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**Trade and Project Finance Security Interest with
particular reference to English and Russian Law**

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Summary

In the current rapidly evolving commercial environment a business, trade and commerce drive the increasing volumes of borrowings by companies from banks. Banks are, in principle, ready to grant such facilities, but subject to their own profitability needs as well as, in most circumstances, their need to limit their risk profile by taking security interests.

A security interest is a key element in commercial banking practice and has a special place among other legal concepts applicable to the relationship between a bank and its client. From the bank's point of view a security interest (depending on its nature) allows a lender to limit its risk profile on a client, thereby facilitating the provision of debt liquidity. The advantage to the borrower is then that it is able to conduct commercial activity that ordinary would not be able to conduct off its own balance sheet.

This paper focuses on three specific security interests: the pledge / charge, suretyship / the guarantee and assignment and the 'cession' of rights, as these three categories represent commonly used, widespread and convenient legal constructs in banking practice.

Similar legal concepts can be found in different jurisdictions, but for the purposes of this paper I have chosen to focus on an analysis of the laws of the Russian Federation and England. These two jurisdictions interest me because, as regards the Russian Federation, being a Russian qualified lawyer, I have a personal insight into its legal systems. English law is the predominant choice of law in commercial transactions and clearly plays an important role in international commerce.

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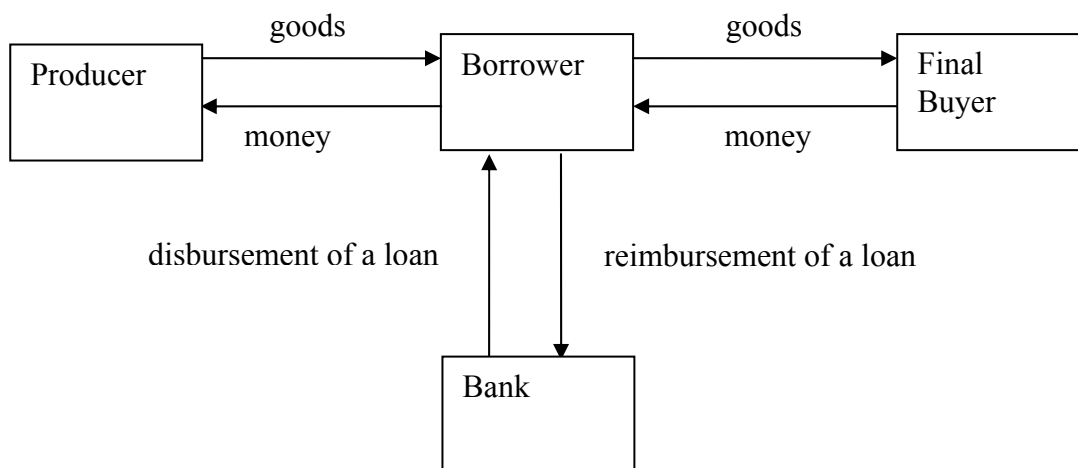
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Introduction

1. One of the main day-to-day functions of a bank is to make available debt finance to its customers in the form of loans. These might be loans to companies or individuals for a variety of purposes such as large long-term loans for business development through to small short-term loans for life's necessities, both of which may be secured or unsecured against a customer's (or a third party's) assets.

2. During my internship I worked in the legal department of the Corporate and Investment Banking (CIB) division of a major European bank which specialises in commodity trade finance, large-scale project finance and large corporate lending by participation in syndicated loan transactions. In this paper I will study certain key issues generally faced by the CIB division of a bank while granting those types of loans and I will focus, in particular, on the taking of security interests in support of such loans.

3. A very common structure for a commodity trade finance transaction is where a bank finances a trader (the borrower) so that it can purchase goods from a producer and then sell the goods later to a final buyer as shown in the diagram below.



4. This is a very general and simplified structure; in practice things are often more complex, with other parties involved, such as a guarantor or several other traders between the producer and the borrower or the borrower and the final buyer.

5. The procedure of granting a loan by a bank to a company is quite complex and needs thorough preparation. Typically, a client (representative of a company) will contact a front officer of a bank (Relationship Manager) asking for a loan and describing the transaction or project which needs financing. Then, having discussed the approximate conditions of the loan with the client, the bank officer prepares a written application (or a term sheet) to be presented to the credit committee of the bank for approval. Depending on the size of a transaction/project and the amount to be financed, different numbers of approvals of different levels may be required within the bank.

6. *“Granting a loan always presumes autonomous and deep analysis of the potential risks¹”*. Before granting a loan the bank must evaluate the purpose of the loan in the context of the underlying transaction or project, the economic situation globally, the financial position of the client, and its ability to pay back the loan (its standing or credit worthiness) and other factors. Having carried out this evaluation the bank decides the level of risk of non-reimbursement and how it might improve the risk of lending. *“Even some very risky deals can be concluded once all risks are correctly identified, and a decision is taken that the bank’s remuneration is adequate to cover the potential risks²”*.

7. Taking security is one of the main methods used by banks to protect themselves against losses connected to a client’s non-reimbursement of a loan and to encourage a client to repay a loan. After analysing the risks, a bank may require its client to grant it some security over assets in support of the loan in case of default of repayment by the client. There are different types of security interests available over different assets (and under different laws) and banks may demand from the client one or more of them in their sole discretion before providing a loan.

8. The term security *“embraces (a) rights enabling the creditor to look to a third party for satisfaction (such as guarantees and indemnities) and (b) rights enabling the creditor to have recourse to particular property in priority to other creditors³”* (such as mortgages, pledges or charges). The most common security that banks demand from their

¹ LOMBARDINI CARLO, *Droit Bancaire Suisse*, 2nd edition, Schulthess Editions Romandes, Genève 2008, p. 73.

² LOMBARDINI CARLO, *Op. cit.*, p. 73.

³ FULLER GEOFFREY, *Corporate Borrowing: Law and Practice*, Jordans Publishing Limited, Bristol 2006, p.67.

commodity trade finance clients are guarantees, assignments of rights and pledges (or charges).

9. After receiving approval from the credit committee(s) and finalisation of loan structuring discussions with a client, the legal department of the bank (or an external lawyer engaged for this task) starts to prepare different documents to formalize the procedure. Typically, the following documents are drafted and signed by the parties:

- (1) a loan agreement (or credit facility letter) to set out the terms and conditions of a loan,
- (2) different security documents, such as:
 - a) a bank guarantee or a corporate guarantee,
 - b) a pledge (or charge) agreement, or
 - c) an assignment of rights agreement.

10. A loan agreement (credit facility letter) is a main document which formalising the relationships between the bank and the borrower. It represents more elaborated and more formal form of term sheet, but making the parties responsible for their undertakings previewed in the agreement. The main conditions to be inserted to such agreement generally are: who is granting a loan, to whom it is granting such loan, an amount of the loan and when it should be reimbursed. If there should be a guarantee provided to the bank, in such guarantee shall be mentioned: who is granting the guarantee, to whom it is granting such guarantee, whose and what are the obligations guaranteed by such guarantee, limits of the guarantee and its expiry date (or when it ceases to exist). Under a pledge agreement the following conditions shall be stipulated: who is giving the pledge and to whom, whose and what are the obligations secured by such pledge, what constitutes a pledged asset and who will possess it. For an assignment of rights it is important to indicate: who assigns its rights and to whom, what are the rights to be assigned and after what event an assignee can use the assigned rights.

11. The security documents are very important for the bank and are a key part of the credit facility structure. To prepare such documents so that they result in valid and enforceable security, a lot of factors have to be verified from the legal point of view. Things to consider might be the following, for example: whether the property to be

pledged in favour of the bank is already encumbered; if there are any special procedures for registration of a pledge or mortgage; whether a guarantor has the capacity to give a guarantee in favour of the bank to secure the obligations of the borrower etc. These and certain other questions to be taken into consideration by the banks will be analysed in this paper for each type of security interest commonly used in banking practice.

12. The security interest and related issues will be analysed from both an English law and a Russian law perspective in this paper. English law is very important for international private law and for international commerce as it is, in practice, the law most commonly used in international contracts. Nowadays Russian law can be considered as an increasingly important law for international commerce as well, since the Russian market is growing quickly and so is very interesting to foreign investors and there are a lot of transactions with Russian companies worldwide. During my internship I worked with both English law and Russian law documents and had to consider many different issues under both these laws.

Chapter 1.

Pledge or charge in secured transactions

1.1 General issues

1.1.1 Definitions

13. The pledge (or charge) is one of the most important instruments, of law which secures a loan and support performance of the obligations by a borrower towards to a creditor. This instrument is well known and extensively used in banking practice worldwide. The essence of this instrument is the possibility of satisfying the creditor's claims from certain property defined in advance in case of non-performance by a borrower of its obligations towards a creditor.

14. The legal regulation of pledge in Russia is provided mainly in the Civil Code of Russian Federation (the "Civil Code RF") and the Federal Law № 2872-I "On Pledge"⁴ dated 29 May 1992, as amended (the "Pledge Law RF"). Federal Law № 102-FZ "On Mortgage (pledge of immovables)"⁵ dated 16 July 1998, as amended (the "Mortgage Law RF") establishes specific legal issues in relation to pledge of immovable property. However, there are inconsistencies between the Pledge Law RF and the Civil Code RF, which came into effect afterwards and has precedence over the Pledge Law RF. Consequently, the Pledge Law RF applies only to the extent it is not in conflict with the rules of the Civil Code RF.

15. The definition of a pledge under Russian law given in Article 334 of the Civil Code RF is as follows: *"By force of the law, the creditor benefiting from the obligation supported by the pledge (the pledgee), shall have the right of priority before the other creditors of the person, to whom this property belongs (the pledgor), in the case of the debtor's non-discharge of this obligation, to be satisfied from the value of the pledged property after the deductions, established by the law"*. This means that in case of repayment default by a borrower its obligations to a creditor will be satisfied from the pledged property.

⁴ Vedomosti Soveta Narodnih Deputatov and Verhovnogo Soveta of Russian Federation, 1992, № 23, Part 1239.

⁵ Sobranie Zakonodatelstva of Russian Federation, 1998, № 29, Part 3400.

16. The Russian law distinguishes between two types of pledge: the pledge of movable property (e.g. goods, equipment, transportation vehicles, money, securities, intangibles (i.e. contractual rights), etc.) and the pledge of immovable property (which is defined in Article 130 of the Civil Code RF and includes: (i) land plots, subsoil plots and separate water objects; (ii) other objects, which are immovables by nature because they are firmly connected with land (“immovables by nature”), i.e., forests, perennial plantations, buildings and constructions; (iii) objects that are subject to the regime of immovable property by virtue of law, i.e., ships and aircrafts, or space objects; (iv) other property can be recognised as "immovable" when stipulated by the law (i.e. lease rights)) – “mortgage”.

17. A movables pledge may be possessory or non-possessory⁶, but an immovable pledge can be only non-possessory. There is no requirement for the creditor to take possession of the movable asset or title documents to perfect the pledge but he may do so if he wishes. However, it is unusual for a creditor to do this and if the creditor takes possession of the asset it is important to note that:

- the pledgee will be liable for the maintenance and safekeeping of the pledged movable assets, unless the pledge agreement contemplates otherwise;
- a creditor may face environmental liability if the assets cause harm to the environment are in its possession and harm to the environment is caused by its wilful default or gross negligence;
- if a secured creditor derives income from the use of the pledged assets, it will have to pay all relevant taxes.

18. A pledge under Russian law basically arises by agreement of the parties. “*As a general rule, a pledge agreement should be concluded in writing*”⁷. The pledge rights arise on execution of a pledge agreement, or in the moment of transfer of the pledged assets for a possessory pledge.

19. In English law the concept of a pledge is somewhat different and nowadays is not so popular as in Russian law (and other countries of the continental system of law),

⁶ A person may choose to take a possessory pledge to secure the asset and have it to hand in the event that enforcement is required. It is unusual for companies to take possession but this may be used by individuals or for example pawn shops.

⁷ PAVLODSKII E.A., *Credit organisations in Russia: legal aspect*, Wolters Kluwer, Moscow 2006, p.192.

because it stipulates imperative “*delivery of possession of an asset to the creditor by way of security with ownership of the asset remaining with the borrower*”⁸. A pledge is created “*by a delivery of possession of the thing pledged, either actual or constructive*” – as specified by Wright LJ in *Official Assignee of Madras v Mercantile Bank of India*⁹. From the practical point of view such physical handing over of possession to the creditor is not always very convenient and reasonable, especially if the borrower needs to use the assets in its daily business. Furthermore, “*pledges can only be used with physical assets or documents of title representing assets, such as bearer shares or bills of lading*”¹⁰, which presents pledging of intangible assets.

20. Therefore, a different instrument for securing obligations under English law is more often utilized in banking practice – namely the charge. Contrary to a pledge, “*a charge conveys nothing and merely gives the chargee certain rights over the property as security for the loan*”¹¹. The essence of a charge is the obtaining of rights by the creditor over specific assets of the borrower (the chargor) and the ability to take and sell such assets in the event of default and apply its proceeds against the debt of the borrower. A charge, in contrast to a pledge, “*is created by an act by the debtor which evidences his intention to create a charge*”¹². In practice it is performed “*by the execution of a document by the debtor, in which event it is the document which creates the security*”¹³.

21. Another form of security used under English law is a mortgage, which involves a transfer of the ownership of an asset to a creditor (the mortgagee) with the implicit condition of such creditor retransferring ownership back to the mortgagor upon the repayment of the debt by the borrower. “*This transfer of title enhances the lender’s ability to realize the security and prevents the borrower from disposing of the asset*”¹⁴. In practice, a mortgage (like in Russian law) usually relates to land.

1.1.2 Requirements for the pledge/charge

⁸ PLC Finance, *Taking security: overview for corporate lawyers*, www.practicallaw.com.

⁹ [1935] AC 53, PC, p.58.

¹⁰ WRIGHT SUE, *International loan documentation*, Palgrave Macmillan, New York 2006, p. 272.

¹¹ FULLER GEOFFREY. *Op. cit.*, p. 68.

¹² CALNAN RICHARD, *Taking Security: Law and Practice*, Jordans Publishing Limited, Bristol 2006, p. 16.

¹³ CALNAN RICHARD, *Op. cit.*, p.16.

¹⁴ PLC Finance, *Taking security: overview for corporate lawyers*, www.practicallaw.com.

22. Under Russian Law in order for a pledgor to grant security over assets, the pledgor must own the assets to be pledged. The parties will then enter into a pledge agreement which must be in writing and specify the following conditions:

- subject of pledge (description of the pledged property);
- its value; and
- nature, amount and time for performance of the obligations secured by the pledge.

23. Failure to comply with these requirements renders the pledge void.

24. A pledge (possessory or non-possessory) does not require registration in any state register. However, the pledgor must maintain a pledge book, an internal record of all pledges granted by it. The pledge book must be available for public inspection. A failure by the pledgor to maintain the pledge book does not affect the validity of the pledge, however the pledgor will be liable for any damages caused by such failure. Contrary to a pledge for a mortgage the registration is obligatory condition and non-registered mortgage will be invalid.

25. As mentioned above, under English law, the most important requirement for a pledge to become effective is the transfer of possession to the pledgee (whether actual or constructive). Generally under the Bills of Sale Acts 1878-1891 or under the Companies Act 1985 there are no registration requirements and “*no documentation is required, although there will normally be a document which evidences the terms on which the pledge has been created*”¹⁵.

26. In contrast, for charges there are the following requirements under English law:

- all (English) companies must have at its registered offices a register (book) of charges, where all charges of the company should be listed;
- all (English) companies must have at its registered offices every instrument creating a charge requiring registration at the company registrar under the Companies Act 1985;

¹⁵ CALNAN RICHARD, Op. cit., p. 29.

- “*certain charges created by English companies are void against a liquidator of the chargor unless the instrument creating the charge and certain prescribed particulars are delivered to the registrar of companies within 21 days of the charge’s creation*¹⁶”.

27. While certain categories of charges given by companies should be registered under English law, but there are some categories of the charges which do not require to be registered (almost all fixed charges, shareholding in other companies, insurance policies etc.) After the registration “*the registrar must give a certificate of registration, stating amount secured, and the certificate will be conclusive evidence that the requirements of the Companies Act as to registration have been complied with*¹⁷”.

1.1.3 Subsequent pledge/charge and priority

28. The way by which the pledgor tries to secure other obligations of the pledgor towards other creditors with the same piece of property is called ‘*subsequent pledge*’. Russian and English law are concordant about their general approach to a subsequent pledge/charge: “*qui prior est tempore, potior est jure*” (he who is first in time has the strongest claim in law)¹⁸. And under the both laws a subordination arrangement theoretically is possible¹⁹ by which “*a creditor agrees that it will not receive repayment of its debt until all or certain other creditors have been repaid their debts in full*²⁰”. But in practice in Russian law there is a prohibition to renounce a right by any person or a company and any such renunciation will be void²¹. There is a danger that a subordination agreement will be considered as renunciation of the right to be indemnified out of proceeds of the pledged property (especially when the value of the property is not enough to cover all pledgors) and such subordination agreement can be deemed void.

¹⁶ HUGHES MARTIN, *Selected Legal Issues for Finance Lawyers*, www.practicallaw.com; see s 395 Companies Act 1985.

¹⁷ FULLER GEOFFREY. Op. cit., p. 99.

¹⁸ For Russian law see Article 342 of Civil Code RF; for English law see *Barclays Bank Ltd v Bird and Others* [1954] 1 All ER 449.

¹⁹ In Civil Code RF there are no special provisions concerning subordination agreement, but it states in Article 421 that the list of contracts specified in CC RF is not exhaustive and anybody can conclude any other type of contract (contractual liberty).

²⁰ COLIN PAUL, *Banking and Capital Markets Companion*, Cavendish Publishing Limited, London 2003, p. 227. For English law see *Maxwell Communications Corporation plc (No 2)* [1994] 1 All ER 737.

²¹ Civil Code RF Article 9 (2).

29. Russian law is rather relaxed on this issue and allows any subsequent pledge of the same item without a consent or even bringing this to knowledge of the first pledgee. If the intention is to exclude any subsequent pledge of the same property, such restriction has to be clearly spelt out in the pledge agreement itself (a negative pledge), otherwise the rule of the law allowing subsequent pledges will apply. In the event that the pledgor is entitled to give a subsequent pledge over the same property (which means that in the first pledge agreement there is no prohibition to do this) priority of two or more competing pledges will be determined by the date of the creation of the pledge. Having given a pledge, if any, movable assets are disposed of by the pledgor without the pledgee's consent (or are subsequently pledged in breach of a prohibition against such subsequent pledge in the original pledge agreement), the pledgee is entitled to declare all of the outstanding obligations secured under the underlying contract to be immediately due and payable and can levy execution.

30. For a mortgage, priority will be determined by the date that the relevant mortgage is registered on the relevant state register for that property. In the case of a mortgage (and assuming that all the correct registrations have been made), if immovable assets which are prohibited from being mortgaged be further mortgaged then the creditor (mortgagee) will be entitled to seek invalidation of any subsequent mortgage. As the immovable assets will be on a state register and that state register has details of the mortgage this should prevent any purchaser from purchasing the immovable property without notice of the mortgage and therefore forces them to take the property subject to that mortgage.

31. In English law there are a few exceptions to this general approach shared with Russian law. There is, for example, a global exception for security interest stating that a legal interest prevails over an equitable interest; and negligence, misconduct or fraud may lead to a loss of priority. In relation to charges, (as mentioned above) for charges which require registration, "*a registered charge will take priority over unregistered charge, whether created previously or subsequently*²²". Also, duly registered floating charges will rank always after any fixed charges (whether taken prior or subsequently) and other interests arising before crystallization of such floating charge.

²² FULLER GEOFFREY. Op. cit., p. 102.

1.2 Pledge of goods in circulation or floating charge as a specific type of pledge/charge

1.2.1 Introduction

32. Contrary to a fixed charge (ordinary pledge) which “*attaches immediately to the specific asset over which it is granted and prevents the chargor from dealing with that asset in certain, specified, ways*”²³ the so called ‘floating charge’ in English law (and ‘pledge of goods in circulation’ in Russian law) “*is a charge that hovers over a changing class of assets*”²⁴.

33. A pledge over goods in circulation (a floating charge) normally (but not necessarily) relates to the goods produced by the pledgor. It is called a 'pledge over goods in circulation' because the goods circulate, i.e. they are produced or purchased by the pledgor, are kept in his possession up to a certain point and then sold to a buyer, after which (on transfer of title) the pledgor loses his rights with respect to the goods. “*The encumbrance does not follow the sold property and shall be terminated as of the moment the property is expelled from the ownership of the person which granted the security.*”²⁵ Generally, after such sale the pledgor shall replace the sold property by new pledged property unless the secured obligations are discharged.

1.2.2 Definitions

34. In Russian law the definition of a 'pledge over goods in circulation' is given in Article 357 of Civil Code RF: “*Pledge of goods in circulation is a pledge of goods left in the possession with the pledgor who has the right to change the constituent and the form of pledge property (commodities, raw materials, materials, half products, final products and etc.) with a condition that the overall cost of the pledged goods shall not be less than the amount specified in the pledge agreement.*”

35. The most used definition of a ‘floating charge’ and its three characteristics under English law was identified by Romer LJ in the case *Re Yorkshire Woolcombers*

²³ BETHELL-JONES RICHARD, *Country Q&A UK (England and Wales)*, Finance Handbook 2008/09, Volume 1: Secured Lending, Third edition, Practical Law Company Cross-border Handbooks, Legal & Commercial Publishing Ltd, London 2008., p. 244.

²⁴ BETHELL-JONES RICHARD, *Op. cit.*, p. 244.

²⁵ BURKOVA ANASTASIA. *Floating Charge: English Law Versus Russian Law*. Journal of International Banking Law and Regulation, № 10, 2008, Sweet & Maxwell and Contributors, p. 550.

*Association Ltd, Houldsworth v Yorkshire Woolcombers Association Ltd*²⁶, where a ‘floating charge’ was described as:

- (a) a charge on a class of assets of a company present and future;
- (b) where the class would in the ordinary course of business be changing from time to time; and
- (c) it is contemplated by the charge that, until some step is taken by the chargee, the company might carry on its business in the ordinary way as far as concerns the particular class of assets in question.

36. But it is important to point out that Romer LJ prefaced his definition by the following qualification: “*I certainly do not intend to attempt to give an exact definition of the term ‘floating charge’, nor am I prepared to say that there will not be a floating charge within the meaning of the Act*²⁷, which does not contain all the three characteristics...²⁸”

37. Under leading case on a floating charge *National Westminster Bank plc v Spectrum Plus Limited & Ors*²⁹ the essential test as to whether a charge was fixed or floating is for a fixed charge was where the creditor’s power to continue to deal with the asset. Thus, to have a fixed charge a chargee must exercise actual control over the asset, what is not always convenient for a bank. And the holder of a floating charge does not have effective control.

1.2.3 Assets that can be encumbered

38. A pledge of goods in circulation under Russian law extends only to goods which have generic features whereas floating charge under English law can be extended to all property of the company (including fixed assets and book debts), which constitute a big advantage over Russian law.

²⁶ [1903] 2 Ch 284.

²⁷ Companies Act 1900.

²⁸ *Re Yorkshire Woolcombers Association Ltd, Houldsworth v Yorkshire Woolcombers Association Ltd* [1903] 2 Ch 284.

²⁹ [2005] UKHL 41.

39. The most specific feature of this pledge for Russian law is that the pledged assets are normally undergoing changes in composition or natural form from time to time, or even entirely replaced by other property of the same nature, but all on condition that the overall value of the pledged property does not become less than indicated in a pledge agreement regardless of the extent and the number of replacements³⁰. A typical example would be raw materials, or newly manufactured products that are kept in a storage and shipped from time to time. It is important to specify in the pledge at which point in the pledgor's production cycle the raw material and/or finished goods are deemed to come under the pledge. This choice is often determined by the need to find a place where it is physically possible to ascertain the value and the volume of the pledged goods at any time, such as a warehouse or a railway terminal. Obviously, it is more difficult to have this type of pledge when the goods are not at the same geographical place at any given moment.

40. *“From the point of view of English law, the main element that differentiates the “floating charge” from the fixed charge is not that the property used as encumbrance may change, but that the company-debtor has a contractual right to manage its assets and deal with them in the process of ordinary course of its business.³¹”* In a judgment of the Board of the Privy Council on an appeal from the Court of Appeal of New Zealand in *Agnew v IRC*³² Lord Millett underlines that *“the critical feature which distinguished a floating charge from a fixed charge lay in the chargor’s ability, freely and without the chargee’s consent, to control and manage the charged assets and withdraw them from the security”*. The floating charge is not attached to any specific asset of the chargor until a special event occurs or chargee takes a special action and such floating charge ‘crystallizes’ into a fixed charge³³.

1.2.4 Registration

41. The pledge of goods in circulation under Russian law is not subject to any registration. However, the pledgor of goods in circulation is obliged to keep a book for recording pledges in which entries shall be made of the conditions of the pledge of goods

³⁰ Article 357 of the Civil Code RF.

³¹ BURKOVA ANASTASIA. Op. cit., p. 550.

³² [2001] UKPC 28.

³³ See *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979; *Illingworth v Houldsworth* [1904] AC 355.

and on all other operations entailing a change of the composition or the natural form of the pledged goods, including their processing, on the day of the operation. The pledgee may chose to request extracts from the pledge book on a regular basis which is in addition to a general right of a pledgee to physically inspect the availability, amount and condition of the pledged assets.

42. Under English law, it is a bit more secured because a floating charge should be registered in compliance with Section 396 of the Companies Act 1985 and the absence of such registration will result in the floating charge being invalid as security.

1.2.5 Pros and cons of pledge of goods in circulation / floating charge

43. Due to the floating and flexible nature of a Russian law pledge, i.e. the constant turnover of the goods under pledge, it is possible to adjust the security and balance it to match outstanding obligations. The rule on this is as follows: "*reduction of the value of the pledged goods is allowed in proportion to the performed part of the obligation secured by the pledge, unless otherwise provided by the contract*".³⁴ This basically means that if, for example, half of the loan is paid off, the value of the goods that come under the pledge arrangements will have to be reduced by half.

44. This type of security is very convenient for a borrower and for performing its business also because it allows the continued use of pledged assets in its operations, as Lord Scott of Foscot remarked in *National Westminster Bank plc v Spectrum Plus Limited & Ors*³⁵: "*It is in the nature of commercial borrows to want to be able to carry on the business for the purposes of which they are borrowing money with as much freedom from restrictions imposed by their lenders that negotiation can achieve for them*".

45. However, from a point of view of commercial lenders this security is not very effective (even with requirement to be registered) because under English law "*only after any fixed charge holders and preferential creditors have been paid in full do the holders of any floating charges get paid out of the proceeds of sale of their assets*"³⁶. This means that the creditors secured by a floating charge will be repaid just ahead of unsecured in the line

³⁴ Article 357 of the Civil Code RF.

³⁵ [2005] UKHL 41.

³⁶ PLC Finance, *Taking security: overview for corporate lawyers*, www.practicallaw.com.

of the creditors, so they are less secured than chargees holding a fixed charge (and behind certain statutory creditors)³⁷.

46. Whereas for Russian law, in the case of insolvency of a pledgor, pledgees secured by the pledge of goods in circulation stand on the same level as all other secured creditors in the line of creditors. However, this type of security may still carry certain risks because of the possibility of the pledgor's record (books) of pledges not being up to date or not showing other encumbrances over its assets. *“In case of breach by a pledgor of the conditions of a pledge of goods in circulation a pledgee has a right to stop the operations with the pledged assets by imposition of its signs and attaching its seals to such assets.”*³⁸

47. Additionally, a *“pledge of goods in circulation is not very reliable way to secure the performance of the obligations by a pledgor, hence when using it as a security, there is always a risk to lose it, and not only because of pledgor's actions.”*³⁹ There are may be the cases where a third party does not perform its obligations to the pledgor and because of this the pledgor can not perform its obligations to the pledgee. For example, where a producer does not deliver the goods to a pledgor and the pledgor has already sold the goods (assuming delivery), the pledgor may not have enough goods in its possession to meet its obligations under the pledge agreement. Therefore the creditor should be very accurate and demanding in constant monitoring of pledged assets (in pledge books of pledgor or by pledgor's reports).

48. Undoubtedly there are advantages and disadvantages of this type of security under both English and Russian law, but this legal instrument is very interesting and has benefits for both parties; on one hand, the pledgor can continue its business using the pledged asset while benefiting from a loan and, on the other hand, the lender will still have security over those assets. This can be useful when other forms of security are not available or a lender wishes to take such form of security in addition to others (e.g. mortgage, fixed security) within a complex security package.

³⁷ See Insolvency Act 1986 Section 175 (2) (b).

³⁸ SITNIKOV SERGEL, *On pledge of oil*, Rossiiskaya iustiziya, № 12, 2006, p. 4.

³⁹ BOYARSKAYA ELENA, *Pledge as one of the effective way to secure the obligations under a loan agreement*, Bank crediting, № 3, 2005, p. 22.

Chapter 2.

Guarantee and suretyship as way to secure obligations

2.1 General issues

2.1.1 Nature of a guarantee/suretyship

49. The word ‘guarantee’ is often used quite generally to include all possible security interests that a borrower may give to a lender. But, in the more traditional legal sense, the expression ‘guarantee’ means a suretyship guarantee (“*assumption of liability for the obligations of another*⁴⁰”).

50. Strictly speaking a suretyship guarantee is not considered by English law as a security interest, some authors call it a ‘quasi-security’ or an ‘alternative to security’⁴¹. English law ‘security interest’ properly means an interest in property (a right ‘*in rem*’ – from Latin ‘in a thing’), while the concept of guarantee only creates a contractual right ‘*in personam*’.

51. In contrast, Russian law declares a suretyship as a ‘security interest’ – one of the means by which it is possible to secure the performance of credit liabilities and it is listed and regulated in Chapter 23 “*Security for performance of the obligations*” of Civil Code RF. It is not uncommon for financings to include suretyships in Russia.

52. The choice of applicable law for the suretyship guarantee concluded by the parties will be determined by considering issues such as, ease of enforcement of such guarantee, the country where it will be enforced, the exact legal characteristics of the suretyship guarantee as against other legal instruments used to support performance, and even by simplicity of execution under different systems of law.

2.1.2 Definitions and categories

⁴⁰ <http://www.britannica.com/EBchecked/topic/574988/suretyship>; see also GARNER BRYAN A., Black’s Law Dictionary, 8th edition, Thomson West, St. Paul 2007, p.1483.

⁴¹ see ADAMS DAVID, *Banking and Capital Markets*, The College of Law Publishing, 2009; or CALNAN RICHARD, Op. cit.

53. Under English law “*contracts of suretyship fall into two main categories; contracts of guarantee and contracts of indemnity*”⁴².”

54. In *Re Conley*⁴³ Sir Wilfrid Greene MR cites and analyses several definitions of a contract of guarantee from textbooks and treatises. The earliest definition of guarantee which he found is in Fell’s *Treatise on the Law of Mercantile Guaranties and of Principal and Surety in General* (2nd Edn), published in 1820: “*A guarantee is a promise to answer for the payment of some debt, or the performance of some duty, in case of the failure of another person, who is, in the first instance, liable to such payment or performance*”⁴⁴”, or there is another definition given in a *Treatise on the Law of Guaranties and of Principal and Surety* by De Colyar: “*A guarantee is a collateral engagement to answer for the debt default or miscarriage of another person.*”⁴⁵”

55. A more recent definition, but with the same meaning, can be found in *Law of Guarantees* by Geraldine Andrews and Richard Millett: “*A contract of guarantee, in the true sense, is a contract whereby the surety (or guarantor) promises the creditor to be responsible, in addition to the principal, for the due performance by the principal of his existing or future obligations to the creditor, if the principal fails to perform those obligations.*”⁴⁶”

56. These definitions explain us that a guarantee is a secondary obligation proving a personal liability of a surety for the debt of another person if that other person does not pay its debt. As underlined by David Adams in “*Banking and Capital Markets*”: “*a guarantee must support a primary liability between two parties other than the guarantor*”⁴⁷”, so that in practice the guarantor will guarantee to the bank (a lender) that the borrower will repay the loan and, if not, the guarantor will reimburse the bank. The obligation of the guarantor is entirely dependant on the guaranteed obligation and no liability will occur for the guarantor unless and until the borrower has failed to perform his obligations.

⁴² ANDREWS GERALDINE, MILLETT RICHARD, *Law of Guarantees*, Sweet & Maxwell, London 2005, p.2.

⁴³ [1938] 2 All E.R. 127.

⁴⁴ *Re Conley (trading as Caplan & Conley), Ex parte The Trustee v Barclays Bank Ltd* [1938] 2 All E.R. 127, p. 130-131.

⁴⁵ *Re Conley (trading as Caplan & Conley), Ex parte The Trustee v Barclays Bank Ltd* [1938] 2 All E.R. 127, p. 130-131.

⁴⁶ ANDREWS GERALDINE, MILLETT RICHARD, *Op. cit.*, p.3.

⁴⁷ ADAMS DAVID, *Op. cit.*, p.163.

57. An alternative to a guarantee is another category of suretyship – an indemnity. The indemnity can be characterised as a primary obligation of a surety to indemnify the creditor against any loss which the creditor may suffer as a result of entering into a transaction with the debtor which is independent from the existence of the underlying debt. An indemnity is “*a duty to make good any loss, damage, or liability incurred by another*”⁴⁸.

58. Even if English law distinguishes these two categories of suretyship as follows: “*An indemnity is a contract by one party to keep the other harmless against loss, but a contract of guarantee is a contract to answer for the debt, default or miscarriage of another who is to be primarily liable to the promisee*”⁴⁹, in practice, contracts of guarantee often contain provisions for both guarantee and indemnity in the same document. In bank business, in particular, there are a lot of mixed contracts entitled guarantee but actually containing primary obligations on the part of the guarantor.

59. Russian law distinguishes two categories: (a) a suretyship guarantee itself given by a physical person or by a legal entity, and (b) a bank guarantee which may only be signed by licensed banks, other lending institutions or insurance companies (see part 2.2 below for more detail). These two instruments of law are separated and considered as two different (even if quite similar) ways of securing the obligations of a debtor.

60. The definition of a contract of suretyship given in Civil Code RF (Article 361) is a contract where by “*the surety shall be obliged to the creditor of the other person to be answerable for the latter's discharge of his obligation in full or in part*”⁵⁰.

61. Suretyships in Russian law are similar to English law suretyship guarantees whereby a third party may accept responsibility for an obligation if the person with primary responsibility for the obligation does not meet it. Russian law suretyships constitute a secondary obligation and depend on a primary obligation of a debtor to repay its debt to a creditor. “*Obligation of a surety to pay a creditor will arise only after debtor non-performance or improper performance of his obligations*”⁵¹.

⁴⁸ also GARNER BRYAN A., *Black's Law Dictionary*, 8th edition, Thomson West, 2007, p. 784.

⁴⁹ *Yeoman Credit Ltd v Latter* [1961] 2 All ER 294 at 296 per Holroyd Pearce LJ.

⁵⁰ Civil Code RF, Article 361.

⁵¹ GONGALO B.M., *Doctrine of securing of obligations (Questions of theory and practice)*, Statut, Moscow 2004, p. 90.

62. As a general rule the surety and the debtor shall be liable to a creditor jointly and severally, unless subsidiary responsibility of the surety has been provided for by a law or by the contract⁵². The general rule means that upon debtor non-performance or improper performance of his obligations “*a creditor may demand performance of such obligations both from debtor and surety jointly, and from each of them severally in full or partially for his own discretion*”⁵³. But as an exception to this rule, the contract for suretyship may provide for the subsidiary responsibility of the surety, in which case the creditor can demand performance of the obligations by the surety only if primary debtor fails or denies performance or the creditor does not receive any answer from him in a reasonable timeframe.

2.1.3 Formal Requirements

63. Under English law, contracts of guarantee or indemnity have to comply with the usual requirements for the creation of a contract, such as the requirement for consideration (“*something bargained for and received by a promisor from a promisee; that which motivates a person to do something, esp. to engage in legal act*”⁵⁴). In addition, contracts of guarantee must comply with further requirements provided for in the Statute of Frauds 1677 (as amended), as follows: (i) it must be in writing or there must be a memorandum of it in writing providing all the material terms of the guarantee; (ii) guarantee or the memorandum must be signed by the guarantor or his agent. “*A guarantee which does not comply with the Statute of Frauds 1677 is not void, but it is unenforceable*”⁵⁵ (meaning one cannot found an action in the courts to enforce it).

64. There are no special requirements in relation to the precise content of a guarantee and special conditions to be included in it, however, it is common to also include some limits on the guarantor’s liability (such as limits in time, limits as to amount or limits as to particular types of transaction).

65. Furthermore, for the purposes of English insolvency law, “*where there is any risk of the transaction being a transaction at an undervalue, it is a prudent practice on the*

⁵² Civil Code RF, Article 363.

⁵³ PAVLODSKII E.A., Op. cit., p.172.

⁵⁴ GARNER BRYAN A., *Black’s Law Dictionary*, 8th edition, Thomson West, 2007, p. 324.

⁵⁵ CALNAN RICHARD, Op. cit., p. 394.

part of the lenders to require the company to deliver a certified copy of the board resolution approving the giving of the guarantee or indemnity⁵⁶”. A transaction is considered as being a transaction at undervalue if the guarantor’s liabilities provided by such guarantee are significantly greater than the benefit obtained by the guarantor from such guarantee.

66. In comparison with English law, Russian law suretyship requirements are much complex and more complicated to perform.

67. First, as a general requirement, a Russian law contract of suretyship should be in writing. Failure to perform this requirement makes the contract of suretyship void.

68. Moreover, for a personal suretyship (when a physical person acts as surety) there exists a requirement to obtain a spouse consent to such personal guarantee, because the surety makes he(her)-self liable by common familial property. In order to protect the spouse of a surety and common property, Russian family law provides in Article 35 of the Family Code of Russian Federation that: “*Any disposal of common property by one of the spouses is considered to be done with the consent of the other spouse. A transaction executed by one of the spouses disposing the common property can be declared as void by the court if the other spouse has not consented to the transaction.*”⁵⁷ That is why it is advisable in practice to have spouse endorsement on the contract of suretyship or given in a separate document.

69. A suretyship contract shall contain the information specifying the secured obligation guaranteed by the suretyship: “*it shall contain information detailing the primary obligation (its nature, amount, time of performance etc), who is the guarantor and who is a principal, and also any limits of the guarantor’s liability*”⁵⁸. If these details are not mentioned in the contract of suretyship, the obligations of surety can not be considered as being created. However, generally the surety shall be liable to the creditor in the same amount as the debtor, including:

- the payment of interest,
- compensation for court costs relating to recovery of the debts,

⁵⁶ FULLER GEOFFREY. Op. cit., p.188.

⁵⁷ Family Code of Russian Federation 1995, as amended.

⁵⁸ PAVLODSKII E.A., Op. cit., p.171.

- other losses relating to recovery of the debt,
- other losses of the creditor caused by the failure to perform or the improper performance of the obligation by the debtor,

unless provided otherwise by the contract of suretyship.

70. There are also a number of corporate issues under Russian law that may need to be considered when taking the benefit of a suretyship related to ensuring that the correct corporate approvals have been obtained:

- a) Interested party transactions;
- b) Major transaction.

2.1.3.1 Interested party transactions⁵⁹

71. An **interested party transaction** (“IPT”) is a transaction where (i) the shareholder, the member of the Board of Directors (“BD”) or the manager of such company owns more than 20% of voting stock of the company and (ii) he is considered as an ‘interested party’ for this transaction. A shareholder, a member of the BD or a manager will be an ‘interested party’ if he is also affiliated with the counterparty to the transaction, in particular, when:

- he acts as a counterparty, a beneficiary or an intermediary of a counterparty of the company in such transaction himself (or through person affiliated to him);
- he is at the same time the member of the BD or a CEO of the counterparty;
- he owns more than 20 percent of voting stock of the counterparty;
- and other cases mentioned in Articles of Association of the company⁶⁰.

72. An IPT transaction has to be approved by the General Shareholders Meeting (“GSM”) in two instances:

⁵⁹ See Chapter XI of Federal Law “On Joint-Stock Companies” 26.12.1995, as amended.

⁶⁰ Article 81 of the Federal Law “On Joint-Stock Companies” 26.12.1995, as amended.

- a) where an IPT amounts to above 2 percent of the net asset value,
- b) where the number of uninterested members of the BD is less than the quorum for adopting such a decision by the BD.

73. In all other cases the general rule shall apply: the IPT has to be approved by the uninterested members of the BD.

2.1.3.2 Major transactions⁶¹

74. In relation to a **major transaction**

- there is a general rule according to which approval of the GSM is required if the transaction is (or several related transactions are) valued at more than 25% of the book value of the assets of the company;
- or unanimous approval of the BD is required if the transaction is (or several related transactions are) valued at between 25 and 50% of the book value of the assets of the company;
- and finally, the approval of a three quarters vote at the GSM is required if the transaction is (or several related transactions are) valued at more than 50% of the book value of the assets of the company.

2.1.4 Parties of Guarantee / Suretyship

75. In relation to guarantees / suretyships in general there are three concerned parties:

- (a) a guarantor / surety – a person who undertakes to perform / be liable for the obligations of a principal in case of principal's default vis-a-vis of a creditor,
- (b) the creditor – a lender (a bank) who gives monies to the principal, and

⁶¹ See Chapter X of the Federal Law “On Joint-Stock Companies” 26.12.1995, as amended.

- (c) the principal – a debtor of the creditor, who's obligations are secured by the guarantee / suretyship.

76. In English law it is significant that a contract of guarantee is concluded between a guarantor and a creditor, otherwise any contract of suretyship where a creditor is not a party will be considered as an indemnity: *“It is essential that the creditor should be a party to a contract of guarantee, because he is the person to whom the guarantor makes the promise to be answerable for the debt, default or miscarriage of the principal⁶²”*.

77. Russian law shares the same requirement and provides for the following standard construction of a suretyship contract: *“there is a surety from one side and a creditor from the other side, who has or will have claims to a debtor⁶³”*. The debtor is not participating in this contract; moreover his consent is not needed for its execution. But it is imperatively indispensable that the creditor signs the contract of suretyship or at least countersigns the contract executed between the surety and the debtor acknowledging the acceptance of surety's liabilities in his favour.

2.1.5 Peculiarities of termination of guarantee / suretyship

78. As far as discharge of the surety is concerned English law does not have a general uniform principle; instead *“the [English] courts have developed a detailed series of conflicting rules, the application of which depends on the nature of the creditor's action⁶⁴”*.

79. Several different ground of discharge can be distinguished as follows:

- (i) the **release of the debtor** by the creditor and **giving time to the debtor** by the creditor to perform its obligations without the guarantor's assent. Lord Porter stated in *Mahant Singh v U Ba Yi*⁶⁵: *“A surety is discharged if the creditor, without his consent, either releases principal debtor or enters into a binding arrangement with him to give him time.”*

⁶² ANDREWS GERALDINE, MILLETT RICHARD, *Op. cit.*, p.5.

⁶³ PETROVA N.F., *Participation of a debtor in a contract of suretyship*, Journal of Russian Law, N4, 2009.

⁶⁴ CALNAN RICHARD, *Op. cit.*, p. 405.

⁶⁵ [1939] AC 601.

- (ii) **variations** to the contract between the creditor and the debtor. This principal is explained clearly in the decision of the High Court of Australia in *Ankar Pty Ltd v National Westminster Finance (Australia) Ltd*⁶⁶: “...to hold the surety to its bargain, the creditor must show that the nature of the alteration can be beneficial to the surety only or that by its nature it cannot in any circumstances increase the surety’s risk.”
- (iii) the **release of co-guarantors** by the creditor: only “if the guarantees are joint or joint and several, the release of one guarantor will release the others⁶⁷”.
- (iv) the **loss of security** held by the creditor. As Dixon J in High Court of Australia in *Williams v Frayne*⁶⁸ explained: “If the guarantee is given upon a condition, whether express or implied from the circumstances, that a specific security shall be obtained, completed, protected, maintained or preserved, any failure in the performance of the condition operates to discharge the surety and the discharge is complete. But otherwise the surety can complain only if the creditor sacrifices or impairs a security, or by his neglect or default allows it to be lost or diminished, and in that case the surety is entitled in equity to be credited with the deficiency in reduction of his liability.”
- (v) **breach of contract** by the creditor, if the creditor’s obligations are “condition precedent to the liability of the guarantor⁶⁹”.

80. Under Russian law there several similar grounds (for example, release of primary obligation, subsequent change of primary obligation), but there are some grounds which differ from English law. Civil Code RF states that a surety shall terminate in following circumstances⁷⁰:

- (i) under the general grounds the surety will be discharged with the termination of the **obligation secured** by it or upon the **expiry** of the period for which it was given specified in the contract of suretyship;

⁶⁶ (1987) 70 ALR 641.

⁶⁷ *Mercantile Bank of Sydney v Taylor* [1893] AC 317.

⁶⁸ [1937] ALR 253.

⁶⁹ CALNAN RICHARD, Op. cit., p. 416.

⁷⁰ Article 367 of Civil Code RF.

(ii) surety will be discharged also with the transfer to another person of the debt relating to the obligation secured by the suretyship unless the surety has agreed with the creditor to be liable for the **new debtor**;

(iii) if the creditor has **refused to accept proper performance** offered by the debtor or the surety; or

(iv) if a suretyship period has not been established, within a year from the date of failed performance of the obligation secured by the suretyship a **suit against the surety has not been brought by the creditor**;

(v) when the period of performance of the principal obligation has not been specified and can not be determined or is determined by the moment of demand, if the creditor does **not bring suit against the surety** within two years from the date of concluding the contract of suretyship;

(vi) in the event of a change to the underlining obligations resulting an **increase of responsibility** or other **unfavorable consequences** for the surety without the consent of the last. This clause of law is very general and often is not interpreted in favour of the creditor and leads to discharging of guarantor's obligations. This poses a big problem for considering a contract of suretyship under Russian law as a stable security interest and is why, in practice, many lawyer-practitioners advise clients (if possible) to avoid Russian law suretyship and execute it under different law system.

2.2 Bank Guarantee as a special type of guarantee

81. A bank guarantee is a special type of guarantee / suretyship in the nature of a documentary payment undertaking by which a bank or other lending organisation promises to pay a certain sum of money in the event that the debtor fails to meet its obligations.

82. Even if generally under English law “*a bank is not different from any other creditor or surety, and there are no special rules which apply to its rights or liabilities*”⁷¹,

⁷¹ ANDREWS GERALDINE, MILLETT RICHARD, *Op. cit.*, p.480.

after analysing the characteristics of a bank guarantee thoroughly one understands that it differs significantly from the general notion of a ‘guarantee’ and has its own peculiar features.

83. Lord Denning had the opportunity of examining such “*a new creature*” as a ‘performance guarantee’ in the case of *Edward Owen Engineering Ltd v Barclays Bank International Limited* [1978] 1 All ER 976, where a buyer asked a supplier to provide him a bank guarantee securing the performance of the supplier’s obligations. Given such use a bank guarantee also received the name a ‘performance guarantee’ or a ‘performance bond’ being a separate third-party undertaking given in support of a counterparty performing its obligations. After analyzing of the case facts and compared requirements for letters of credit and performance guarantees, Lord Denning sums up: “*All this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with relations between the supplier and the customer; nor with the question whether the supplier has performed his obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions.*”⁷²

84. In another case *Howe Richardson Scale Co Ltd v Polimex-Cekop* [1978] 1 Lloyd’s Rep 161 Roskill LJ stated the same opinion: “*Where the obligation arises under a letter of credit or under a guarantee, the obligation of the bank is to perform that which it is required to perform by that particular contract, and that obligation does not in the ordinary way depend on the correct resolution of a dispute as to the sufficiency of performance by the seller to the buyer or by the buyer to the seller as the case may be under the sale and purchase contract; the bank here is simply concerned to see whether the event has happened on which its obligation to pay has arisen.*”⁷³

85. Hence, a performance guarantee can be characterised as a primary obligation – separated from the underlying contract – and not a secondary obligation as with a normal guarantee (suretyship). By this feature it is close to a contract of indemnity or documentary credits, requiring the beneficiary simply to present a written demand for payment.

⁷² *Edward Owen Engineering Ltd v Barclays Bank International Limited* [1978] 1 All ER 976.

⁷³ *Howe Richardson Scale Co Ltd v Polimex-Cekop* [1978] 1 Lloyd’s Rep 161.

86. In order to unify the rules about bank guarantees the International Chamber of Commerce published in 1992 the Uniform Rules for Demand Guarantees (URDG), which are designed to be in accordance with established bank guarantee practice, where most demand guarantees are payable on first written demand (therefore another term for a bank guarantee: a ‘demand guarantee’). The URDG stipulate in Article 2(a) that a demand guarantee is any guarantee, bond or other payment undertaking by a bank, insurance company or other body or person given in writing for the payment of money on presentation in conformity with the terms of the undertaking of a written demand for payment and such other document(s) as may be specified in the demand guarantee; this undertaking can be given in favour of a beneficiary at the request or on the instructions and under the liability of a principal or a bank, insurance company or any other body or person acting on the instructions of a principal.

87. To summarise the following main features under English law of a ‘bank guarantee’ are:

- it is usually issued by a bank,
- it should be in writing,
- it is a primary obligation of the issuing bank and does not require proof of default of a principal,
- it should be paid by the bank upon the first demand of the beneficiary.

88. A Russian law bank guarantee is similar to English law bank guarantee in that it too and very differs from a Russian law suretyship, although formerly under Soviet Civil Codes⁷⁴ a bank guarantee was equated with a suretyship and was submitted to the same rules. Nowadays, under Russian law, a bank guarantee presents an independent way to secure the applicant’s obligations and has its particular features. The similarity with English law bank guarantee arises from the fact that “*during the process of preparation of*

⁷⁴ Civil Code of Russian Soviet Federative Socialist Republic on 1964 and Essential Principles of Civil Legislation of the Union of SSR and republics on 31 May 1991.

a new Civil Code RF initial material for determining and formulating of the regulations on bank guarantee was URDG⁷⁵.”

89. According to Article 368 of Civil Code RF: *“By force of the bank guarantee, the bank, the other credit institution or the insurance company (the guarantor) shall issue, upon the request of the other person (the principal) a written obligation to pay to the creditor (the beneficiary), in conformity with the terms of the obligation, given by the guarantor, a certain amount of money upon the beneficiary's presenting the written claim on its payment.”*

90. Federal Law “On banks and bank’s activities” considers a bank guarantee as a category of the bank’s operations, so that an issuer of such guarantees should have a special bank licence.

91. There main characteristics of a bank guarantee under Russian law are:

- it is independent from the underlying obligation between a principal and a beneficiary and remains valid, even if the underlying contract becomes invalid, hence it represents a primary obligation of a guarantor;
- it can be issued by a bank, the other credit institution or the insurance company with a special license (as was mentioned above);
- it should be in written form and is usually expressed as an unilateral undertaking of a guarantor;
- the right of a beneficiary vis-à-vis the guarantor can be enforced the means of presenting a (written) demand which conforms with conditions set out in the terms of guarantee;
- generally a principal (applicant) shall pay a guarantor for issuance of the guarantee.

92. This research allows us to come to the conclusion that English law and Russian law bank guarantees (demand bonds) have a lot of similar features, and both differ from a

⁷⁵ BABANIN V.A., VORONINA N.V., *Suretyship and Bank Guarantee: particularities of the legal regulation securing of fulfilment of the obligations*, *Zakonodatelstvo i ekonomika*, № 11, 12, 2005.

normal guarantee (in English law) or a suretyship (in Russian law). This makes it a special method of securing performance of the obligations used commonly in international trade and the global bank practice.

Chapter 3.

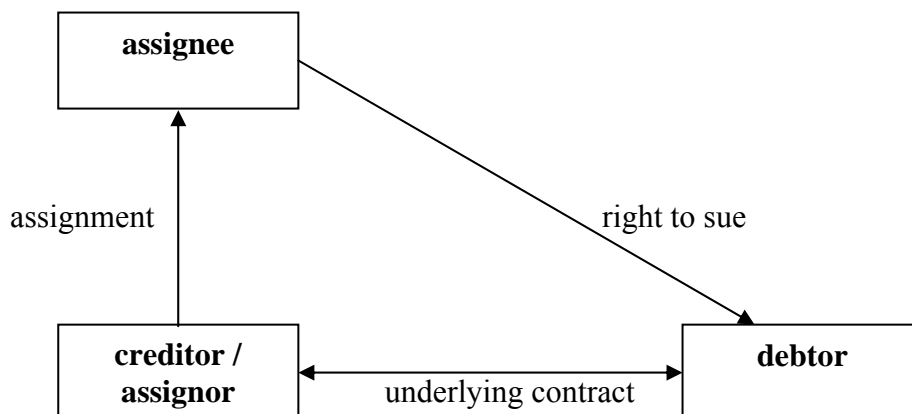
Assignment / 'cession' and possibility to use it as a security interest

3.1 Definition

93. Modern commodity relations transactions tend to utilize the advantages of crediting structures, whereby the transfer of goods from one party to another is made in exchange for a future claim of payment, which matures upon the expiry of an agreed period. The right of the creditor to claim receipt of the proceeds of the payment obligation becomes a valuable asset it-self and can be transferred to another person or be the subject of further transactions.

94. An 'assignment' is a conceptually broad denomination which can have different characteristics depending on its application. The term 'assignment' (Latin *cessio*) means an instrument by which a transfer of rights or property is effected: "*Assignment is simply the transfer of rights*⁷⁶". Sir Guenter Treitel gives a more comprehensive definition in *The Law of Contract*: "*This is a transaction between the person entitled to the benefit of the contract (called the creditor or "assignor") and the third party (called the "assignee") as a result of which the assignee becomes entitled to sue the person liable under the contract (called the "debtor")*".⁷⁷

95. It is easier to understand the structure of an assignment looking on the diagram set out below:



⁷⁶ ADAMS DAVID, *Op. cit.*, p. 131.

⁷⁷ TREITEL GUENTER, *The Law of Contract*, 11th edition, Sweet & Maxwell, London 2003, p. 672.

96. From the above diagram we can see that there is an underlying contract between a creditor and a debtor. The debtor owes certain obligations to the creditor, and by way of assignment the creditor transfers to the assignee its rights to enforce such obligations against the debtor.

3.2 Concept of assignment / cession by way of sale and contract of factoring

97. It is not possible to study an assignment as a form of security interest without the examination of a general concept of assignment (cession) as an independent instrument of law. Moreover, under both English and Russian law, assignment by way of security is not a widely researched legal instrument and the explanations about it contained in legal texts can be quite confusing and poor. In this part we will first look at the general concept of assignment under English law, and then to the general concept of cession and factoring under Russian law.

3.2.1 Concept of an assignment under English law

98. The assignment of ‘choses in action’ is a process where a right under a contract is transferred to a third party. In *Torkington v Magee*, Justice Channell explains that a “*chose in action is a known legal expression used to describe all personal rights of property which can only be claimed or enforced by action and not by taking physical possession*”⁷⁸.

99. Under English law an assignment can be statutory and equitable. In practice statutory and equitable assignments are governed by many common rules (e.g. what rights are not assignable, or priorities between successive assignees), however there are some different characteristics which will be discussed further below.

3.2.1.1 Statutory assignment

⁷⁸ *Torkington v Magee* [1902] 2 K.B. 427, revd. [1903] 1 K.B. 644.

100. Section 136 of the Law of Property Act 1925 (LPA 1925) lists three conditions in the for an assignment to be statutory:

- (1) the assignment must be absolute and not purport to be by way of charge only;
- (2) it must be in writing under the hand of the assignor; and
- (3) express notice in writing thereof must be given to the debtor.

101. An absolute assignment presupposes the transfer of the whole of a debt and not only part: “*The expression ‘absolute’ is used to mean a complete transfer, in which the assignor does not retain any interest in the property assigned*⁷⁹”. Such condition is required to protect a debtor, who may wish to dispute the debt (where an assignor may have split the debt into several assigned parts) and should not have to defend multiple claims arising out of the same transaction.

102. Whilst a statutory assignment must be in writing under hand of the assignor, there is no requirement for a special form and such writing may be informal. An oral assignment cannot take effect under statute, however it can constitute a valid equitable assignment.

103. The LPA 1925 requires the existence of the finalised unconditional assignment be conveyed in writing to the debtor it self. This information can be in the form of a notice or even a written demand for payment sent by the assignee to the debtor.⁸⁰ “*A debtor with notice of an absolute assignment is entitled, and indeed bound, to treat the debt as transferred to the assignee. Payment by the debtor to the assignor will therefore not give him a good discharge, and he will remain liable to pay the debt again to the assignee.*⁸¹”

104. Whilst there is no strict requirement for a statutory assignment to be made for consideration, the assignor should execute the assignment as a deed to the extent it is not receiving consideration.

105. Therefore under a statutory assignment, the assignor transfers its right to receive payment of a debt entirely to the assignee, and accordingly, the assignee can be considered the new rightful creditor of the debtor. As a result of this form of assignment,

⁷⁹ WRIGHT SUE, *International loan documentation*, Palgrave Macmillan, New York 2006, p. 275.

⁸⁰ *Van Lynn Developments Ltd v Pelias Construction Co Ltd* [1968] 3 All ER 824.

⁸¹ CHITTY *on Contracts*, 28th edition, Volume I, Sweet & Maxwell, London 1999, p. 1038.

the debtor must make payment directly to the assignee, and not to the assignor. The main difference between a statutory assignment and an equitable assignment is that “a statutory assignee can sue the debtor without joining the assignor as a part to the action, whereas an equitable assignee often cannot do this⁸²”.

3.2.1.2 Equitable assignment

106. Any assignment which does not comply with the requirements of the section 136 (1) of the LPA 1925 is considered as an equitable assignment.

107. Contrary to a statutory assignment, an equitable assignment in almost all cases does not demand such formalities and need not be in writing or any special form. Notice of an equitable assignment given to a debtor is also not strictly required to be in writing: “A notice of an equitable assignment need only be in writing where it concerns an assignment of an equitable in trust property (because otherwise the notice cannot affect the priorities of completing claims – LPA 1925, s 137 (3)), whereas an equitable assignment must be in writing if the interest being assigned is an equitable interest of any kind (whether or not arising under trust) (LPA 1925, s53 (1) (c)).⁸³”

108. For an equitable assignment it is necessary for the assignor to receive consideration, whereas for statutory assignment there is no such requirement⁸⁴: “For every equitable assignment... there must be consideration. If there be no consideration, there can be no equitable assignment.⁸⁵”

109. If the equitable assignment is made without notice given to the debtor it results in the debtor having to make payment to the assignor, and the assignor is then obliged to account for the moneys to the assignee.

3.2.1.3 Some principles applicable to statutory and equitable assignments

⁸² CHITTY on Contracts, Op.cit., p. 1033.

⁸³ HUGHES MARTIN, *Selected Legal Issues for Finance Lawyers*, www.practicallaw.com

⁸⁴ *Re Westerton* [1919] 2 Ch 104; *Holt v Heatherfield Trust Ltd* [1942] 2 K.B. 1, 5.

⁸⁵ *Glegg v Bromley* [1912] 3 K.B. 474, 491.

110. Under English law there are some restrictions on which rights can be assigned regardless of whether an assignment is statutory or equitable. The following are situations the choses in action which can not be assigned:

- (a) if an underlying contract provides that the rights arising under it shall not be assigned (contracts expressed to be not assignable)⁸⁶;
- (b) if it is a crucial to the debtor that it discharges such obligation in favour of the original creditor (personal contracts)⁸⁷;
- (c) if an assignment prohibited by statute or public policy, for example it is not possible to assign benefits under social security legislation, assign a public officer's salary, or assign by a spouse's right to maintenance;
- (d) if such assignments savours of maintenance or champerty.

111. In the event an assignor assigns the same chose in action successively to several persons it must be determined in which order such assignees will be paid. Generally **priority** will be determined according to the dates on which notice was given to the debtor relating to such assignments. This rule was determined in *Dearle v Hall* (1823) 3 Russ. 1, where the priorities regulated as follows: "*the assignee who first gives notice to the debtor has the prior right, unless he knew of the earlier assignment when he took his assignment*"⁸⁸. Thus it is in the interest of an assignee to give notice to a debtor as soon as possible, because a subsequent assignee may gain priority over an earlier one by giving notice first. As was mentioned above, notice of an equitable assignment can be oral, however it will not guarantee the priority between successive assignees.

3.2.2 Cession and contract of factoring under Russian law

112. Under Russian law, as a civil system of law and successor of Roman law, there exists a general concept of cession, which represents an act by which a personal claim is transferred from one party (the cedent) to another (the cessionary). The principal is: whereas real rights are transferred by delivery, personal rights are transferred by

⁸⁶ Leading case *Linden Gardens Trust Ltd v Lenesta Sludge Disposals Ltd* [1994] 1 A.C. 85.

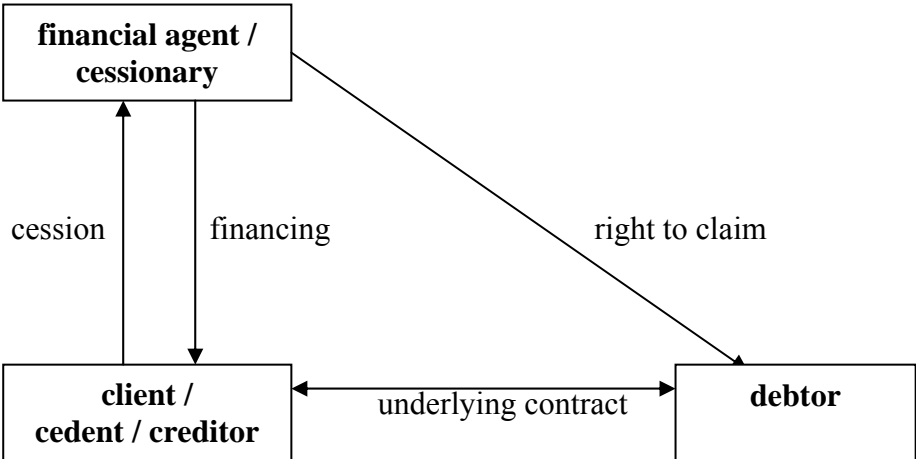
⁸⁷ Leading case *Tolhurst v Associated Portland Cement Manufacturers Ltd* [1902] 2 K.B. 660, 668.

⁸⁸ *Dearle v Hall* (1823) 3 Russ. 1.

cession. Once the obligation the debtor owes to the creditor is transferred, the creditor is entirely substituted in respect of such right. The original creditor (cedent) loses its right to claim in relation to an obligation and the new creditor (cessionary) gains such right. Generally the concept of cession under civil law is similar to the concept of assignment under common law system (e.g. English law), but on closer inspection of the respective legislations there are some noteworthy distinctions.

113. Fundamental principals of cession of a right to claim⁸⁹ in Russian law are prescribed by Chapter 24 of the Civil Code RF: *“Agreement of cession of right to claim results in replacement of a creditor in a transaction and represents an action of a previous creditor of refusing its subjective right towards a debtor in favor of a new creditor⁹⁰”*. In such agreement the right to claim a debt represents an asset to be transferred from one creditor to another one.

114. However, the general principles of cession provided by the Chapter 24 of the Civil Code RF are enriched by the special regulations of the Chapter 43 of Civil Code RF, where the concept of factoring is detailed. Factoring or financing in exchange of cession of right to claim for Civil Code RF means: *“An agreement where one party (a financial agent) delivers or undertakes to deliver to another party (a client) some moneys in exchange of cession of monetary claim of the client (a creditor) to a third party (debtor) resulting from the providing by the client some goods, services or performing of some work in favor of the third party, and the client cedes or undertake to cede this monetary claim to the financial agent⁹¹”* (see the diagram below).



⁸⁹ Under Russian Law full name of the concept of cession is ‘cession of a right to claim’ (word-to-word translation).

⁹⁰ PAVLODSKII E.A., Op. cit., p. 89.

⁹¹ Article 824 of Civil Code RF.

115. The special regulations of law contained in Chapter 43 of the Civil Code RF apply together with the general rules of cession stated in the Chapter 24 of the Civil Code RF, but the former prevail if there is a discrepancy. The fact that the special regulations prevail in a respect of the fact that the general rules of cession were not drafted to capture a financial agent and the legislator have clarified their position in this regard. But factoring can not technically be considered as a special form of cession as Russian legal academics assert that an agreement involving factoring has a more complex character than a simple cession. It can combine a loan relationship (financing by an agent of a client), as well as the possibility to provide other financial services under the same agreement⁹².

116. Therefore, in the case of a bank financing a commodity trade transaction or a project, an instrument under Russian law more adequately comparable with an English law assignment of debt proceeds is a factoring (together with some general principles of cession). A factoring under Russian law is more similar to a statutory (as opposed to equitable) assignment under English law, taking into consideration only the part of cession and not the related element of the agreement of financing (providing some moneys) by the financial agent to a client.

3.2.2.1 Formalities and form of agreement

117. When drafting an agreement of factoring it is essential to separate the **main agreement of financing** which provides for the rights and liabilities of a financial agent and a client, and a **deal of cession of a right to claim**, which is to be performed in the framework of the main financing agreement.

118. The main financing agreement should be executed in a simple written form as one of the parties (the financial agent) will be always a legal entity under Article 825 of the Civil Code RF. With respect to a cession of a right, the general rules of cession should apply: the form of a cession should comply with the same rules under which were

⁹² For more details see SUHANOV E.A., *Civil Law*, Volume II, second edition, Publishing House BEK, 2000, p.230.

concluded the underlying agreement (meaning the agreement between initial creditor and a debtor) from which the ceded right arises⁹³.

119. A cession under a factoring agreement constitutes an absolute transfer of a creditor's right to claim a debt from a debtor. After such transfer a financial agent becomes a new creditor of the debtor and it does not have a right to claim repayment from its client, but instead the financial agent should recuperate these moneys from the ceded claim.

120. There is no general requirement to provide notice to a debtor; whether such notice is necessary depends on the type of factoring. If factoring is 'open', the general practice is that a client (cedent) sends a debtor invoices with a notification in writing about the cession and at the same time request the debtor pay the debt in favor of a financial agent. However the debtor has a right to refuse to perform its obligation to pay a new creditor if it did not receive evidence of the transfer of the right. If factoring is 'closed' or 'silent' a debtor does not know about the cession and continues to pay to the former creditor, but the former creditor receives the payment for account of the new creditor (financial agent).

121. There is another very important requirement that the right of monetary claim to be ceded "*should be defined in such manner which allows one to identify an existing claim at the moment of execution of the factoring agreement, or future claim – not later than in the moment of its accrual*"⁹⁴. The respected legal academic Gongalo B.M. considers following features as sufficient for identifying the right:

- the underlying agreement between a creditor and a debtor from which it arises; and
- the substance of such right.⁹⁵

3.2.2.2 Rights which can not be subject to cession

⁹³ So the form of a deal of cession can be a simple writing, but also can demand a notarial certification and even state registration, this depends on the form of underlying obligation. See Article 389 of Civil Code RF.

⁹⁴ Article 826 (1) of Civil Code RF.

⁹⁵ For more details see GONGALO B.M., Op. cit., p.152.

122. The transfer of rights which are inseparably related to the personality of a creditor are prohibited⁹⁶. An example of such rights is a claim for maintenance or a claim for indemnification of a physical or mental injury. This group of rights is captured by the public policy prohibition.

123. The cession without a debtor's consent is prohibited when the personality of a creditor represents a particular importance for the debtor⁹⁷. In other words, it makes a difference to the debtor to which creditor it owes its obligation. This group of rights is captured by the personal contracts prohibition.

124. One significant difference from English law is that under Russian law it is not possible to make a contract not assignable. Even if a creditor and a debtor expressly agree in the contract that the debt arising out of it can not be ceded, subsequent cession will still be valid. This approach was settled in UNIDROIT Convention on International Factoring (Ottawa, 28 May 1988) which sought to free financial agents from reviewing all underlying contracts containing contractual restrictions on the cedents they are dealing with.

125. Under a special provision for factoring, successive cession of a monetary claim is not permitted if it is not provided by a factoring agreement⁹⁸. When such successive cession is permitted the priority of the new creditors will be determined by the date of notification of a debtor. So it is in the interest of each financial agent (cessionary): first, to check whether the claim (obligation) to debtor was already ceded and, second, to send a notice to the debtor as soon as possible to have a better position towards other possible cessionaries.

3.3 Using concept of assignment / cession as a security interest

3.3.1 General

126. In the financial industry the concept of assignment / cession is often used not as a means of sale, but as a security to secure performance of the obligations of a borrower.

⁹⁶ Article 383 of Civil Code RF.

⁹⁷ Article 388 (2) of Civil Code RF.

⁹⁸ Article 829 of Civil Code RF.

Such security interest is frequently a part of a security package for complex commodity trade or project transactions. Both an assignment and cession as a form of security are governed by certain further laws than such instruments used in non-security transactions. This is described further below.

127. Under both English and Russian laws the possibility to use the instruments of assignment / cession as a form of security exists, but academic research in this area is not very extensive.

128. Under English law “*it is also possible to carry out an assignment by way of security over a borrower’s choses in action, as security for that borrower’s debts*”⁹⁹. The difference between an assignment by way of sale and an assignment by way of security is that “*where the assignment is being given as security, the lender’s interest in the debt will last only until the secured claim has been paid*”¹⁰⁰.

129. Russian law stipulates for such method to secure performance of the borrower’s obligations in Civil Code RF: “*A monetary claim to a debtor can be ceded by a client to a financial agent also as a method to secure performance of the client’s obligations towards the financial agent*”¹⁰¹. This construction differs from cession by way of sale under a factoring agreement by virtue of the fact that it requires the reimbursement of the financing by a client to a financial agent, and the financial agent can use the ceded right to claim against the debtor only if the client fails to reimburse it.

3.3.2 Different ways of assignment / cession as a security interest

130. There are two ways of using an assignment / cession by way of security: (1) where a right to claim passes to a lender (an assignee / cessionary) and after fulfilment of the obligations by the assignor / cedent towards the lender the right to claim revert to the assignor / cedent; and (2) where practically a right to claim passes to a lender only after failure by a client to perform its obligation of repayment of the financing provided by the lender, and therefore the lender can not enforce such assignment / cession before the client’s failure.

⁹⁹ PLC Finance, *Taking security: overview for corporate lawyers*, www. Practicallaw.com.

¹⁰⁰ WRIGHT SUE, *Op. cit.*, p. 275.

¹⁰¹ Article 824 (1) o Civil Code RF.

131. An English law security assignment, as with any assignment, can either be statutory or equitable. If security assignment is to be a statutory assignment then it should comply with rules of the section 136 of the LPA 1925, i.e. it should be absolute, in writing and a borrower should be provided with a notice. In addition, such assignment should contain a provision for re-assignment on satisfaction of the secured obligation. “*An assignment may be absolute although it is made by way of mortgage, and does not transfer the subject-matter out-and-out.*”¹⁰² The court in *Tancred v Delagoa Bay and East Africa Rly Co*¹⁰³ declared that: “*A mortgage of debts due to the mortgagor, made in the ordinary form with a proviso for redemption and reconveyance upon repayment to the mortgagee, was ‘an absolute assignment (not purporting to be by way of charge only)’*”. Accordingly an assignment by way of security can constitute a statutory absolute assignment when a debt was assigned as a security for a loan with provision for reassignment in case of assignor’s repayment of the loan. However, on reassignment a new notice should be provided to the debtor, to provide certainty as to whom it ought to pay the debt¹⁰⁴.

132. Another important feature of a statutory assignment by way of security is that it is only possible in relation to debts which are already in existence. To take security interest over rights under future contracts only an equitable assignment is possible.

133. In the event an assignment does not comply with the section 136 of the LPA 1925 it will be considered as equitable. When an assignor assigns just a part of its right to claim a debt from a debtor (not absolute) or when such assignment is subject to any condition, the assignment will be equitable. “*The test seems to be, has the assignor unconditionally transferred to the assignee for the time being the sole right to the debt in question as against the debtor? If so, the assignment will be absolute; but if the debtor cannot tell whether to pay the assignor or the assignee without examining the state of accounts between them, it will be held to be by way of charge only.*”¹⁰⁵ Thus when an assignment of a debt to a bank is expressed to be made as security for a loan from such bank, and is to become operative only on the assignor’s failing to perform his obligations under the underlying contract (i.e. it is a conditional), it will be considered to be by way of charge, meaning it is an equitable assignment.

¹⁰² TREITEL GUENTER, Op. cit., p. 676.

¹⁰³ (1889) 23 QBD 239.

¹⁰⁴ This rule set in *Durham Brothers v Robertson* [1898] 1 Q.B. 765, 772.

¹⁰⁵ CHITTY on Contracts, Op.cit., p. 1036.

134. Under Russian law: “*there is a variant when a right to claim a debt is ceded to a financial agent under a condition that after performance by a client of its obligation of repayment of provided moneys the right to claim the debt from the debtor will be considered as being returned to the client*¹⁰⁶”. In other words, there will be an absolute cession with re-cession back when the client performs its obligation towards the financial agent, and accordingly, the condition of the re-cession is fulfilled.

135. Also under Russian law it is possible to put a condition in a cession agreement that the cession will only take effect at the moment when a client fails to perform its obligation of repayment of the financing provided by a financial agent.

136. Importantly, the provisions of Russian law about assignment by way of security “*can serve as an example of fragmentary adoption of certain law instruments which are not yet quite elaborated legislatively and doctrinally*¹⁰⁷”. Therefore Russian legal academics do not consider the concept of assignment as a possible security interest and consider this method to amount to a special pledge of rights, as a factoring agreement can not, from a strict legal interpretation, state that a cession will take place at a future point in time¹⁰⁸. Cession, in their opinion, represents an absolute transfer and can not be limited or conditional¹⁰⁹. Hence, in practice, Russian lawyers advise their clients to draft and execute a Russian law agreement of pledge of rights rather than use a Russian law cession by way of security interest.

¹⁰⁶ PAVLODSKII E.A., Op. cit.,p. 88.

¹⁰⁷ SARBASH S.V. *Some issues of securitization of performance of the obligations*, Vestnik Visshego Arbitrazhnogo Suda RF, № 7, 2007.

¹⁰⁸ For more details see GONGALO B.M., Op. cit., p. 46.

¹⁰⁹ NOVOSELOVA L.A. *Deals for cession of right (to claim) in business practice. Factoring.*, Moscow 2003. p. 326.

Chapter 4.

Enforcement of security interest and insolvency issues

137. Any security interest (pledge / charge, guarantee / suretyship or an assignment / cession of rights) taken by a bank is intended to secure the debtor's obligations, protecting the bank in the event a debtor fails to pay an outstanding sum. A security interest also gives a bank priority in relation to other creditors of the debtor and third parties in the event of debtor's insolvency. Just as important as correctly taking security is the practical enforcement of such security. The enforcement is crucial since only after a successful enforcement with a creditor will be able to restore its position and recover the secured sum.

138. Taking into account that an enforcement of a security interest is principally a practical issue, the analysis in this chapter shall be largely based on the common practice of the banking industry on enforcement of a security and less on academic research.

4.1 What is an enforcement of a security interest and what are reasons to enforce?

139. An enforcement of a security interest is an act or a process undertaken by a creditor in order to reimburse itself by exercising its rights granted pursuant to a security interest.

140. Typically, a security interest becomes enforceable if a secured obligation is not satisfied when due. If the parties provide for a trigger event whereby the security becomes enforceable, it is typically stated in a loan / facility contract and not in a security interest agreement, because such trigger is ordinary linked to a financial breach of the debtor (repayment default) or a failure to fulfill other undertakings of the debtor.

141. The situation whereby a bank enforces its security is quite rare (although it was rarer before the global financial crisis of 2008-2009). “*Whilst enforcement of most types of security will be a last resort, until that time a secured bank has greater control over the borrower and greater leverage to get the borrower ‘around the table’ to talk if a problem should arise.*”¹¹⁰ The option to enforce a security will generally only be considered by a bank in the case where a debtor is not repaying its outstanding debts and is not willing to negotiate. The reasons why a debtor may not repay the debts can vary, for example: change of the debtor’s owner, conflict with the bank or, more normally, the insolvency of the debtor.

4.2 Methods of security enforcement

142. There are two options that a creditor can undertake to enforce a security interest given to it by a debtor: (i) through an out-of-court enforcement or (ii) through a judicial foreclosure.

141. Out-of-court enforcement means that a creditor enforces its right itself without applying to a court. A judicial foreclosure means the enforcement of a security by applying to a court and applying the court decision.

143. As a practical example of enforcement procedures, a procedure of enforcement of a pledge / mortgage under Russian and English laws will be discussed below.

4.2.1 Enforcement of pledge and mortgage

4.2.1.1 Russian Law rules

144. Under Russian law, pledges and mortgages can be enforced following an event of non-performance or improper performance by the debtor of a secured obligation. The creditor is entitled to foreclose on the pledged property and have its claim satisfied out of

¹¹⁰ ADAMS DAVID, *Op. cit.*, p. 171.

the proceeds of the sale of the pledged/mortgaged property. Under the previous wording of Article 349 of the RF Civil Code, foreclosure of a pledge must have been performed on the basis of a court decision. However this general principle was recently substantially amended by the new legislation¹¹¹ (the “New Pledge Law RF”) to provide for a wider possibility of the out-of-court foreclosure on the pledged property. These changes were implemented as a response to the financial crisis of 2008 and by the intention of legislators to make Russian law more creditor-friendly and advantageous for investments.

145. According to this New Pledge Law RF, foreclosure on the movable and immovable (which was not the case before) pledge without recourse to a court is permitted now unless otherwise provided by the law; however there must be an agreement between pledgor and pledge stipulating for such out-of-court resolution (which can be concluded at any time as a separate agreement or can be embedded in the pledge agreement itself).

146. For an immovable pledge¹¹², however, pursuant to Section 1 of Article 55 Mortgage Law RF an enforcement agreement stipulating for out-of-court foreclosure may only be concluded on the condition of the receipt of a notarised consent of the pledgor. This may be granted by the pledgor prior to its entry into a pledge agreement.

147. The options for out-of-court foreclosure are as follows: (i) the title to the pledged property is transferred either to the pledgee or to a third party (if the subject-matter of the pledge is not a land plot); (ii) through a public sale or (iii) at an private auction organized by a specialised institution. It is currently debated in the legal industry whether only one of these may be provided for in an agreement, or whether it can include all three.

148. In the absence of enforcement agreement stipulating for out-of-court foreclosure or in a situation where the agreement fails to be realized within a prescribed period, an application to the judicial levy of execution may take place.

149. Even if a judicial levy of execution is more complicated and time consuming than out-of-court foreclosure there are certain benefits of it. The benefits included: it is a tested method, the court provides certainty on the exact amount of debt and / or the starting

¹¹¹ Federal Law Russian Federation "On Amending Some Legislative Acts of the Russian Federation in Connection with Improvement of the Order of Foreclosure on the Pledged Property" No. 306-FZ as of 30 December 2008.

¹¹² As was mentioned already in Chapter 1 under Russian law immovable pledge called ‘mortgage’.

price for the sale of the pledged property, there is a possibility to adopt judicial measures to ensure security of the pledged property before the sale.

150. In case of a judicial levy of execution, a foreclosure on the pledged property is generally undertaken by the court marshal through a public sale in accordance with the procedure set forth in the Russian procedural legislation. However, such foreclosure may be realised by the specialised institution through an auction if the court, upon the mutual consent of the pledgor and the pledgee, has provided for it in its ruling.

151. It should be noted that:

- The court has the right, if the pledgor requests, to suspend sale of the pledged/mortgaged property for a period of up to one year;
- The court may refuse to enforce a pledge if it determines that the non-performance is "extremely insignificant" and the creditor's claim is "manifestly disproportionate" to the value of the pledged property. Additionally, certain assets that may be capable of being pledged may not be readily saleable i.e. contractual rights.

4.2.1.2 English law rules

152. English law is generally permissive in allowing the parties' contractual intentions to prevail in an enforcement scenario. The general rule is that the parties can agree upon the moment when a debt becomes payable and upon the type and procedure of the enforcement applicable in their case. It is usual for a creditor and a debtor to include enforcement provisions in their security agreement. Only if this is not the case (the procedure of enforcement is not provided by the parties) will the law provide for default remedies for a secured creditor when the debt became payable.

153. As it was described in Chapter 1 above, under English law the essential feature of a pledge is that the creditor has possession over the pledged asset, however, it does not have title to such asset. Nevertheless, the enforcement of pledge is effective through an implied power of a pledgee to sell the pledged assets on the default of the debtor and repay itself out of the proceeds. Thus, Bowen LJ, says in *Re Harwick, Ex parte Hubbard*¹¹³:

¹¹³ 17 QBD at p 698.

“There is at common law an authority to the pledgee to sell the goods on the default of the pledger to repay the money either at the time originally appointed or after notice by the pledgee.”

154. In *Re Morritt, Ex parte Official Receiver*¹¹⁴ Cotton LJ, says:

“A contract of pledge carries with it the implication that the security may be made available to satisfy the obligation, and enables the pledgee in possession (though he has not the general property in the thing pledged, but a special property only) to sell on default in payment and after notice to the pledger, although the pledger may redeem at any moment up to sale.”

155. It is the pledgee itself who is entitled to sell the pledged assets, but it must act properly and sell it for the best price which he can reasonably obtain at the time of the sale¹¹⁵.

156. Concerning a legal mortgage over land, historically there were two possibilities of enforcement: possession (with a purpose to enable a secured debt to be repaid) and foreclose (meaning a confirmation of a final transfer of an ownership title and foreclosure of the debtor’s equity of redemption). As these two options were not entirely effective and satisfactory for the parties, mortgage agreements tend to stipulate in the security documents for direct power of sale by a creditor of the land and then the rule migrate to the law. Nowadays the LPA 1925 provides for the creditor’s implied power of sale of the land and for the creditor’s power to appoint a receiver of income in relation to any mortgage or charge over land which was created by deed. However, the Enterprise Act 2002 which focuses on corporate rescue has limited the powers of the creditor in certain circumstances.

157. In relation to a legal mortgage over movables, there is no a lot of regulations providing for implied powers of a creditor, but *“in principle, they should be similar to those in relation to legal mortgages of land, although the mortgagee may, in addition, have an implied power of sale similar to that of a pledgee*¹¹⁶”.

¹¹⁴ 18 QBD at p 232.

¹¹⁵ In *re Cargo Ex Steamships “Odessa” and “Woolston”* [1916] AC 145 at 159.

¹¹⁶ CALNAN RICHARD, Op. cit., p. 269.

158. Because English law is very contractually driven on this matter, it is always advisable to provide for express enforcement scenarios and creditor's powers in the security agreement in order to provide certainty on how the security interest will be enforced. It is considered as unwise to just rely on implied statutory provisions. In contrast under Russian Law, the new provisions of law (the New Pledge Law RF) have not been tested yet, and there are still some technical gaps in law and nobody knows precisely how it is going to work. Hence, Russian lawyers advise to use the new enforcement options prudently and, if using it, try to draft the agreement about out-of-court enforcement very thoroughly and leave an possibility to go for a traditional way of enforcement.

4.2.2 Enforcement of other security

159. Where a security is taken over receivables (e.g. assignment of debt) the basic remedy under the both laws is to give notice to the counterparty to pay them directly to the creditor. Only in case of dispute by the counterparty to pay the creditor does it make sense to go to a court and ask the court to confirm that the payment is due to the creditor.

160. Legally speaking, one does not “enforce” a guarantee. When a debtor not repaying its obligation, a creditor has a right to “call” upon the guarantee. This means that the creditor can demand a guarantor to repay the obligation of the debtor as if were the principal obligor. The creditor has direct recourse to the guarantor if it does not fulfil the debtor's obligations after the guarantor is called.

4.3 Enforcement problems and issues to be considered

161. There are many enforcement risks that can be foreseen and therefore eliminated or mitigated by the parties at an early stage. Two of the most important issues to be considered before executing a security document is what legal jurisdiction will govern such document, and which applicable law is better to chose by the parties (see 1.3.1 for more details). Another practical issue to keep in mind is that preparation of the documents for enforcement is difficult and time consuming process (see 1.3.2 for more details). A

creditor (or its lawyers) should also verify if there is any prior security interest over an asset or if there is any prohibition to put a new security in place (e.g. negative pledge or prohibition of further assignment). Some administrative issues should be considered as well, for example notice to third parties such as licensing authorities, landlords or land registration registrar. The fundamental (although complex) issue to bear in mind is an insolvency scenario: in the event of debtor's insolvency an enforcement process will be significantly affected according to the insolvency law applicable to the situation. Below some of these issues will be discussed in more detail.

4.3.1 Applicable law and jurisdiction

162. The applicable law which governs a security interest will determinate how the security should be perfected and how it may be enforced. The legal system applicable to a security interest generally depends on type of the secured asset: movable or immovable. From a practical point of view, security over immovable (e.g. mortgage over land) will be governed by the law of the place where such asset is situated. But under both Russian and English law general rule is that the parties can chose applicable law and precise it in a security document.

163. It should be noted that Russia is not a party to treaties on the reciprocal enforcement of judgments with the jurisdictions normally used for international financing documents (such as England). As a result, lawyers advise the creditors always include an option in the financing documentation of seeking a ruling in arbitration, which can take place outside Russia, since the Russian courts should enforce a foreign award in accordance with the 1958 New York Convention on the Recognition and Enforcement of Arbitral Awards, to which the former USSR was a party. However, in certain cases it may be easier to submit disputes to the jurisdiction of the Russian '*arbitrazh*' (commercial) courts (mortgage cases for example).

164. Since enforcement of security interests in Russia in the majority of the cases deals with the enforcement of court judgments or arbitral awards, it is worth mentioning that the enforcement of a security interest will need to comply with some applicable restrictions and procedural formalities. These include:

- (i) the obligation to obtain anti-monopoly approval when acquiring pledged shares (and, in some cases, assets) above relevant thresholds;
- (ii) ownership restrictions in relation to some Russian companies (e.g., Gazprom) and some immovable property (e.g., land situated near a state border); and
- (iii) the obligation to obtain a spouse consent for a suretyship.

4.3.2 Preparation of documentation for enforcement process

165. Preparation of the documents for enforcement is very practical and technical issue, but nevertheless it is very important and often very difficult stage of the whole ‘taking a security interest’ process. From the outset, to ensure itself of the enforceability of a security interest a creditor should be very cautious with all documentation and correspondence taking place between the parties. The creditor must ensure that it collects the original of a security document with a signature of authorised person representing counterparty (a debtor or other security provider) on it. It should also make sure that it possesses all other necessary documents in originals (board resolutions, countersigned notifications, spouse consent etc). In the event of judicial enforcement the creditor must prepare its claim with notarised and apostilled translation of the documents into language of the court jurisdiction (if the documents executed on another language). The process of document compilation and the preparation of documents for court can be very costly and time-consuming.

Conclusion

166. Historically, the core business of a bank has been providing loans. Under a loan, a bank gives a sum of money to a borrower, and in return receives interest payment on the principal amount lent. In such loans, banks take the risk of not being reimbursed and, in order to minimize such risk, banks often take security interests to cover the obligations of borrowers.

167. There are a many different types of security interest and parties can use all kinds of legal constructions, and combinations thereof, to secure the liabilities (there is no exhaustive list of security interests). The most commonly used security interests in debt financing are: pledge / charge, mortgage, guarantee / suretyship and assignment / cession of debts.

168. These above forms of security interests exist in different legal systems and jurisdictions. Reflecting upon the research in the present paper, the following conclusion can be reached: there are similar forms of security interests used in two different types of legal systems (common law and civil law), even in such distinct legal jurisdictions as England and Russia. However, the specific characteristics of the relevant security interests differ from jurisdiction to jurisdiction.

169. The most popular and widespread type of security in debt financing is a pledge / charge. Pledge under Russian law is a general notion for all variations of the instrument, by which the creditor's claims can be satisfied from certain property defined in advance, irrespective of the type of such property¹¹⁷ or peculiarities of the enforcement regime (possessory or non-possessory pledge). For English law it is different: a pledge is always possessory, a non-possessory pledge is called a 'charge' and a mortgage not only deals with immovables.

170. Contrary to Russian law suretyship, an English law guarantee does not constitute a security interest, however, it is still very popular in debt finance and more advantageous than Russian law suretyship.

¹¹⁷ Even if there is a special term for pledge of immovables under Russian law: 'mortgage'.

171. A bank guarantee is a special creature under the both laws and is considered a special instrument with completely different characteristics and essence to a normal guarantee.

172. Surprisingly for many foreign lawyers, in Russian law there is no concept of assignment of debt as a security interest, but only an absolute assignment or cession. This causes some problems for foreign banks which often use this simple and effective method to secure a borrower's obligations. Under English law this instrument of security exists, but is quite confusing and associates a lot with an assignment itself.

173. When taking a security interest, it is fundamental for a bank to be confident that such security is not just a signed piece of paper, but that in the event of the borrower's failure to meet its obligations such security will be effective and enforceable.

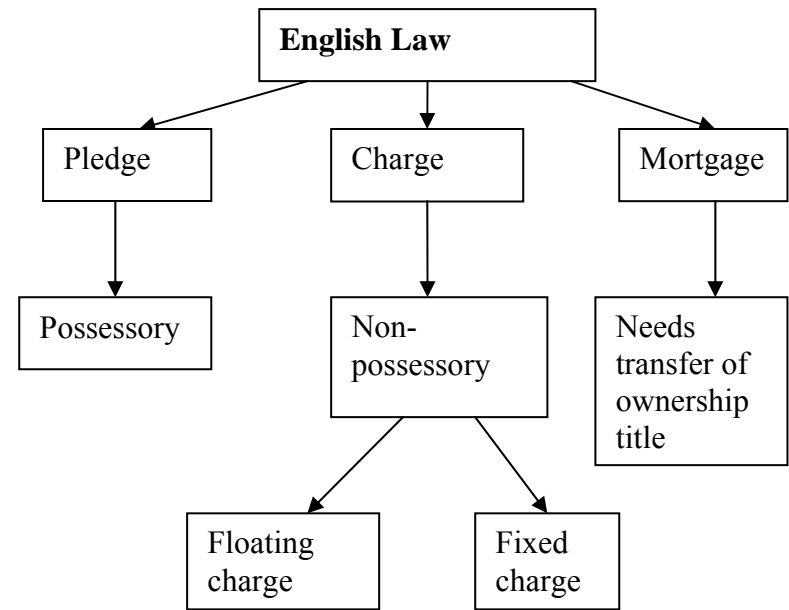
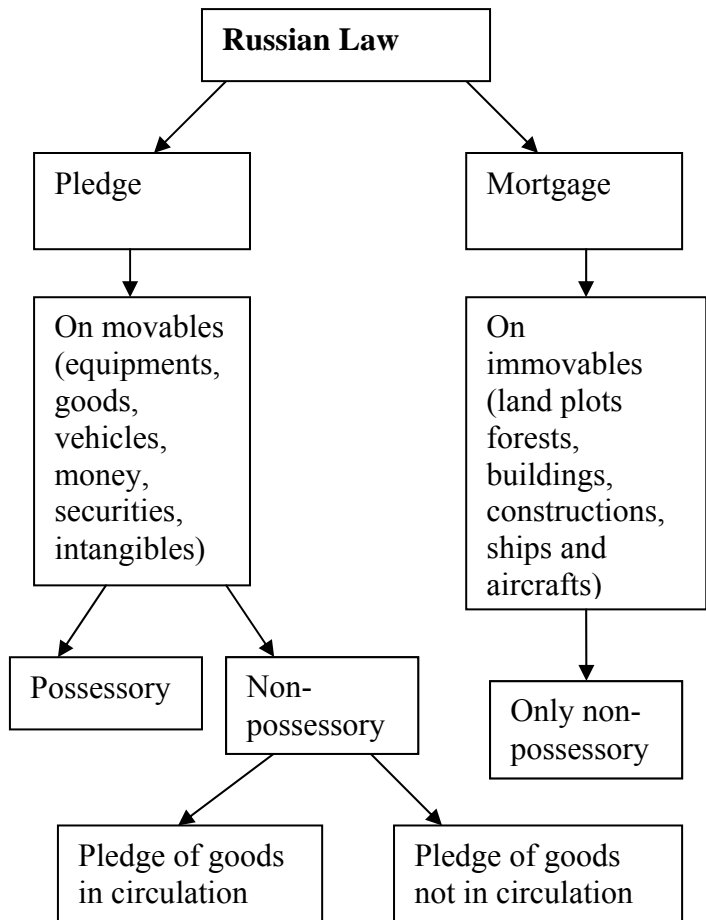
174. It is crucial to analyze all risks and benefits in having a security interest governed and enforced by one law / jurisdiction, rather than another. Hence, security documentation should provide for an advantageous governing law, and satisfy all formal conditions which is imposed by such law, and also apply an appropriate jurisdiction for enforceability of the security.

175. Summing up the research set out above, Russian law can be considered as more under-developed and debtor friendly than English law, in relation to security interests in commodity and project finance transactions. However, it is changing and such global events as the global economical crisis of 2008-2009 have forced legislators to develop Russian law and make it more advantageous for the business and banking world. In any event, English law remains the most widely used and creditor-friendly system of law in the international banking industry.

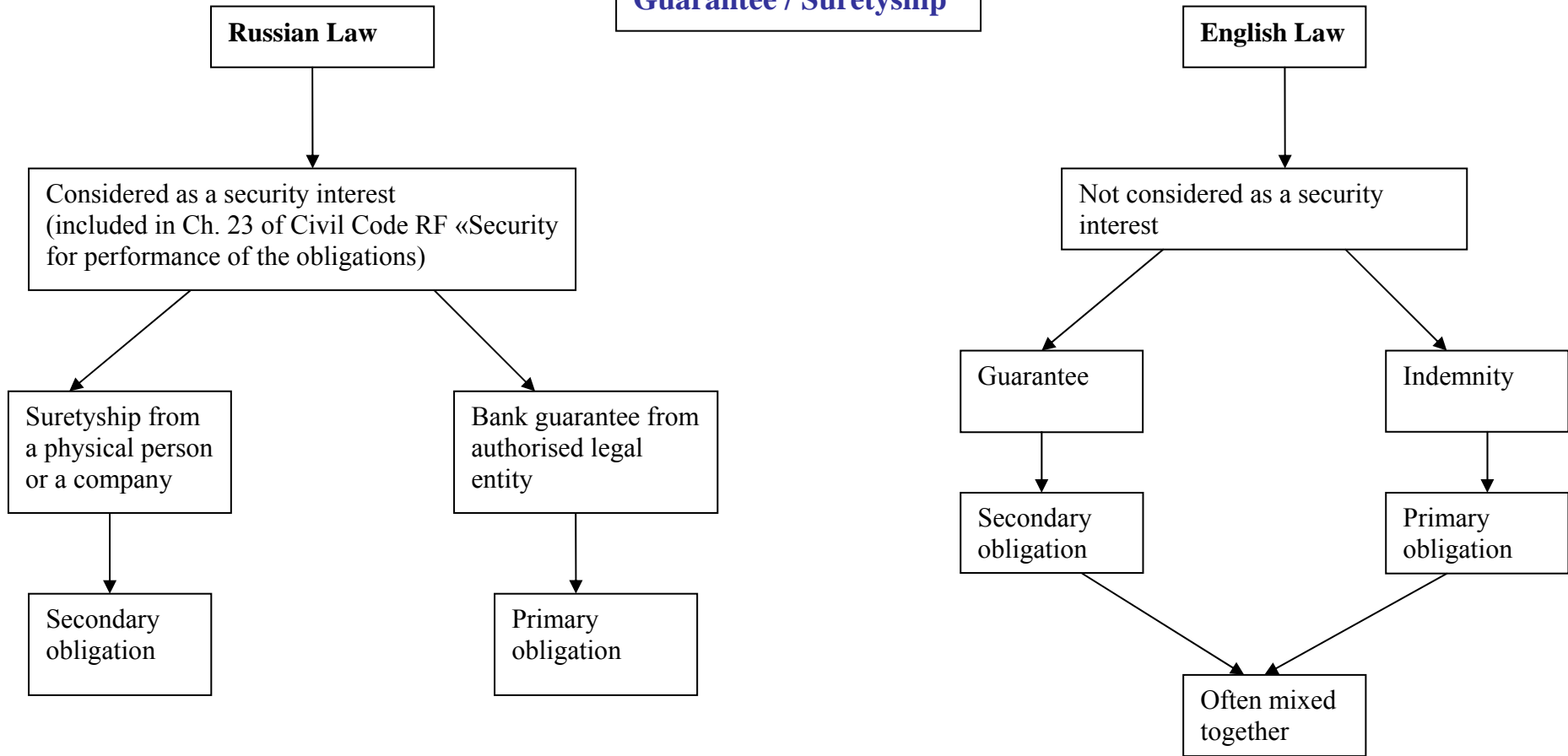
Annexes

- (1) Comparative Table “Pledge / Charge”;
- (2) Comparative Table “Guarantee / Suretyship”;
- (3) Comparative Table “Assignment / Cession”.

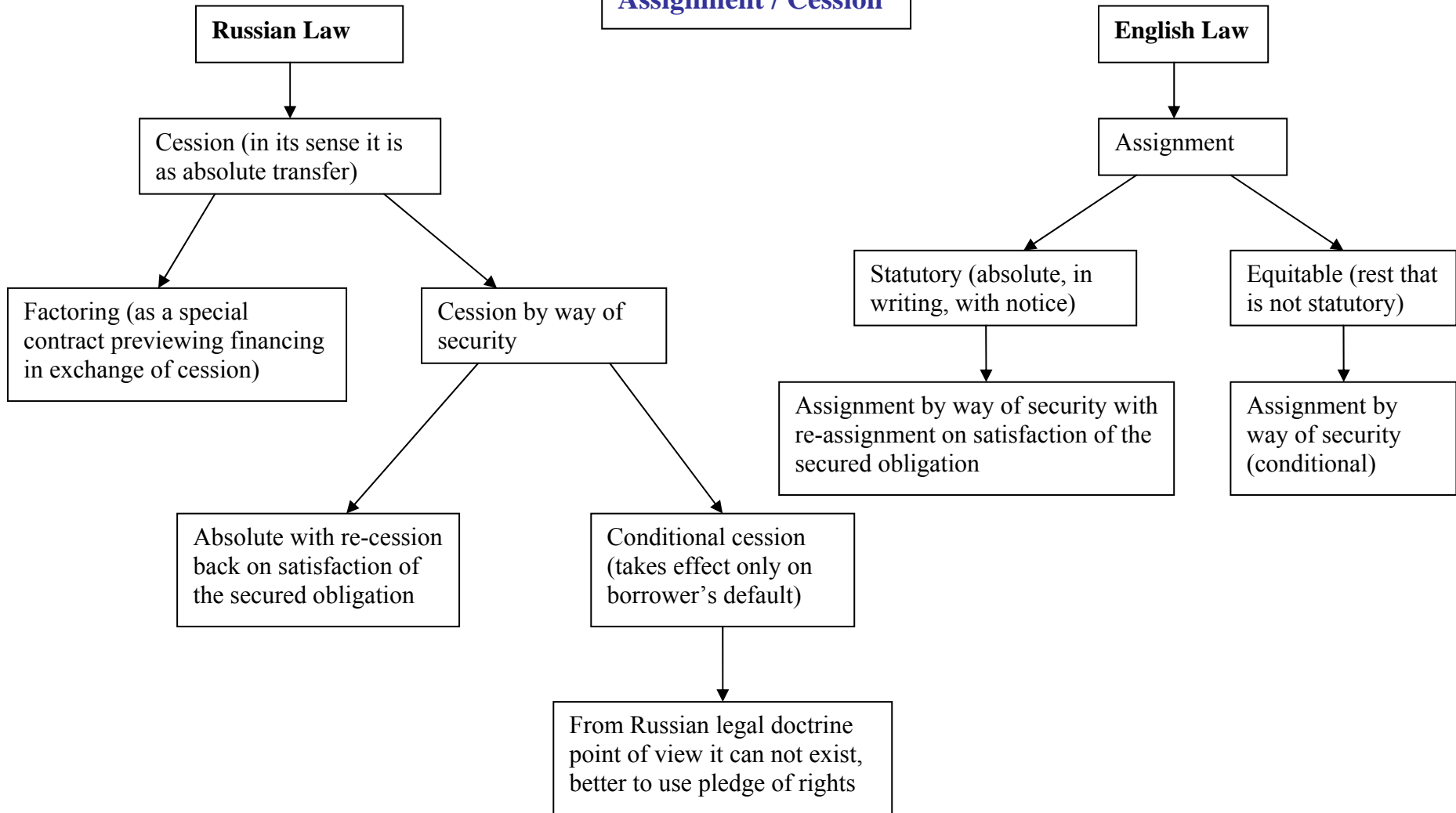
Pledge / Charge



Guarantee / Suretyship



Assignment / Cession



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