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Proprietary Security in Russian Law in the Light of the Draft Common Frame of Reference[1]

I. Overview

Two types of proprietary security are used in the contemporary business practice: security right in property[2] (pledge/mortgage[3]) and ownership retained under retention of ownership devices.[4]

Security rights in property are treated differently depending on the legal system in question (e. g., a possessory pledge is the only form of pledge recognized in some jurisdictions). Therefore, the authors of the DCFR had to render a detailed description of those features that classify a security device as a security right in property (Article IX. – 1:102 DCFR). In Russian law, these features correspond to the pledge governed by Article 334 of the Civil Code of the Russian Federation.[5] According to Russian law, the pledge might or might not involve the transfer of the pledged assets to the pledgee's possession. According to the DCFR, possessory security right is created, inter alia, when the pledger's property is retained by the creditor (Article IX. – 2:114 DCFR). Both the DCFR and Russian law characterize retention in a similar way: "a creditor retaining the asset may exercise his rights under the procedure provided for enforcement of security rights" (Article 360 of the Civil Code).

The DCFR views retention of ownership devices as a proprietary security (Article IX. – 1:103 DCFR). However, the DCFR considers it a *sui generis* type of security which is distinct from security rights. The DCFR singles out two legal constructs: retention of ownership devices by the creditor for security purposes (the creditor retains ownership, while possession transfers to the debtor); and transfer of ownership for security purposes (the debtor retains possession, while the title is transferred to the creditor). The DCFR's authors presume that the separate type of security tools can only be created through retention of title. The ownership transfer contract for security purposes is considered by the DCFR to be a contract of pledge (Clause [3] of Article IX. – 1:102). In other words, the transfer of title for security purposes is treated as a sham transaction concealing a pledge.

Russian law allows transactions involving retention of title by a person requiring no possession of the property and retaining ownership with security purposes only. Those include financial leasing, rent-to-own contracts (hire purchase), and retention of title by the seller of goods until full payment by the purchaser (Article 491 of the Civil Code).

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1 Hereinafter referred to as the DCFR. See: Principles, Definitions and Model Rules of European Private Law. Draft Common Frame of Reference. Full Edition. Prepared by the Study Group on a European Civil Code and the Research Group on EC Private Law (Acquis Group). Edited by Christian von Bar and Eric Clive. Volumes I-VI., Sellier. Munich 2009. The DCRF is an academic publication prepared by scholars of the EU member states. It aims to provide legislators with patterns regulating matters of private law.

2 The paper is focused on Russian legislation on pledge in general. The DCFR, in contrast, covers security rights in movable property only. However, the principles of pledge regulation specified in the DCFR are applicable to pledge of any kind of property. This allows making a comparison of the DCFR's rules and Russian legislation on pledge of both moveable and immovable property.

3 Hereinafter – security right.

4 See Articles IX. – 1:101, IX. – 1:102, IX. – 1:103 DCFR; see also *Ulrich Drobnig*, Present and Future of Real and Personal Security // European Review of Private Law 5|2003, p. 623.

5 Hereinafter – the Civil Code.

However, the legislator failed to mention retention of ownership devices for security purposes in Article 23 of the Civil Code, which specially governs security tools. Both judicial practice and the doctrine are vague about the matter. In particular, the impact of the retention of title on the calculation of bankruptcy assets in case of the creditor's insolvency (a seller, a leaser, etc.) remains largely unclear.

The transfer of ownership for security purposes is not governed by law, while courts' position on the issue is contradictory. However, the negative attitude to such transactions seems to prevail. The courts can consider these to be sham transactions designed to conceal pledge. The examples include contracts for transfer of the borrower's shares to the lender's[6] ownership on condition that the borrower shall redeem the shares in a defined period and for a defined price.[7] The courts' approach is underlain, among other things, by the fact that Russia's law allows the pledger to retain possession of the pledged assets. Conversely, the transfer of ownership for security purposes is widely recognised as a separate legal tool in the jurisdictions that treat possessory pledge as the only type of pledge. Furthermore, transfer of ownership was habitually used in Russia to circumvent unjustifiably strict regulation of pledge. Today most of the restrictions have been lifted, and we can expect that this controversial tool will become less attractive.

Transactions on financial markets constitute a separate group (e. g., repurchase agreements). Their structure is similar to that of ownership transfer contracts for security purposes. However, their special economic purpose disallows to legally treat them as security devices. Therefore, repo agreements and other similar transactions are governed by special rules.[8]

II. Recent Amendments to Pledge Provisions of the Civil Code

On 1 July 2014, comprehensive changes[9] were introduced to Subchapter 3 (Pledge) of Chapter 23 (Securing performance of obligations) of the Civil Code. They were primarily caused by the practice of Russia's courts which attempted, with a varying degree of success, to make up for the deficiencies in pledge regulation. To a sophisticated reader, however, many new provisions of the Civil Code mirror the ones included into the DCFT (Book IX, Proprietary security in movable assets). Firstly, this testifies to "close-relative relations" enjoyed by Russia's proprietary security law (as well as the civil law in general) and the private law of other European states within the continental legal system. Secondly, this indicates that the DCFR has influenced the concepts of Russian lawyers with regard to the contemporary model of legal regulation.[10]

The new regulation of the pledge demonstrates the triumph of the principle of good faith (bona fide principle).[11] In particular, the rules on acquiring encumbered property in

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6 Such lenders most often include banks issuing a loan to the borrower.

7 See, for example, Resolution of Federal Commercial Court of the East-Siberian District No. A19-14857/04-47-F02-73/05-S2 of 2 March 2005.

8 See, for example, Clause 51.3 of Federal Law No. 39-FZ "On the Securities Market" of 22 April 1996.

9 See Federal Law No. 367-FZ of 21 December 2013.

10 *Наталия Рассказова* (ред.), Модельные правила европейского частного права (*Rasskazova* (ed.), Model Rules of European Private Law), Moscow 2013; The DCFR was translated into Russian at the Department of Civil Law, St. Petersburg State University, and is available in the Consultant-Plus legislation data bank.

11 Reference to the principle was incorporated in "Fundamental Principles of Civil Legislation", Article 1 of the Civil Code, in 2013.

good faith and acquiring the security right in good faith were included (Article 335 and 352 of the Civil Code, respectively).

The recent changes to the Civil Code largely increased the number of general rules on pledge. A large number of new rules emerged with regard to pledge of securities, rights of obligation, rights under bank account agreements, rights of shareholders of legal entities, and intellectual property rights.

The amendments of the Civil Code also entailed difficulties in using the rules on mortgage (hypothec). As before, mortgage is governed by a separate law[12] that prevails over the general rules of the Civil Code (Article 334 of the Civil Code). However, the Law on Mortgage was not amended together with the general provisions on pledge in the Civil Code. To a certain degree, it is "lagging behind" the Civil Code. As a result, courts will need to extend, by way of interpretation, the new approach of the Civil Code to mortgage transactions.

The legal nature of security right is one of the problems that must be resolved by the legislator. The legislator is going to amend the proprietary rights section of the Civil Code, so as to directly specify that mortgage (security right in real estate) is a limited proprietary right.[13] The list of limited proprietary rights includes only mortgage (security right in real estate), but not pledge (security right in movable property). The Russian doctrine and court practice adhere to the *numerus clausus* rule with respect to proprietary rights. Therefore, if the Draft Amendments are adopted in their current version, they will create a collision unacceptable both in practice and theory: mortgage (security right in real estate) will be treated as a proprietary right (since included into the respective list by the legislator), while pledge (security right in movable property) will be treated as a right in personam (since they are not included in the list of property rights and are described in the "Right of Obligations" section of the Civil Code). But the security right is a security device by legal nature, which is not contingent on the type of encumbered assets: the pledgee's interest is in all cases secured by the special right in the pledger's property, and the pledgee's right is the one in rem – that is, having an *erga omnes* enforceability (Article 347 of the Civil Code). The registration of pledge in moveable property has been introduced in Russia only recently (in 2014). As a result, the pledge acquired the elements of publicity which previously characterized only mortgages (because mortgage must be included to the unified state register of rights in real estate). This added to the similarity in the position of creditors having security rights in moveable property and in real estate. In terms of legal policy, creation of two independent regimes of pledge regulation is hardly advisable, because it gives an erroneous idea that pledges in moveable property lack the advantages of property rights. This will undermine the practical value of pledge and, consequently, will have a detrimental effect on the credit sector. The pledge should be governed in a common and coherent way. Pledges in incorporeal assets must be governed by rules of property right with due regard to the nature of such assets.

The DCFR classifies security rights based on the way in which they are created: 1. the pledger grants the security right to the pledgee, 2. the security right is retained by

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12 Federal Law No. 102-FZ On Mortgage (Pledge of Real Estate) of 16 July 1998. Hereinafter – the Law on Mortgage.

13 Draft Federal Law "On Amendments to the first, second, third and fourth parts of the Civil Code and to some legislative acts of the Russian Federation", N 47538-6, available under: http://www.consultant.ru/law/doc/gk/. The amendments to the Civil Code were drafted as a single paper. However, it is being adopted in parts, which is justified by neither theory of law nor practical considerations. Each part is completed separately following a discussion in the State Duma. This has already resulted in a discrepancy between the rules contained in different parts of the Civil Code.

the pledgee upon the disposal of assets to the acquirer, who obtains the status of a pledger. This classification is not employed in the Russian law, but does not run counter to it, either. Therefore, we can use it for doctrinal purposes. In both cases, we observe creation of a limited property right by the owner of the pledged assets. The difference consists in the conditions under which the pledgee's right arises.

The authors of DCFR single out three groups of rules determining development of security rights: rules on creation of security rights (Chapter 2, Book IX); on effectiveness as against third persons (Chapter 3, Book IX); and on priority of secured creditor's rights (Chapter 4, Book IX). The Civil Code, in its previous version, used this classification neither expressly nor by implication. Moreover, many rules were not provided at all. Today this shortcoming is eliminated, and the Civil Code contains all three groups of rules, which testifies to significant progress made in the sphere of security rights.

Nonetheless, the legislator ignored many details of security rights that also require regulation. This is accounted for, inter alia, by underdevelopment of respective social relations. It is hardly surprising in a country where a major part of land is still not included in commercial turnover. The lack of statutory regulation will partially be compensated by court practice, while the approaches described in the DCFR can be used as guidelines for statutory regulation.

III. The concept and mechanism of the pledge

According to the Civil Code, the pledge is a limited proprietary right in assets owned by others.[14] This right classifies as a right of priority, or a privilege. This privilege creates a special procedure for satisfaction of the pledgee's rights in the event the pledger has multiple creditors. The pledgee's claim is satisfied from the cost of the pledged assets and is not subject to the sequence of priority that applies to "ordinary" creditors. The right of priority most vividly comes to the foreground in two instances: in enforcement proceedings and in the event of the pledger's insolvency.[15]

As a matter of common knowledge, a privilege cannot be imposed on a person, and any person enjoying a privilege is entitled to waive it. The waiver means that such person becomes subject to general rules.[16] The secured creditor is not compelled to use his priority right and is entitled to claim fulfilment of the secured obligation without enforcing the security. However, even in the event the pledgee waives the privilege and claims fulfilment of the secured obligation, the pledgee's status (where the debtor and the pledger are one and the same person), according to the Russian law, will still be different from that of other creditors – that is, a secured claim is satisfied, in the first place, from the cost of the pledged assets, notwithstanding any other property owned by the debtor.[17] Consequently, the pledged assets will inevitably be redeemed should the creditor (the pledgee) win the case in court.

Generally, it might entail extra overhead (non-productive) expenses for the pledger, which is not desirable in terms of both private and public interest. Presumably, this procedure creates an additional incentive for the debtor-pledger to voluntary fulfil the se-

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14 These can include both a debtor under the secured obligation and a third party.

15 See Clause 4 of Article 78 of Federal Law No. 229-FZ "On Enforcement Proceedings" of 2 October 2007 (hereinafter – the Law on Enforcement Proceedings); Articles 18.1, 138 of Federal Law No. 127-FZ "On Insolvency (Bankruptcy)" of 26 October 2002.

16 *Юлиус Барон*, Система римского гражданского права (*Baron*, The System of Roman Civil Law), St. Petersburg 2005, p. 78.

17 Article 78 of the Law on Enforcement Proceedings.

cured obligation. The pledger's interests are protected by means of a mandatory rule (Clause 4, Article 348 of the Civil Code): the pledger can perform the secured obligation at any time prior to the sale of the pledged assets and, by doing so, to keep the assets to himself. On the whole, this rule corresponds to the rule in the DCFR's Article IX. – 7:106. However, there is a difference. The authors of the DCFR presume that the pledger's right to redemption terminates as soon as a binding contract to sell the encumbered asset to a third person is concluded. According to Article 348 of the Civil Code, interpreted literally, the security provider's right of redemption is effective until the asset becomes a property of the purchaser. This approach means there might be a collision of two rights when the pledged assets are being sold: the purchaser's right to claim transfer of the assets to the purchaser's ownership under a contract of sale, and the pledger's right to fulfil the secured obligation and to prevent such a transfer. The Civil Code resolves the collision in favour of the pledger. For reasons of legal policy, the priority might be given to the interests of the pledged assets purchaser (as proposed by the DCFR), but such approach must be provided in law *expressis verbis*.

The pledge, as any other right based on the security interest, has an exclusively auxiliary nature: it provides a creditor with an additional source of secured obligation fulfilment and can be used with the sole purpose of the unpaid debt collection. Hence it is not allowed to get enrichment at the cost of pledged assets. In the event the funds gained by the sale of the pledged assets exceed the amount of debt, the surplus must be transferred to the pledger as an owner of the assets (Article 334 of the Civil Code, Article IX. – 7:215 DCFR). It is a mandatory rule in both the Civil Code and the DCFR. It applies even where the contract of pledge allows the pledgee to seize ownership of the assets (*lex commissoria*), the only difference being that the value of debt is compared to the market value of the asset.

The pledge operates by means of encumbering a property. Its functioning rests on three principles underpinning the regulation of pledge both in the Civil Code and the DCFR.

The first of these principles is specialization: the right of pledge can arise only in the event the pledged assets are individually determined. The right of pledge, as any other right with absolute effect (having an *erga omnes* enforceability), cannot arise with respect to property in general, but only in property which is specific, or ascertained.[18] The floating charge recognized by Russian law (Article 357 of the Civil Code[19]) is no exception. The only difference is that the goods are ascertained by means of their locations and generic description.

Being pressured by the banking lobby, the legislator for the first time allowed the following changes in the pledged assets description in contracts concluded with persons involved in entrepreneurial activity (a business): the assets can be described as the entire property of the pledger ("a general pledge"), as certain part of this property, or as property of a certain type (Article 339 of the Civil Code). The impact of these amendments on practice is hardly reassuring. How can one describe such pledge? Should it be "the entire property of the pledger", "all motor cars owned by the pledger", etc.? Remarkably, the current legislation provides that any pledge becomes effective against a third party only when it is made public by means of registration. Therefore, any sensible pledgee

[18] *Mikhail Agarkov*, "Obyazatelstvo po sovetskomy grazhdanskomu pravu (Obligation in Soviet Civil Law)," in Izbrannya trudy po grazhdanskomu pravu (Selected Works on Civil Law), Moscow, 2002, 1:209.

[19] Article 357 of the Civil Code: "The changing assets ('goods in circulation'), alienated by the pledger, shall cease to be the object of pledge from the moment of their passing into the ownership of the acquirer, while the commodities, acquired by the pledger, which have been indicated in the contract of pledge, shall become the object of pledge from the moment, when the pledger's ownership arises".

must ensure the property encumbered by his right is included into the registry. This in no way implies that under the new rule the principle of individualization is abandoned. There is also another reason making it problematic to pledge "all property" as a whole: various types of assets (obligation as a duty to perform; securities; real estate, etc.) are governed by different rules.

The second principle is: no property – no security right. The death of the pledged asset terminates its encumbrance and, consequently, the pledge itself (Article 352 of the Civil Code, Book IX. – 6: 101 DCFR). Exceptions to this principle are aimed at maintaining stability of legal relations governed by civil law. Their legal meaning is as follows: under the relevant circumstances, the security right does not follow the fortunes of the pledged asset, but is transferred to a different object. That sort of exception is now included in the Civil Code (Article 345 of the Civil Code): if the pledged property was reworked by the pledger, the security right by the operation of law is transferred to the newly created product. A similar rule is included in the DCFR (Article IX. – 2: 307), but according to the authors of the DCFR, it can only be used by mutual agreement. The peremptory wording of the Russian legislator can be explained by an attempt to stop the violations of pledgers who try to terminate the encumbrance by reworking the asset. Article 345 of the Civil Code contains another exception to the principle under consideration: in case of death of the pledged asset, the pledger is entitled to pledge a new asset to replace the lost one. This principle is not mentioned in the DCFR.

Importantly, that in the cases described above, the right of pledge does not arise anew but is transferred to a newly pledged asset. Accordingly, the security right is considered to arise before the encumbered asset is created. In this case, we see an exceptional rule used to determine the moment of the security right creation. However, the pledge becomes effective against third parties in accordance with the general provisions. Hence, its effectiveness is determined by the time when the encumbrance becomes public.

The third principle is the following: the pledge follows the pledged asset (Article 353 of the Civil, Article IX. – 5:303 DCFR). An exception to this principle has always been applied with regard to the floating charge, due to the peculiarities of this type of collateral.

An exception to the principle under consideration is the rule of good faith acquisition of ownership included in Article IX. – 6:102 of the DCFR. Recently this rule also appeared in the Civil Code: the security right shall be terminated if the pledged property was acquired for value by a person who did not know and could not be expected to know that the said property is an object of pledge (Article 352 of the Civil Code). The provision was adopted following the practice of courts, which, in the absence of direct statutory references, based their decisions on the need to protect the good-faith party to the business transaction.[20] Today, the application of the provision under consideration is so much more justified, since the existence of a publicly available system of security rights registration allows any good faith purchaser to ascertain whether the property is encumbered. Regrettably, the Russian legislator, unlike the authors of the DCFR, failed to include in the law an important provision: the acquirer of a duly registered encumbered asset is deemed a good faith acquirer if "the transferor acts in the ordinary course of its business" (paragraph (2), Article IX. – 6:102 DCFR). Without this clause, the literal interpretation of the rules of the Civil Code leads to absurd implications. For example, when shopping in a store, all of us should obtain information from the register on whether or not the items we are purchasing are encumbered with security rights? Hopefully,

[20] See paragraph 25, Resolution No 10, Plenum of the Supreme Commercial Court of the Russian Federation of 17 February 2011.

the courts will eliminate this deficiency and embrace the provision proposed by the DCFR.

IV. Creation of the security right

The security right arises from the contract or by the operation of law. The latter traditionally included the seller's security right to goods sold on credit (Article 488 of the Civil Code) and the rent recipient's security right to secure for the rent payer's obligation (Article 587 of the Civil Code), etc. Two more provisions were added to this list recently.

Firstly, the security right for the encumbered asset is acquired by a good faith pledgee if the right is transferred by a security provider who is not an owner of the asset (Article 335 of the Civil Code). In this case, the owner is regarded as a pledger. This provision repeats the rule included in Article IX. – 2:108 of the DCFR. However, the DCFR stipulates the condition for a good faith acquisition of a security right in the case described above: the asset is in the security provider's possession, or the asset is included into the official register as owned by the security provider. No such provision is included in the Civil Code. However, it is quite clear without any additional clauses that a person who accepts as collateral an asset that is registered in a public register is presumed to act in good faith where relying on the registration entry. As to the actual possession of the asset, its legitimizing meaning escaped the notice of the Russian legislator. This obvious omission will probably be rectified in court practice.[21] According to the DCFR, the rules on good faith acquisition of the security right do not take place with regard to a thing stolen from the owner or the legal possessor. The Russian legislator gives more protection to the owner: this rule does not apply to any case when the thing has gone out of the possession of the owner or the legal possessor contrary to their will.

Secondly, the rights and obligations of a pledgee are now also given to a person in whose interest an injunction on disposal of property has been imposed (Article 334 of the Civil Code). In this case, the security right arises as soon as the court's decision comes into force. The question whether this kind of pledge is effective against third parties, due to the absence of special rules, is resolved in accordance with the general rule. The innovation described above has a lot in common with the rule stipulated in Article 4:107 of the DCFR:

> For the purpose of determining priority, an execution creditor is regarded as holding an effective security right as from the moment of bringing an execution against specific assets if all preconditions for execution proceedings against these assets according to the procedural rules of the place of execution are fulfilled.

The Civil Code and the DCFR talk about different procedures. But both, given their public-law nature, have a similar effect on pledge relationships. As for the contractual pledge, we should clearly distinguish between an obligation under a contract of pledge, on the one hand, and the security right on the other. An obligation arises from the pledge agreement, while the security right is created following its own logic. The text of the Civil Code has traditionally used the terms "a pledge agreement" (договор залога), "a pledge obligation" (залоговое обязательство), and "the right of pledge" (право залога).

[21] It is evident from the DCFR (Article IX. – 3: 102 and others, DCFR), the possession of an asset affects a number of issues, such as determination of good faith, distribution of risks, etc. The only instance when the Russian legislator takes into account the importance of possession of the pledged asset is provided for in Article 358.16 of the Civil Code: "Security right encumbers corporeal securities as soon as the pledgee takes the possession of them unless otherwise stipulated by law or agreement".

The authors of the latest amendments amateurishly deemed the diversity of terms an unnecessary complication and decided "to simplify" the law by "leaving everywhere only one word, "the pledge" (залог). As a result, throughout the text of the Civil Code, one will find a vague term "creation of pledge". "Not only does the meaning of this term coincide with the conclusion of the pledge agreement (the latter in this legislative text is in most cases also called just "a pledge"), but is also connected with absolutely different legal facts and engenders legal consequences different from those of a contract."[22]

However, despite the faulty technicalities, it is possible to perceive from the text of the Civil Code that in order for the security right to arise, the same conditions are required that are provided for this purpose in the DCFR (Article IX. – 2:102): 1) a valid contract of pledge, 2) the existence of the pledged asset and its transferability, 3) the existence of the secured obligation, 4) the pledged asset must belong to the pledger (because a pledger is not entitled to restrict the another person's ownership[23]).

According to the general rule, the security right is created at the time when the pledge contract is concluded. If the above conditions occur later, then the right is created later as well (Article 341 of the Civil Code). The pledge contract is a contract under which a security provider undertakes to grant a security right to the secured creditor, therefore, it can be concluded in respect of assets that do not yet exist or do not belong to the pledger, as well as before the secured obligation is created.

In certain cases, expressly stipulated by law, additional official (or other compulsory) registration of the security right is required for the security right to arise (Article 339.1 of the Civil Code).[24] In cases under consideration the moments of the right's registration and the right's creation coincide.

V. Effectiveness against third parties

When intending to conduct a transaction in relation to the property of another person, everyone reasonably expects to be informed about any third-party rights to that property. The sphere of civil law relations requires the information on the limited rights in the property of other persons to be publicly accessible.

In Russia, similarly to other countries, the official register is a traditional way of providing publicly available information on rights in real estate, including mortgage.[25] Registration is a compulsory condition for the creation of the right itself. The registry is open to public; therefore, it is presumed that any person acquiring a right in real estate knows or is expected to know about any encumbrance thereof.[26]

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22 *А.Л. Маковский*, Собственный опыт – дорогая школа (*Makovskij*, Your own experience – an expensive school), Актуальные проблемы частного права: сборник статьей к юбилею Павла Владимировича Крашенинникова (*Makovskij*, in: Current Issues of Private Law: A Collection of Articles to Celebrate the Anniversary of Pavel Vladimirovič Krašeninnikov, Moskva/Ekaterinburg, 21 July 2014), Moscow 2014, available at http://normapravaspb.ru (ConsultantPlus legislation data bank).

23 See Article 4 of the Information Letter of the Presidium of the Supreme Commercial Court of the Russian Federation No 26 "Review of the practice of settlement of disputes related to the application of pledge regulations of the Civil Code of the Russian Federation" of 15 January 1998.

24 Registration is required for mortgage (Article 11 of the Law on Mortgage), pledge on intellectual property rights (Article 358.18 of the Civil Code), pledge on the rights of the participants of a limited liability company (Article 358.15 of the Civil Code), and pledge on uncertified securities (Article 358.16 of the Civil Code).

25 See: Federal Law No 122-FZ "On the Government Registration of Real Estate Titles and Real Estate Transactions" of 21 July 1997.

26 Pledge of some other types of property is subject to compulsory registration (see fn. 24).

Until recently, the publicity was not an attribute of pledge of movables in Russia (except when subject to compulsory registration). There was a lot of contradiction in the practice of making court decisions on the possibility for the pledgee to counter his/its security right against the third parties' claims. Some courts recognised that the pledge is preserved in the case of acquisition of the pledged property by a person who did not know and could not have been expected to know about the pledge, because there is no reference in the law as to this particular ground for the termination of pledge. Others, on the basis of general principles of civil law and the requirements of good faith, gave opposite decisions.

The amendments to the Civil Code resolved this contradiction. A register of pledged movables has been created.[27] Though registration of the security right of pledge is not obligatory, as between third parties and the pledgee, the latter is not entitled to refer to his security right until the registration of the said right has occurred (Article 339.1 of the Civil Code). As we already mentioned, the Russian legislator did not attach importance to the fact that the pledged asset has been transferred to the pledgee's possession. At the same time, it is obvious that the physical control of the pledgee over the pledged asset makes it possible for third parties to discover the existence of encumbrance. Let us say that jewellery has been pledged to a bank. Any bona fide buyer of this jewellery will inquire where it is located, and thus will be able to find out that it have been encumbered with the bank's limited proprietary right. But according to Russian legislation, the bank that possesses the goods as collateral, cannot refer to its security right in a relationship with the purchaser of the jewellery if the information about the said pledge has not been entered in the notarial register.

The DCFR is more consistent in its treatment of the issue. For the security right to be effective against third parties, the secured creditor may use on of the following three ways of "informing" the public about the pledge: by registering the pledge in a public register; by holding possession of the encumbered assets (in the case of corporeal assets); or (in the case of certain intangible assets) by exercising control over the encumbered asset (Article IX. – 3:102 DCFR). Apart from the fact that such a provision is consistent with common sense, it also makes it possible to take some burden off the register. The latter point is of particular importance for Russia, given its vast territory. Hopefully, this deficiency will be corrected under the influence of court practice.

The pledge that is made public is effective against other creditors of the pledger or acquirers of the pledged asset (or the rights in it). The pledge that has not been made public can be effective against the pledgee and also any person who knew or was expected to know about the pledge, i. e. a person who gives a bad-faith reference to the formal absence of publicity of the pledge – absence of the entry in the register concerning the pledge (Article 339.1 of the Civil Code).

Due to the internal logic of pledge relations, there is no direct correlation between the creation of the security right and its effectiveness against third parties; that is why various combinations are possible. The exception includes a security right that is subject to mandatory registration, since this pledge is effective against third parties starting from the moment when it is created. In other cases the security right may arise but has no implications for third parties (e. g., the notice of pledge has not been listed in the public register); and vice versa, a security right that has not yet been created can be entered into the public register. When applying for the notice of pledge to be entered in the register,

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[27] In Russia the Register of Pledged Movable Property is maintained by the Federal Notary Chamber. The notice of pledge is submitted to the public notary, who shall enter the information into the register (chapter XX.I of the Fundamental Principles of Legislation for Notary Activities approved by the Supreme Soviet of the Russian Federation on 11 February 1993, No. 4462-1. Hereinafter – Fundamental Principles).

the secured creditor does not have to submit any proof that the security right has been created. The purpose of making an entry is to declare to all third parties that in case of recovery proceedings against the owner of the pledged asset they will have to take into account the pledger's right, if it is still effective at the time.

VI. Priority between security rights

If the pledged property becomes a subject of another pledge agreement (subsequent pledge), a conflict arises between the rights of the prior (senior) and subsequent (junior) pledgees. Prior to the amendments, the Civil Code mentioned subsequent pledges in a cursory way only.[28] Today, regulations of these relations in the Civil Code are more detailed. The text of the law for the first time contains the term "seniority of pledges", which previously had a purely doctrinal character.

The procedure for the resolution of the conflict of pledge rights security rights as set by the Civil Code is based on a traditional approach. The pledgees are put in order, with each subsequent pledgee being satisfied after the claims of the prior pledgees are satisfied. The main principle for determining priority is "*prior tempore – potior jure*". The priority between the security rights, both in the Civil Code and the DCFR, is determined by the moment when the security right acquires the attribute of publicity (Article 342.1 of the Civil Code, Article IX. – 4:101 DCFR). According to the Civil Code, this moment coincides with the time of registration (compulsory or voluntary); according to the DCFR – it coincides with the time of registration, or the time when the security right to or control over the pledged asset have been acquired, whichever is earlier.

An innovation of the Civil Code is the rule included in Article 342 stipulating that the priority between security rights can be changed via an agreement between the pledgees or between the pledgees and the pledger (a similar rule is included in the DCFR, Article IX. – 4:108). Obviously, the agreement does not act against persons who are not parties to the agreement. It is interesting that previously such agreements were not prohibited either. In this case, however, just like in many others, the famous principles of the private law, "everything which is not forbidden is allowed", was used with caution by the Russian judges. It is not surprising given that for 70 years (during the Soviet period) of the dominance of the command economy which prevented the development of the market, Russian civil law was not only objectively limited in its development, but also subjectively got under the influence of the principle of the administrative law, viz. "everything which is not directly prescribed is forbidden". In order to overcome the ill-founded limitation of contractual freedom today, one has to use, among other things, the method of direct permission.

Another innovation of the Civil Code, in stark contrast, is intended to limit contractual freedom. From now on, a pledge agreement provision prohibiting subsequent pledges is void (Article 342, paragraph 2 of Article 168 of the Civil Code), while previously such provisions were permitted. The new rule is justified since it supports the development of credit relations. The balance of the parties' interests is maintained by the following rule. If a subsequent pledge is created regardless of the will of the senior pledgee and the junior pledgee intends to enforce its security rights, the senior pledgee may claim the debtor to perform the secured obligations before the maturity date and carry out the enforcement procedure; but if the senior pledgee does not use this right, the pledged asset that was sold by the claim of the junior pledgee is transferred to the transferee as encumbered with the prior pledge (Article 342.1 of the Civil Code). Besides, the senior pledgee

[28] This can be explained, first of all, by the fact that land in Russia had been involved in mortgage relations to a limited extent.

may set conditions regarding subsequent pledge agreements. If a subsequent pledge agreement is concluded in violation of these conditions, of which the junior pledgee was or should have been aware, the claims of the latter shall be satisfied subject to the conditions the senior pledgee specified (Article 342 of the Civil Code).

The ranking of security rights that are ineffective against third parties is determined by the time of their creation (Clause 10, Article 342.1 of the Civil Code, Article IX. – 4:101 DCFR).

Russian law does not know the concept of "superpriority" or rules connected with it, which can be found in Article IX. – 4:102 of the DCFR. Besides, the Civil Code does not regulate the issues of the continuity of priority in the event the pledged asset is changed (if the goods are commingled, combined, etc.). For the Russian legislator, the provisions included in the DCFR (e. g., Article IX. – 4:103) can serve as a model solution.

VII. Exercise of the security rights

The Civil Code approaches exercising the security right in substantially the same way as established by the DCFR: if the debtor fails to perform the secured obligation, the secured creditor shall have the right either to sell the encumbered assets to apply the proceeds towards satisfaction of the debt or to appropriate the encumbered assets at a reasonable price to satisfy the secured debt, in the corresponding amount. However, the details differ significantly.

The DCFR regards extra-judicial enforcement as a general rule to be applied by the secured creditor (Article IX. – 7:103). It is evidently, that "any party or third person whose rights are violated by enforcement measures or by resistance to justified enforcement measures may call upon a competent court" (Article IX. – 7:104 DCFR).

Conversely, the Civil Code considers judicial enforcement as a general rule (Article 349), while extra-judicial enforcement may be applicable if the parties have agreed to it. Furthermore, in certain cases where the balance of interests between the parties involved is considerably disturbed, judicial enforcement is the only option (Article 349 of the Civil Code). In particular, it applies to those cases when the living quarters, as encumbered assets, are the only housing owned by the pledger.[29]

Apparently, when introducing the amendments to the Civil Code's rules on pledge, the Russian legislator did not venture to challenge the paternalistic approach, presumably due to insufficient level of legal culture in the country. Still, with regard to the current situation pledge relationships between entrepreneurs should be governed in accordance with the approach adopted by the DCFR.

Under the Russian law, there are two stages in exercising the security right (Articles 348–350 of the Civil Code). Each stage has its consequences in substantive civil law.

The first stage is "foreclosure". In the sense ascribed to it by the Russian law, it is a procedure in which the pledgee`s right to dispose the encumbered asset is confirmed. Foreclosure calls for testing the grounds to realize the asset (viz. violation of the secured obligation and the existence of the encumbered asset) and grounds to reject the claim. In particular, these grounds may include the following: the amount of the claim of the pledgee is obviously disproportionate to the value of the encumbered property (Article 348 of the Civil Code). Where the court's decision is in the creditor's favour, the creditor is entitled to dispose the encumbered asset.

[29] However, in those cases, extra-judicial enforcement is also applicable upon the pledger's agreement after default.

The second stage is "realization" (sale as a general rule) of the pledged asset. Realization is viewed as a procedure that follows the foreclosure and should result in satisfaction of the secured right (either partially or fully).

The authors of DCFR do not single out the "foreclosure" stage, as specified in the Russian law, and entirely focus on the rules regarding realization of the pledged asset as a way to satisfy security right. According to the DCFR, the debtor's failure to perform the secured obligation serves as a ground for realization (sale as a general rule) of the asset, whereas according to the Civil Code the ground is the completion of the "foreclosure" procedure. After default, the pledgee may realize the asset to apply the proceeds towards satisfaction of the debt (Article IX. – 7:101 and Article IX. – 7:201 DCFR). Therefore, the pledgee is entitled to take possession of the encumbered asset and take any steps necessary to protect the asset in question (Article. IX. – 7:201, Article IX. – 7:202 DCFR). The pledgee's authorities mentioned above aren't recorded expressis verbis in the Civil Code, although they are presumed.

Both the Civil Code and the DCFR state that enforcement of the security right is to be undertaken by the secured creditor in a commercially reasonable and bona fide way (Article 349 of the Civil Code; Paragraph 4, Article IX – 7:103 DCFR).

According to the Russian law, there are two ways to foreclose on the encumbered asset: judicial and extra-judicial one.

There are two scenarios in case of an extra-judicial procedure is carried out. If the pledger does not resist to the realization of the secured creditor's rights, the latter may act by himself and therefore notify the pledger that the foreclosure on the asset has taken place. When conflicts between the parties occur, the secured creditor may appeal to the notary in order to enforce seizure under endorsement of execution performed by the notary.[30] To seek notary assistance is more convenient than to call upon a court. After the notary performs endorsement of execution, the document in question becomes a writ of execution (Article 12 of the Law on Enforcement Proceedings). Therefore, the enforcement officer (bailiff) may undertake the further steps for realization of the asset: either to sell the asset by auction or to transfer it to the pledgee.[31]

In order to carry out judicial enforcement of the security right, the pledgee is to make a claim against the pledger, i. e. a claim for foreclosure. The experts in the Civil Procedure Law tend to challenge this traditional approach towards pledge primarily due to the following arguments.[32] As pledge essentially presupposes the pledgee's priority over the pledger's creditors, the claim over the encumbered asset has to be based on a dispute between the pledgee and the pledger's creditors. Meanwhile, according to the current procedure, a claim for pledge is the claim against the pledger. The pledger's creditors do not join as a party to the process, notwithstanding their rights being concerned. Thus, it may provide absolute grounds for declaring the judgment invalid (Article 330 of the Civil Procedure Code of the Russian Federation). If no such creditors exist, the claim is to be dismissed due to the absence of the dispute, as the pledgee cannot affirm the priority over the non-existent creditors. As a creditor of the secured obligation, the pledgee

30 For details on endorsement of execution, see: Chapter 16.1 of the Fundamental Principles.

31 Foreclosure on the asset performed by an enforcement officer and through endorsement proceedings are generally referred to as "enforced seizure" (Article 69 of the Law on Enforcement Proceedings). This term should not be confused with the term "foreclosure", the latter being of purely substantive civil law nature. In foreclosure, the pledgee's right to realize the asset is confirmed, whereas in enforced seizure the court officer assists in satisfying the pledgee's claim, thus repaying the debt.

32 See: *Михаил Шварц*, К вопросу о феномене противопоставимости судебных актов (например, решения об обращении взыскания на предмет залога) (*Švarc*, The adverse nature of acts of court: A case study of bringing an execution against the asset), Арбитражные споры (Arbitration) 4|2014, p. 55–57.

may claim debtor to perform it. Where the debtor and the pledger are one and the same person, a claim for foreclosure as a claim against the pledger "is accompanied by creating a dispute over the encumbered asset, even though no dispute occurs between the parties, as the debtor is aware that he/it failed to perform the obligation, and is obliged to pay".[33]

This view may be opposed by a counter-argument which is fully justified in terms of substantive civil law: security right is a right to dispose of the pledger's property, so the pledgee's claim is made against the pledger. If no third person is involved, the procedure may slightly differ without affecting its core elements: the security right remains effective against the pledger as well as the claim for exercising the security right. This conclusion can be obviously drawn from Article IX. – 7:101 DCFR. In terms of Civil Procedure Law, a claim for foreclosure is based on a dispute between the pledgee and the pledger on the right to dispose the encumbered asset, where the pledger disclaims the pledge.

It is remarkable, that the court decision on foreclosure (when a judicial way to exercise the security right is used) is sufficient to start to realize the encumbered asset; secondary claim is not necessary. Under the judgement, the asset is sold out by auction according to the Law on Enforcement Proceedings (Article 350 of the Civil Code). Subject to the parties' approval, the court may impose another way of enforcement.

Eventually, according to both Russian law and the DCFR, judicial enforcement of security right presupposes only one claim to be made by the pledgee: i. e. as set forth by the Civil Code, a claim for foreclosure, whereas as set forth by the DCFR, a claim on enforcement of security right. When considering both types of claims, it is necessary to test and confirm/reject the pledgee's right to dispose of the encumbered asset.

According to the Civil Code, disposition of the encumbered asset is performed in accordance with the general rule by sale at public auction (Article 350 of the Civil Code; Article 56 of the Law on Mortgage). If the pledger is an entrepreneur (a business), the pledgee may either appropriate the pledged property or sell it to the third party, as it is agreed by the parties to the contract (Article 350.1 of the Civil Code; Article 55 and Article 59 of the Law on Mortgage). The DCFR approaches *lex commissoria* more carefully: any agreement concluded before default providing for the transfer of ownership of the encumbered assets to the secured creditor after default, or having this effect, is void (Article IX. – 7:105 DCFR).

If a secured right is prescribed, the collateral right (e. g. pledge) is prescribed too (Article 207 of the Civil Code). The DCFR grants more protection to the secured creditor: a security right can be enforced even if the secured right is prescribed and up to two years after the debtor of the secured right has invoked this prescription as against its creditor (Article IX. – 6:103).

VIII. Consequences of the enforcement of the security right

The secured right ceases to exist when the proceeds from realization of the encumbered asset are used for repayment of the debt, or a market price of the asset appropriated by the secured creditor is set-off against the debt. The collateral nature of pledge presupposes the termination of the security right as consequence of the secured right termination (Article 352 of the Civil Code; Article IX. – 6:101 DCFR).

According to both the Civil Code and the DCFR, after the event of realization of the encumbered asset, the security provider who is not the debtor of the secured right (a third party security provider), shall acquire the rights against the defaulting debtor. According

[33] Ibid. p. 55.

to the Civil Code, the rights are transferred under subrogation (Article 335, Paragraph 1; Article 364, 387 of the Civil Code), whereas according to the DCFR – under the rights of recourse (Article IX. – 7:109 DCFR). Both approaches have its own benefits and drawbacks, which can be revealed on a case-by-case basis, thus it is difficult to favour any.[34]

IX. Regulations as against a consumer security provider

To ensure advanced consumer protection, four special rules on pledge are stipulated in the Civil Code.[35]

Firstly, the consumer may grant pledge to secure a specific obligation only, whereas the entrepreneur (a business) may create a security right in case the secured obligation is to be defined at the moment of foreclosure on the asset, including all effective and/or future obligations of the debtor, in the amount stated (Article 339 of the Civil Code). This provision is implicitly suggested by the DCFR as well (Article IX. – 2:401, Article IV. G.–1:101, Article IV. G.–4:105).

Secondly, the asset to be encumbered must be identified individually (Article 339 of the Civil Code), whereas the entrepreneur's assets may be encumbered either fully or partially. The DCFR also includes the rule mentioned above (Article IX. – 2:107), and it tends to ensure more legal protection for consumer:

> An asset not yet owned by the consumer upon conclusion of the contract for proprietary security can only be encumbered as security for a credit to be used for the acquisition of the asset by the consumer. Rights to payment of future salary, pensions or equivalent income cannot be encumbered in so far as they serve the satisfaction of the living expenses of the consumer security provider and his or her family (Article IX. – 2:107 DCFR).

It is advisable to include similar rules into the Civil Code.

Thirdly, unlike relationships with the entrepreneur, the secured creditor is not entitled to appropriate encumbered asset owned by a consumer (Article 350.1 of the Civil Code). According to the DCFR, the secured creditor is entitled to appropriate such an encumbered asset, only if the consumer has agreed to it after the event of default (Article IX. – 7:105 DCFR).

Finally, according to Article 349 of the Civil Code, if the encumbered asset is living quarters as the only housing owned by the pledger, a security right in the asset can only be enforced by a court, unless after the event of default the pledger has agreed to extra-judicial enforcement. Extra-judicial enforcement is applicable for the realization of any other type of assets owned by a consumer. On the contrary, according to the DCFR, a security right in an asset of a consumer can only be enforced by a court, unless after default the consumer has agreed to extra-judicial enforcement.

On the whole, the authors of the DCFR suggest a more effective consumer protection than the Russian legislators.

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[34] For further details, see *Наталия Рассказова*, Последствия исполнения обеспечительного обязательства (*Rasskazova*, Consequences of exercising the secured right), Вестник гражданского права (Bulletin of Civil Law), Vol. 10, 6 |2010.

[35] Furthermore, pledge is governed by the general provisions of Federal Law No 2300-1 "On the Protection of Consumers' Rights" of 7 February 1992.