specified by statute. Without indicating the parties may agree otherwise, the law specifies three instances where a creditor may demand early performance of an obligation secured by immovable property.[196] Such a limited right to accelerate, combined with a debtor's right to fulfill only the overdue portion of a debt, imposes substantial cost. A creditor could find it necessary to return to court upon nonpayment of each individual installment. The debtor could respond to each of these attempts to enforce the security interest against the collateral by producing only the latest overdue payment, which might cover the creditor's corresponding legal fees.

6. Disposition of Collateral.—The Civil Code limits disposition to public auction. Collateral against which "execution is levied" shall be sold by public auction, unless a different procedure has been established by law.[197] The creditor has the right to receive any deficiency from the debtor's other property, although without priority.[198] Any amount received in excess of the creditor's claim is returned to the debtor.[199] The Civil Code's deficiency and excess provisions are substantively the same as those in the UCC and the Model Law.[200] The public auction requirement, however, is unique to the Civil Code. This feature alone has the potential to "seriously undermine creditor comfort" with Russia's secured credit laws.[201] The Law on Mortgage provides one limited

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creditor] not only the right to demand early performance of primary obligations, but also the subsidiary right to effect recovery through the collateral. It consolidates three different situations . . . ." *Id.* at 557.

196. *See* Law on Mortgage, *supra* note 37, art. 50.4. First, the mortgage holder can accelerate an obligation in response to certain acts or omissions by the debtor that threaten loss or damage to the mortgaged property. *See id.* art. 35. Second, early foreclosure is allowed when the debtor violates procedures concerning the sale of collateral. *See id.* art. 39. Third, the mortgage holder can demand accelerated payment if the government takes the collateral for one of several reasons. *See id.* art. 41.

197. GK RF, *supra* note 18, art. 350(1).

198. *Id.* art. 350(5).

199. *Id.* art. 350(6).

200. *See* U.C.C. § 9-504(2) (1995) (requiring the creditor to account to the debtor for any surplus and, unless agreed otherwise, holding the debtor liable for any deficiency); MODEL LAW ON SECURED TRANSACTIONS art. 28.3.6 (1994) (providing for distribution of any surplus to the debtor); *id.* art. 7.5 (authorizing the parties to assign the risk of a deficiency in the security agreement). The Model Law utilizes an interesting feature, called a proceeds depositary, to disperse the proceeds of collateral. Once a creditor has disposed of collateral in a manner of his choosing, he must appoint someone to receive and properly disperse the proceeds of the sale. *See id.* art. 27.1 & cmt. The proceeds depositary, which must be independent of the creditor and possess certain professional qualifications, should "promptly" identify the amount and priority of all interests in the proceeds of the collateral. *See id.* arts. 27.2, 27.5. Within 30 days of the later of receipt of the proceeds or establishing a final list of interests, the proceeds depositary should distribute the proceeds according to priority, but first in payment of his own fees and costs. *See id.* arts. 28.1, 28.3.

201. *See* Kilborn, *supra* note 23, at 257. Kilborn convincingly illustrates that the Civil Code's public auction provision can be plausibly interpreted only as an exclusive means of disposition, not

circumstance in which immovable collateral may be disposed of without public auction. Where a debtor is willing to enter a post-default agreement with the creditor authorizing foreclosure without recourse to court action,[202] the parties may specify in the agreement other means for sale of the collateral to a third party or acquisition by the creditor.[203] As discussed earlier, a defaulted debtor may well be unwilling to forego the protection and delay available in a court proceeding.[204]

In contrast, the UCC and the Model Law provide secured creditors with the flexibility and the obligation to dispose of collateral in a way that makes commercial sense. Under Article 9 of the UCC, "[d]isposition of the collateral may be by public or private proceedings and may be made by way of one or more contracts. Sale or other disposition may be as a unit or in parcels and at any time and place and on any terms . . . ."[205] The UCC balances this broad authority with an obligation designed to maximize return on the collateral: "[E]very aspect of the disposition including the method, manner, time, place and terms must be commercially reasonable."[206] Although it authorizes any commercially reasonable disposition, the UCC encourages the sale of collateral through private sale.[207] As the Official Comments point out, "private sale through commercial channels will [frequently] result in the higher realization on collateral for the benefit of all parties."[208]

Under the Model Law secured creditors may dispose of collateral according to their discretion. Disposition may be made "by way of sale in such manner as [the creditor] considers appropriate which may include transfer by private agreement on the open market or at public or private auction."[209] The Model Law Commentary recognizes that the "best" manner of disposition will vary with the particular circumstances, and therefore the article is "intentionally broad."[210] Similar to the UCC, the Model Law obligates creditors to "endeavor to realise a fair price" for the collateral.[211] Additionally, a creditor must wait sixty days after

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subject to contrary agreement of the parties. *See id.* at 262 n.26 (concluding that "given the historical formalism of the Russian judiciary, Russian judges will likely interpret the [public auction provision] literally and exclusively").

202. *See supra* note 145 and accompanying text.

203. *See* Law on Mortgage, *supra* note 37, art. 55.3(2). However, the agreement may not allow the secured creditor to acquire the subject of the mortgage where "a land plot" serves as collateral. *Id.*

204. *See supra* note 176 and accompanying text.

205. U.C.C. § 9-504(3) (1995).

206. *Id.* § 9-504(3).

207. *See id.* § 9-504 cmt. 1.

208. *Id.*

209. MODEL LAW ON SECURED TRANSACTIONS art. 24.4. (1994).

210. *Id.* art. 24.4 cmt.

211. *Id.* art. 24.3.1. The Model Law provides two general standards by which a creditor's efforts should be evaluated. Where there is a recognized market for a particular type of collateral, the

delivering the enforcement notice before disposing of the collateral.[212] This limited delay is designed to afford the debtor or other interested parties the opportunity to contest the creditor's rights in court.[213]

By effectively requiring disposition of collateral by public auction, the Civil Code deals another blow to the value of a secured creditor's interest. Disposition at public auction is likely to substantially limit what and when a creditor can ultimately recover from the collateral. As recognized by the UCC and the Model Law, private sales allow creditors to adjust to the particular circumstances and type of collateral and therefore will often realize a greater recovery. Plausibly, the public auction restriction may be motivated by a desire to protect debtors from potential abuse by secured creditors.[214] However, restricting disposition to public auction does not effectively accomplish this goal,[215] but rather significantly impairs the viability of secured financing by seriously limiting what creditors ultimately recover from collateral. Debtors and other interested parties could be better protected, and secured finance better served, by applying a commercial reasonableness obligation, possibly supplemented by a limited waiting period like that in the Model Law. These measures adequately protect the debtor and other interested parties without drastic injury to the value of security interests.

IV. Related Legal and Economic Factors

This Part generally discusses related laws and economic factors that directly affect secured financing and the value of security interests in Russia. Four concerns are especially relevant to secured financing. First, Russian banking and tax laws add substantial cost and difficulty to lending transactions. Second, the prevalence of tax evasion in Russia puts collateral at considerable risk of government seizure. Third, Russian bankruptcy laws create uncertainty about what secured creditors can ultimately recover

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standard is that of a "prudent person operating in that market." *Id.* art. 24.5.1. In all other cases, the standard is what would be "expected in the circumstances of a prudent person." *Id.* art. 24.5.2.

212. *Id.* art. 24.1 & cmt. During the 60 days the creditor may take measures necessary to protect the collateral. *See id.*

213. *See id.* However, merely initiating court proceedings does not stop the 60-day clock from running. A creditor may dispose of the collateral after 60 days unless a court declares the enforcement notice invalid or utilizes its limited power to issue a temporary stay. *See supra* note 177; MODEL LAW ON SECURED TRANSACTIONS art. 29.1 (1994).

214. *See* Kilborn, *supra* note 23, at 273 ("Lawmakers feel that the creditor occupies a position of advantage over the debtor from the beginning and that, in order to level the playing field, the law must make every provision for controlling possible abuse by the creditor.").

215. It has been argued that the public auction limitation can actually disadvantage debtors by facilitating abuse by creditors. *See id.* at 278, 278-79 (observing that the public auction requirement enables creditors to "appropriate the devalued collateral and realize a premium by reselling the collateral later," leaving the debtor liable for deficiency based on the auction sale price).

in bankruptcy proceedings. Finally, security interests to foreign creditors may require government approval.

A. Tax Laws and Banking Regulations

Several features of Russian banking and tax laws add difficulty and expense to secured financing transactions and thereby discourage lending. First, particular tax laws substantially augment the cost of certain types of lending. For example, interest payments on nonbank loans are subject to Russia's twenty percent value-added tax (VAT),[216] consequently raising the cost of borrowing. This is also problematic for borrowers because they must make VAT payments on the interest at the time the interest is paid, which is often prior to receiving any revenue and offsetting VAT payments from sales.[217] The potential problem for borrowers is essentially cash-flow difficulty. A borrower must pay VAT to its lender with each interest payment, which may very well be prior to realizing any return on the use of the borrowed capital. Therefore, the borrower essentially must borrow additional funds in order to pay the VAT on the interest, also increasing the cost of the loan. In response to the added cost and complications of VAT, many companies have turned to bank financing at higher nominal rates or created convoluted structures to avoid being subject to VAT, measures which themselves add cost and delay.[218] Additionally, interest on fixed-asset financing is not tax deductible.[219] This of course makes it more expensive to acquire assets with debt financing, thus making equity more attractive and potentially limiting the acquisition of fixed assets.

Second, Russian Central Bank regulations prohibit hard currency loans with maturities in excess of 180 days to Russian companies without Central

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216. *See* Telephone Interview with Scott C. Antel, Tax Partner, Arthur Andersen (Mar. 5, 1998).

In brief, Russia's VAT system requires VAT payments to be made currently, *i.e.*, monthly. *See* Law on Value Added Tax of December 6, 1991, as amended, art. 8(1), *in* RUSSIA & THE REPUBLICS LEGAL MATERIALS: RUSSIAN FEDERATION (John N. Hazard & Vratislav Pechota eds., 1998). The amount of VAT payable to the government by a particular company is calculated by offsetting the amount of VAT the company paid on its purchases of goods and services subject to VAT against the amount of VAT collected by that company from its sales of goods and services subject to VAT. *Id.* art. 7(2). If a company has collected more in VAT than it has paid out, it must pay the government. On the other hand, if a company has paid more than it has collected, it has a VAT credit.

217. *See id.* When a Russian enterprise makes interest payments to a foreign nonbank entity (*i.e.*, one without a tax presence in Russia), the Russian enterprise must withhold the VAT from the amount paid. *See VAT System in Russia*, 1996 BUSINESS TAX GUIDE TO THE RUSSIAN FEDERATION, (Coopers & Lybrand), Sept. 20, 1996, *available at* <http://www.mondaq.com/docs/mainbody/1002953.html>. There is, however, a detailed counterargument that VAT should not be withheld from interest payments abroad. *See* E-mail from Vladimir Gidirim, Senior Tax Consultant, Arthur Andersen, Moscow, Russia, to author (Mar. 13, 1999) (on file with the *Texas Law Review*) (noting a clarification by the Ministry of Finance which supports the counterargument but has no legal force).

218. *See* Telephone Interview with Robin M. Bergen, Attorney, Cleary, Gottlieb, Steen & Hamilton, Washington, D.C. (Mar. 30, 1999).

219. *See* Telephone Interview with Scott C. Antel, *supra* note 216.

Bank approval.[220] Secured loans must be licensed under a rigorous Central Bank approval process.[221] Additionally, recent legislation requires Central Bank approval if the export of goods from Russia is to occur more than 90 days after prepayment has been made to a Russian company (previously the time period had been 180 days).[222] Applying for a Central Bank license is a burdensome, time-consuming process, and is not always successful.[223] During the lengthy application process companies may not be able to obtain financing or may have to rely on expensive bridge-financing in the interim, which itself takes time to arrange.[224] The relative difficulty and expense involved with loans with maturities exceeding 180 days and prepayment exceeding 90 days makes long-term financing much less available, consequently impairing the economic viability of projects that depend on such financing, such as start-up businesses, construction, and real estate purchases. The resident director of the IRIS-Russia Project in 1994 commented that "[t]his commercial failure presents a clear impediment to the advancement of Russian economic reform . . . . [T]here will be no new entrepreneurial activity, production facilities, or investment, beyond what can be accomplished in three-month blocks."[225]

Businesses prohibited by the license requirement from acquiring long-term loans have responded in a variety of ways. One response has been to establish revolving short-term credit arrangements, in which, for example, every three months a new loan is issued by the same lender to "pay off" the preceding three-month loan.[226] Another response, utilized by Russian companies seeking a loan from parent companies outside Russia, has been to arrange a complicated, expensive, and commercially awkward surety, which requires cash collateral in the amount of the loan plus interest.[227]

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220. *See Russian Hard Currency Regulations: Developments During the Last Year*, THE RUSSIA DIGEST (Akin, Gump, Strauss, Hauer & Feld, L.L.P.), Fall 1998, at 6, 7 (discussing Russian Central Bank Regulation No. 527, adopted October 6, 1997).

221. *Id.*

222. *See Currency Control Changes*, TAX ALERT (Arthur Andersen), Jan. 18, 1999, at 2 (discussing the Law on Top-Priority Measures in the Sphere of Budgetary and Tax Policy, effective December 31, 1998). The law fails to specify whether the change applies to contracts existing prior to the law's enactment. *Id.* at 3.

223. *See* Telephone Interview with Scott C. Antel, *supra* note 216 (characterizing the application process as painfully difficult and slowed by procedural delay); E-mail from James D. Krejci, Chief Financial Officer, TV3 Russia, to author (Feb. 13, 1998) (on file with the *Texas Law Review*) (relating that acquiring a license is "often next to impossible"). Krejci also indicated that his company might not have acquired its Central Bank license, had they not utilized high-level government contacts. *See id.*

224. *See* Telephone Interview with Robin M. Bergen, *supra* note 218.

225. Blumenfeld, *supra* note 89, at 15.

226. *See* Telephone Interview with Scott C. Antel, *supra* note 216.

227. *See* E-mail from James D. Krejci, *supra* note 223. Under such an arrangement a foreign parent company, *e.g.*, a U.S. corporation, will deposit a cash pledge in an international bank, located

These peculiar, economically inefficient arrangements create the potential for official sanction,[228] recurrent transaction costs, frequently shifting interest rates, and injury to credit history, thereby imposing additional cost, difficulty, and risk to lending transactions.

B. Government Seizure of Collateral for Violation of Law

Under the Civil Code, a security interest terminates when the debtor loses rights in the collateral as a sanction for a crime or other violation of law.[229] This provision, in combination with Russia's tax environment, places a secured creditor's collateral at significant risk. Tax evasion is widespread in Russia.[230] Although tax collection has been minimal and unsophisticated,[231] significant reforms have been directed at improving collection efforts.[232] Bold, if symbolic, action has accompanied these reforms. For example, in the summer of 1998 tax authorities raided

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for instance in New York. The New York bank then arranges through its Moscow branch a loan to the Russian subsidiary of the U.S. corporation, which is secured by the deposit in New York. *See id.* One possibility arising from such an arrangement is that the Russian subsidiary could intentionally default on the loan from the bank's Moscow branch, thus leaving the Russian subsidiary with long-term capital and the bank with the deposit in New York.

228. The Central Bank is authorized to seize funds loaned in excess of 180 days and impose a 100% penalty. *See* Telephone Interview with Scott C. Antel, *supra* note 216. In practice, enforcement measures have not been that drastic. *See id.* Enforcement has been limited in large part by the minimal contact the Central Bank authorities have with the commercial enterprises required to comply with the regulations. *See* Telephone Interview with Scott C. Antel, Tax Partner, Arthur Andersen, Moscow, Russia (Feb. 22, 1999). However, a recent proposal by the Central Bank, which would delegate authority for enforcement of currency regulations to the tax authorities, could significantly augment the frequency and effectiveness of enforcement. *Id.* In performing their auditing responsibilities, tax officials are in frequent contact with commercial enterprises. *Id.* Such regular oversight by government officials responsible for enforcing the currency regulations could lead to a dramatic rise in enforcement. *Id.*

229. GK RF, *supra* note 18, art. 354(2).

230. *See* Newcity, *supra* note 144, at 42 (characterizing tax evasion as a "national habit" in Russia); Myuri Volgin, *Widespread Tax Fraud Uncovered*, BUSINESS INTELLIGENCE BULLETIN - MOSCOW, May 16, 1996 (reporting that "numerous" instances of tax violations were revealed by renewed enforcement efforts in early 1996).

231. *See Russian Firms Prepare for Boom Time*, INT'L FIN. L. REV., Mar. 1998, at 33, 34 (citing 1997 IMF findings of poor tax collection in Russia); *Editorial Note* to Decree on Main Lines of Tax Reform in the Russian Federation and Measures to Tighten Up Tax and Payments Discipline, Russian Federation President's Decree No. 685 of May 8, 1996, Sobr. Zakonod. RF, 1996, No. 20, Item 2326 (W.E. Butler ed.) (noting the need for improved tax collection).

232. *See* Decree on Main Lines of Tax Reform in the Russian Federation and Measures to Tighten Up Tax and Payments Discipline, Russian Federation President's Decree No. 685 of May 8, 1996, Sobr. Zakonod. RF, 1996, No. 20, Item 2326 (establishing measures designed to "[ensure] full and timely collection of taxes . . . and . . . tightening up tax and payments discipline"); *Russian Firms Prepare for Boom Time*, *supra* note 231, at 34 (reporting renewed efforts by the Russian government to introduce a modern tax system in hopes of improving tax collection); Betsy McKay, *Yeltsin Backs Crackdown on Taxes; Russian Parliament Endorses Overhaul*, WALL ST. J., July 6, 1998, at A12 (noting that the Russian parliament passed critical portions of a new tax code designed in part to augment tax collection).

Gazprom, Russia's largest corporation, threatening to seize assets in response to Gazprom's tax delinquency.[233] A secured creditor must therefore consider the possibility that the collateral securing his loan could be seized if his debtor is audited by the tax inspector. Although in this instance the creditor may accelerate the outstanding balance,[234] this provides little comfort or guarantee that the debtor will have additional resources to satisfy the debt.

C. Bankruptcy

Bankruptcy laws are a crucial counterpart to secured credit laws. In January of 1998, Russia established a new bankruptcy law.[235] Although a full explication of the new Russian bankruptcy law is beyond the scope of this Note, three elements in particular merit discussion here because they pose potential threats to secured claims. First, as in the prior bankruptcy law, the claims of secured creditors are satisfied only after tort claimants and back wages are paid.[236] Second, under certain circumstances, liquidation of large enterprises can be delayed for up to ten years.[237] Third, and largely because tort claims and unpaid wages have higher priority, secured creditors are not entitled to their particular collateral, but rather have a claim to the extent of their security interest in the debtor's remaining assets.[238] Each of these three provisions operates to devalue security interests by creating uncertainty about what and when a secured creditor can collect from his collateral. As a result, secured creditors may insist upon collateral well in excess of the amount loaned or require collateral outside of Russia, both of which would lead to higher costs and less flexibility for the debtor.

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233. *See* McKay, *supra* note 232. *See also Moscow's Tough Tax Collector Aims to Make Deadbeats Squirm*, WALL ST. J., July 10, 1998, at A10 (providing an interview concerning tax collection with then Finance Minister, Boris Fyodorov). Fyodorov mentions that "[a]ll major culprits," and specifically "all oil companies are targeted" for increased enforcement measures. *Id.* "'When you are fighting in the public school with bullies,' [Fyodorov] says of his tangle with Gazprom, 'you select the biggest one and punch him in the nose, and after that, others behave much better.'" *Id.*

234. *See* GK RF, *supra* note 18, art. 354(2).

235. *See* Federal Law No. 6-FZ of Jan. 8, 1998, On Insolvency (Bankruptcy). The law provides an effective date of January 1, 1998. *See id.* art. 185.1. For further discussion of Russia's new bankruptcy law, see generally *Russia's New Bankruptcy Law Workable But Flawed*, 31 No. 26 BANKR. CT. DEC. (LRP), Feb. 24, 1998, at 7; *Russia: New Federal Law to Take Force March 1*, INT'L BUS. & FIN. DAILY (BNA), Feb. 26, 1998, at d10.

236. *See id.* art. 106.

237. *See id.* art. 135.3 (providing for an extension of up to ten years of external management of "town-forming" entities).

238. *See id.* arts. 109.3, 112, 114.

D. *Ministry of Finance Approval*

Security agreements involving Western lenders or debtors may be subject to special registration not mentioned in the Civil Code or Law on Pledge. According to William Frenkel, an attorney involved with work in Russia and a frequent commentator on the Russian legal environment, security transactions with foreign involvement are "said" to be subject to registration at the Ministry of Finance.[239] As experience working in Russia illustrates, much of the "law" in Russia is essentially legal rumor, usually stemming from unpublished assertions made by state officials.

This uncertainty alone imposes risk. If registration with the Ministry of Finance is in fact required, complying with the registration process would create additional costs for creditors. The registration requirement could also further limit a creditor's foreclosure rights. The Civil Code restricts enforcement of security interests to court action when "consent or authorization" from "another person or agency" was required to execute the security agreement.[240] A registration requirement might also suggest that the Ministry of Finance intends to further regulate security transactions involving foreigners, thus creating further costs and limitations.

V. Policy Concerns

As illustrated in Parts III and IV of this Note, Russia's secured credit and related laws create numerous ambiguities, difficulties, and inefficient incentives. Although this criticism was made by way of comparison to the UCC and the EBRD's Model Law, the important realization is not that Russia's Civil Code varies from the established Western systems, but rather that the Russian system fails to adequately meet the needs of the Russian economy. Security interests in Russia are expensive to acquire, cannot be verified as first in time, and are difficult to enforce. Consequently, credit in Russia is expensive and often unavailable. As the resident director of the IRIS-Russia Project has observed, "[w]hat lending does occur . . . is inadequate, inefficient, and expensive."[241] Similarly, the World Bank's country director for Russia commented that "[a]mong the most worrisome aspects of Russia's economy is the persistence of high domestic interest rates, which raise questions about growth prospects."[242] This observation has been consistently echoed by those involved with work in Russia.[243]

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239. Frenkel, *supra* note 12, at 13.

240. GK RF, *supra* note 18, art. 349(3)(1).

241. Blumenfeld, *supra* note 89, at 15.

242. *See* Diana I. Gregg, *Russia: Senior World Bank Official Questions Continued Stability of Russian Economy*, INT'L BUS. & FIN. DAILY (BNA), Apr. 9, 1998, *available in* Westlaw, 4/9/98 IBFD d9 (quoting Michael Carter, World Bank country director for Russia).

243. *See* E-mail from James D. Krejci, *supra* note 223 (referring to the existence of a "credit crunch" in Russia); Telephone Interview with William D. Morris, *supra* note 59 (noting the conspicuous absence of debt financing in Russia); Telephone Interview with Scott C. Antel, *supra* note

Russia's largest and most attractive enterprises, such as those in the oil and gas sector, have been able to acquire significant equity investments and thus avoid relying on Russia's secured credit laws. Lured by the high returns previously available in the Russian stock market, Westerners invested heavily in equity, concentrating mostly on a select group of large utilities and oil and gas companies.[244] Equity in twenty-eight of Russia's largest companies has even been made available through the New York Stock Exchange.[245] In contrast, no Russian start-up company has ever raised capital on the Russian stock market.[246]

Similarly, prior to the August 1998 financial crisis, investors also provided significant amounts of capital to the Russian government and large businesses in the form of loans.[247] Much of the debt financing available in Russia was unsecured, such as government treasury bills and eurobonds.[248] In order to entice lenders, unsecured Russian debt offered incredibly high interest rates, as in the case of ruble-denominated treasury bills, or was denominated in hard currency, as in the case of eurobonds.[249] The secured lending transactions that have occurred,

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216 (confirming the difficulty of acquiring credit in Russia); E-mail from Steven N. Robinson, Partner, Cleary, Gottlieb, Steen & Hamilton, to author (Jan. 13, 1998) (on file with the *Texas Law Review*) (suggesting that the legal difficulties in acquiring security interests have limited project financing).

244. *See* Steve Liesman, *Russia: It Would Be Tempting to Ignore Russia. But Its Performance—and Potential—Makes That Difficult*, WALL ST. J., June 26, 1997, at R15 (noting substantial investor interest in Russia, despite "cliffhanging" risk). The Russian stock market realized gains of 63% in the first half of 1997 and 129% in 1996. *See id.* In June of 1997, market capitalization was $65 billion, and was expected to rise to $200 or $250 billion in the next three to four years. *See id.* The Russian stock market reached its zenith in October of 1997, at which time it was described as "the world's best performing emerging market." *See* Mark Whitehouse, *In Russia, Falling Stocks Don't Hit Home: Market Experiment Was Mainly a Foreign Affair*, WALL ST. J., Sept. 9, 1998, at A18. Investment activity was primarily concentrated on select monopolists and exporters, including Lukoil, Unified Energy Systems, Rostelekom, and Moscow City Telephone Network. *See* Liesman, *supra*, at R15. Even before the Civil Code was passed, "savvy" investors were not deterred by the difficult legal conditions, investing an estimated $500 million per month. Lieberman, *supra* note 16, at C10. By the spring of 1998, however, the Russian stock market had started its decline as the "cliffhanging" risks began to materialize. In April the Russian Trading System Index was down 22% for the year. *See* Sara Webb & Michael R. Sesit, *Russian Stocks: Good Choice or Roulette?*, WALL ST. J., Apr. 13, 1998, at C1. By August the market had fallen over 70% for the year. *See* Mark Whitehouse et al., *Bear Tracks: In a Financial Gamble, Russia Lets Ruble Fall, Stalls Debt Repayment*, WALL ST. J., Aug. 18, 1998, at A1.

245. *See* Joseph Kahn & Timothy L. O'Brien, *For Russia and Its U.S. Bankers, Match Wasn't Made in Heaven*, N.Y. TIMES, Oct. 18, 1998, at A1 (reporting the availability through the New York Stock Exchange of shares in Russian companies, including several banks and energy companies, some industrial concerns, and a department store).

246. *See* Whitehouse, *supra* note 244, at A18.

247. *See* Kahn & O'Brien, *supra* note 245, at A1 (describing the lending practices of investment banks in the "roaring" Russian bond market).

248. *See* Whitehouse et al., *supra* note 244, at A1. In August, 1998, Russia's total domestic treasury debt totaled $60 billion, $40 billion of which was to mature by the end of 1999. *Id.* Russia's sovereign debt denominated in hard currency was an estimated $135 billion. *Id.*

249. *See* John Kenyon, *Yields Soar as Market Hits Low*, MOSCOW TIMES, Aug. 8, 1998, *available at* <http://www.moscowtimes.ru/archives/issues/1998/Aug/08/story19.html> (reporting yields of

principally in the form of loans from large, sophisticated Western investors to Russian energy companies secured with earnings from exports of oil or natural gas, have typically avoided Russia's secured credit laws altogether.[250] In contrast to the high yields that attracted investors to the equity and unsecured bond markets, the reliable security furnished by such receivables-backed arrangements reduces the risk involved in the transaction and enables investors to lend at lower rates.[251] Avoiding Russia's secured credit laws appears to be a key element in achieving the necessary confidence in the security mechanism. The Gazprom arrangement, for example, required the European account debtors to pay the Gazprom receivables into a trust established under United Kingdom law.[252] Such an arrangement, often referred to as a "lock box," provides "airtight security" by requiring the Russian borrower's account debtors to place payments in an escrow account outside of Russia.[253]

Unlike the government and large companies, Russian entrepreneurs and small businesses are unable to pay exorbitant interest rates or take advantage of sophisticated secured financing techniques. The burden, then, of Russia's inadequate secured credit laws is particularly felt by entrepreneurs and small businesses, and consequently raises serious public policy concerns for the Russian government. Despite the significant amount of Western investment in Russia, affordable credit has remained largely unavailable to entrepreneurs and small businesses,[254] consequently stifling

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over 55% on one to three month treasury bills and yields of over 94% on nine to twelve month bills); Whitehouse et al., *supra* note 244, at A1 (reporting yields of over 200% on Russian government bonds in mid-August, 1998); Kahn & O'Brien, *supra* note 245, at A1 (defining eurobond as "denominated, or payable, in dollars or other hard currencies and sold to investors outside the country of the issuer").

250. Several such receivables-backed deals have garnered significant media attention. For example, in November of 1997, the Russian natural gas company Gazprom initiated a $3 billion, eight year credit facility arranged by Dresdner Kleinwort Benson and Credit Lyonnais which was secured by Gazprom's receivables from long-term gas supply contracts with several European gas companies. *See* Marcel Michelson, *Gazprom Signs $3B Financing Facility*, MOSCOW TIMES, Nov. 6, 1997, *available at* <http://www.moscowtimes.ru/archives/issues/1997/Nov/06/story37.html>. In late 1997, the Russian oil company Yukos provided export earnings as collateral on a loan arranged by Goldman, Sachs & Company. *See* Kahn & O'Brien, *supra* note 245, at A1. Russian oil companies Lukoil, Komitek, and Tatneft have also used proceeds from oil exports to secure debt financing. *See* Jeanne Whalen, *Yuksi Oil Defaults on Loan Repayment*, MOSCOW TIMES, Apr. 29, 1998, *available at* <http://www.moscowtimes.ru/archives/issues/1998/Apr/29/story18.html>; Gary Peach, *Tatneft Avoids Eurobond Default*, MOSCOW TIMES, Nov. 21, 1998, *available at* <http://www.moscowtimes.ru/archives/issues/1998/Nov/21/story23.html>.

251. For instance, in the context of the Gazprom credit facility, the Chairman of Credit Lyonnais explained that "without the receivables as a security—which cuts the Russian country risk to the deal—Gazprom would have had to pay a premium of 400 to 500 basis points and would not have been able to get an eight-year maturity." Michelson, *supra* note 250 (paraphrasing Credit Lyonnais Chairman Jean Peyrelevade).

252. *See id.* (citing Credit Lyonnais).

253. *See* Telephone Interview with Howard B. Hacker, Attorney, Akin, Gump, Strauss, Hauer & Feld, L.L.P. (Nov. 20, 1997).

254. This observation has been reiterated frequently in the press and by those involved in work in Russia. *See, e.g.*, Blumenfeld, *supra* note 89, at 14 ("Russian businesses are unable to obtain credit

their development.[255] In Russia the estimated contribution to the gross domestic product by small businesses is ten percent, whereas in most developed countries the percentage is much higher, around seventy percent.[256] The rate of establishment of new businesses in Russia is well behind that of central European countries.[257] The lack of development in this sector in turn impedes the development of a large middle class and its accompanying tax base, which are crucial to a successful political and economic future for Russia. In the words of the Russian government, small businesses are important for both economic and political reasons: "Small-business development means creation of a middle class of proprietors that is the backbone of economic systems throughout the world."[258]

Russia's current financial crisis, evidenced by the government's forced debt restructuring and the devaluation of the ruble in August of 1998,[259] both augments and highlights the importance of reforming Russia's secured credit laws. John Odling-Smee, director of Russia affairs at the International Monetary Fund, commented that the availability of public financial support and private investment from Western countries convinced many Russian decision makers that economic reforms "could be abandoned altogether."[260] The events in August of 1998, however, severely dampened, if not extinguished the Western investment community's interest in supplying Russia with additional capital for the foreseeable future.[261]

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domestically to finance new entrepreneurial activity."); Yelena Bragina, *Small Business Blues*, MOSCOW TIMES, Feb. 6, 1998, *available at* <http://www.moscowtimes.ru/archives/issues/1998/Feb/06/story30.html> ("Small entrepreneurs have little hope of obtaining bank credits."); *Ivan of All Trades*, ECONOMIST, Nov. 7, 1998, at 73 (noting that the businesses of many "talented and well-informed" Russians "suffocate," partly due to the lack of available capital).

255. *See* TRANSITION REPORT 1997, *supra* note 66, at 195 ("The number of officially registered small businesses remains at only around 1 million.").

256. *See* I. Dyomina, *Small Businesses Suffer Without Government*, BUS. INTELLIGENCE BULLETIN - MOSCOW, Nov. 30, 1995.

257. TRANSITION REPORT 1997, *supra* note 66, at 195.

258. *See* Michael Gulyayev, *Small-Business Agency Pledge*, MOSCOW TIMES, Aug. 16, 1995, *available at* <http://www.moscowtimes.ru/archives/issues/1995/Aug/16/story37.html> (quoting Vyacheslav Prokhorov, Chairman of the State Committee for the Promotion of Small Business).

259. *See generally* Whitehouse et al., *supra* note 244, at A1 (discussing the Russian government's announcement in August of the restructuring and devaluation); John van Schaik & Geoff Winestock, *If the Dam Bursts . . .*, MOSCOW TIMES, Aug. 25, 1998, *available at* <http://www.moscowtimes.ru/archives/issues/1998/Aug/25/story38.html> (describing Russia's financial difficulties in general and the crisis in the banking sector in particular).

260. Floriana Fossato, *1998 In Review: Russia's Economic Collapse*, RADIO FREE EUROPE/RADIO LIBERTY '98 REVIEW, *available at* <http://www.rferl.org/nca/features/1998/12/F.RU.981218145814.html> (quoting John Odling-Smee).

261. *See* Whitehouse et al., *supra* note 244, at A1 ("[T]he IMF and the West [have] refused for the first time to throw Russia a lifeline . . . ."); John Kenyon & Kirill Korukin, *Report: West Lost $100Bln in Russia*, MOSCOW TIMES, Sept. 9, 1998, *available at* <http://www.moscowtimes.ru/archives/issues/1998/Sep/09/story1.html> (quoting a financial strategist: "With the commercial debt default it is very unlikely Russia or a Russian entity will be able to borrow on the market"); van Schaik

Now, more than ever, Russia's future depends on Russia's politicians and businessmen: "These are the only folks with any real chance of fixing Russia."[262]

U.S. Deputy Secretary of State Strobe Talbott characterized the collapse of the Russian banking system as "an opportunity for the Russians to build, virtually from scratch, real banks that do real business, rather than just engage in speculation and arbitrage."[263] The failure of Russian banks to provide conventional commercial lending is frequently cited as a fundamental flaw of the Russian economy.[264] Reforming Russia's secured credit laws would be an important step in creating a traditional banking system to service Russian entrepreneurs and small businesses. "True conversion" to a market economy "is necessarily accompanied by, if not even conditioned upon, making available reliable and liberal legal instruments allowing enterprises to offer nonpossessory security for their debts."[265] Hopefully the observations made in this Note can provide at least a small contribution to this endeavor.

VI. Conclusion

Despite substantial improvement since the dissolution of the Soviet Union, Russia's secured credit laws still contain significant shortcomings and ambiguities. The rules and procedures for acquiring a valid security interest are expensive to comply with and fail to provide creditors with an adequate means of verifying first-in-time status. Enforcement rights are limited and ambiguous and usually will necessitate court action, which can be significantly delayed at the debtor's request, or even terminated if the debtor pays the overdue portion of the debt. Additionally, tax laws and banking regulations, the frequency of tax evasion, bankruptcy laws, and possible additional registration requirements for foreign lenders all contribute further injury to an already beleaguered security interest. The

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& Winestock, *supra* note 259 (reporting that rating agencies have "downgraded outstanding debt of Russian banks to 'not meaningful,' which pushed Russia into the category of countries like the Democratic Republic of Congo"); *id.* (concluding that it would take Russian banks "a few years" to shrug the stigma of "world pariah").

262. *Financing Capital Flight*, WALL ST. J., July 14, 1998, at A18.

263. Strobe Talbott, *Dealing with Russia in a Time of Troubles*, ECONOMIST, Nov. 21, 1998, at 54.

264. *See, e.g.*, Steve Liesman & Andrew Higgins, *Seven-Year Hitch: The Crunch Points: How Russia Staggered from There to Here*, WALL ST. J., Sept. 23, 1998, at A1 ("[I]nstead of lending money to entrepreneurs, banks used the government funds to make bets on the ruble and bond markets."); Kahn & O'Brien, *supra* note 245, at A1 ("Russia built a roaring bond market, but never developed a bricks-and-mortar banking system that provided loans the conventional way").

265. Drobnig, *supra* note 2, at 55. Ulrich Drobnig is the former Director of the Max-Planck-Institut for Foreign and Private International Law, General Editor of the International Encyclopedia of Comparative Law and actively involved in contributing to secured credit legislation in Eastern Europe. *Id.* at 53.

unfortunate result is that affordable credit is largely unavailable to entrepreneurs and small businesses. Enhancing the viability and availability of secured financing would provide significant support to entrepreneurs and small businesses, which are vital to a large middle class and its corresponding tax base, and a successful economic and political future for Russia.

—Brandon Bennett