



# RUSSIA / EURASIA

## *Executive Guide*

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#### Cutting Labor Costs in Ukraine

Massive lay-offs are taking place in the Ukraine. Some employees are being terminated because of the economic crisis, while in other cases the economic crisis provides a company with the opportunity to rid itself of unwanted employees who perform their duties in a formal manner but with no professional effect or creativity. *REEG* discusses the various issues involved in cutting labor costs and downsizing the workforce.

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#### Changes to Procedures for Foreclosing on Pledged Property in Russia

In January, Russia enacted new procedures for foreclosing on pledged property. Key changes include broadening the options for the extrajudicial foreclosure and securing the possibility of extrajudicial disposal of pledged movable property.

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#### Changes to the Russia-Cyprus Double Tax Treaty

The Russian and Cypriot Ministries of Finance have agreed on a Protocol that introduces significant changes to the existing Russia-Cyprus Double Tax Treaty. The Protocol revises several other provisions which will have a fundamental impact on all Russia-Cyprus corporate structures used for real estate investment vehicles, joint-ventures or otherwise.

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#### Work Permits in Ukraine

The Ukrainian Parliament has recently passed legislation that increases the requirements of obtaining a work permit. *REEG* takes a look at the new changes.

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#### Re-Negotiating Lease Agreements in Ukraine

Landlords and tenants are painfully aware that pursuing their legal disputes through the Ukrainian court system would not necessarily lead to victory since there is no stable or predictable outcome to judicial proceedings. Therefore, landlords and tenants usually are quite happy to re-negotiate their lease agreements without involving the court system.

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# FORECLOSURE PROCEDURES

## Changed Procedure for Foreclosing on Pledged Property in Russia

By Dmitry Zhdanov and Anna Kelina  
(Hogan & Hartson LLP)

On January 11, 2009, the Federal Law of the Russian Federation No. 306-FZ on Amendments to Certain Regulatory Acts of the Russian Federation in Relation to Improving the Procedure for Foreclosing on Pledged Property ("Law") came into force. The Law introduced

a number of amendments to provisions relating to the foreclosure and disposal of pledged property.

The key innovations include:

- specifying the grounds for foreclosure of pledged property;
- broadening the options for the extrajudicial foreclosure of pledged property; and
- securing the possibility of extrajudicial disposal of pledged movable property.

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## Russia *(from page 3)*

The Law also changed the procedure for satisfying a creditors' claims secured by the pledge of a debtor's property in the course of a bankruptcy proceeding

### **Grounds for the Foreclosure of Pledged Property**

In accordance with the Russian legislation, foreclosure of pledged property is generally the consequence of a pledgor's breach of an obligation secured by a pledge. However, in certain cases foreclosure may not be allowed. In particular, a foreclosure cannot proceed if the debtor's breach of the obligation, which is secured by a pledge, is insignificant when compared to the value of the pledged

property. The Law introduces certain specifications stipulating that, unless proved otherwise, the breach of the obligation secured by a pledge is deemed insignificant if the two following conditions are both met:

1. the amount of the outstanding obligation does not exceed five per cent of the value of the pledged property; and
2. the delay in performance of the obligation, which is secured by the pledge, is less than three months. Thus, the Law introduces explicit criteria pursuant to which foreclosures are not allowed. If these conditions are not met, then foreclosures can proceed.

**Russia** *(from page 9)*

With regard to obligations performed in installments, the Law introduces specific conditions for foreclosures. Unless a pledge agreement provides otherwise, foreclosure of the pledged property securing such an obligation is allowed in case of the systematic violation of payment deadlines, i.e. more than three times within twelve months, even if the delay is insignificant.

**Foreclosure of Pledged Property**

Russian law provides for two methods of foreclosing on pledged property:

- (1) judicial (i.e. when a court decision is issued to satisfy the pledgee’s claims over the pledged property), and
- (2) extrajudicial (i.e. when the procedure for satisfying of the pledgee’s claims is governed by an agreement between the pledgee and the pledgor “foreclosure agreement”).

The new statute introduced by the Law allows the pledgee and the pledgor to enter into an agreement on foreclosure of pledged real estate and other immovable property at any time and not only upon the failure to perform or the inappropriate performance of an obligation secured by a pledge, as was provided before. Moreover, the foreclosure agreement may be either incorporated into the pledge agreement or entered into as a separate instrument.

Under certain conditions, however, the law does not permit a foreclosure agreement, and, thus, judicial foreclosure of a pledged property may be required. The list of such exclusions is directly specified by the law and includes, among others, the following:

- (1) when the consent or permission of another person or authority is required in order to enter into an agreement to pledge an individual’s property;
- (2) the mortgaged property is a residential premises owned by an individual under a freehold title;
- (3) the mortgaged property is in governmental or municipal ownership;
- (4) the pledge agreement or other agreement between the pledgee and the pledgor does not provide for a foreclosure procedure of the pledged property or the foreclosure procedure agreed on by the parties is not enforceable.

The Law specifies the execution procedure and the terms and conditions of the foreclosure agreement depending on the type of property pledged, movable or immovable. In particular, under the extrajudicial procedure, if real estate or other immovable property is pledged, entering into the foreclosure agreement requires the notarized consent of the pledgor. In the case that movable property is pledged, the pledgor’s notarized consent with regard to the extrajudicial foreclosure is required only if the pledgor is an individual. In the mortgage agreement the parties shall, among other

items, specify the initial sale price of the property or the procedure for determining it; in the case of a movable property pledge, it is the parties’ right, but not an obligation, to incorporate such terms and conditions into the foreclosure agreement.

The new statute introduced by the Law provides that if the pledgor does not perform the foreclosure agreement, the foreclosure may occur by virtue of an executive endorsement of a notary. An executive endorsement may be signed if the provided documents confirm the indisputability of the pledgee’s claims, and not more than three years have passed following the date that the right to the claim was established (in the case of legal entities – not more than one year), unless another period of limitation is provided by law with respect to the claim, pursuant to which the executive endorsement is signed by the notary. Similar to the provision that existed earlier in relation to immovable property, foreclosure of movable property encumbered by a subsequent pledge is added to the list of conditions pursuant to which the pledgee of the movable property is entitled to claim early performance of the obligation secured by the pledge. If the pledgee under the preceding pledge does not exercise its right, the foreclosed property securing subsequent obligations is transferred to its acquirer as the property encumbered by the preceding pledge.

**Disposal of Pledged Property**

*Extrajudicial Disposal of Pledged Property*

The Law introduces a new extrajudicial procedure for disposal of pledged movable property (earlier this procedure was provided for only with regard to immovable property). This amendment is one of the most important changes, as it reflects the existing practice of extrajudicial disposal of pledged property. Although the practice existed before the Law came into force, the legality of extrajudicial disposal of pledged property sometimes was disputable. Adoption of the Law resolved this problem.

The Law envisages several alternative procedures for the extrajudicial disposal of pledged property:

- (1) through a public auction;
  - (2) through a sale to a third party, thus bypassing the auction, including a sale under a commission agreement; and
  - (3) through transfer of ownership to the pledgee.
- Not all these alternatives existed earlier or they applied not to all types of property. In most cases involving the extrajudicial sale of foreclosed property, the price of the pledged property should be equal to its market value, and confirmed by an independent assessor.

The disposal of movable property through its sale to a third party, bypassing the auction, or through the transfer to the pledgee, is allowed only if the pledge agreement is entered into between legal entities and/or individual entrepreneurs for securing entrepreneurship-related obligations. If the agreement is entered into by

an individual who is not an entrepreneur, disposal of the pledged movable property can only be performed through a public auction. The choice of the disposal procedure also depends on the type of pledged property. For example, if the subject of the pledge is securities traded on an established securities market, their disposal is allowed only through an auction to be held by the trade organizer in the applicable securities market. If the subject of the pledge is immovable property, its disposal is allowed through an auction or acquisition of the property by the pledgee for its own benefit or under a commission agreement for the benefit of third persons. The Law provides, however, that the foreclosure agreement cannot stipulate the acquisition of the property by the pledgee for its own benefit, if such property is a land plot. In such a case, an auction must be held or the pledgee must acquire the property for the benefit of third persons.

Another important amendment introduced by the Law relates to the disposal of pledged immovable property. Earlier, in the cases of extrajudicial disposal, following the execution of a mortgage agreement, all lease and other use rights to the immovable property granted by the pledgor to third parties without the consent of the pledgee were terminated at the moment that the agreement on extrajudicial disposal of the pledged property was notarized. Now, these rights terminate at the execution of the sale-purchase agreement by the preferred bidder and the auction organizer (subject to the pledged property being disposed through the auction) or upon the state registration of the pledgee's title (if the pledged property is acquired by the pledgee).

If the foreclosure agreement provides for a term in which the pledged property is to be disposed of, and if the extrajudicial disposal has not occurred within the term due to the pledgor's fault, the pledgee is entitled to take legal action claiming the foreclosure of the pledged property under the judicial procedure.

### *Judicial Disposal of Pledge Property*

The Law has retained the possibility to dispose of pledged property through public auctions arranged by a court bailiff on the basis of a court decision. At the same time, certain amendments have been introduced with regard to the disposal of immovable property. In particular, the time period for announcing the coming auction by the auction organizer has been reduced; in accordance with the new requirements such an announcement should be placed not earlier than 10 and not later than 30 days before the auction date (earlier the Law provided for 30 and 60 days, respectively). The announcement should be published at the location of the immovable property; additional obligation to place the announcement via Internet has been introduced.

### **Sale of Pledged Property in the Course of Bankruptcy Proceedings**

The Law establishes specifics for satisfying creditors' claims secured by a pledge of the debtor's property in

the course of bankruptcy proceedings. From the date of initiating the supervision procedure the debtor's property can not be sold in the extrajudicial procedure.

The Law changed the order of satisfying creditors' claims under obligations secured by a pledge of the debtor's property. Previously, satisfying claims under such obligations had priority over other creditors' claims, except for the so called first and second priority creditors (i.e. creditors entitled to compensation for causing harm to the health and well being and creditors entitled to payments under labor or intellectual property agreements), whose right of claim occurred before the conclusion of the respective pledge agreement. Upon adoption of the Law, claims under secured obligations have lost their priority of

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satisfaction, creditors under secured obligations are now made equal to the third priority. However, creditors under secured obligations are still in a more secure position than other creditors of the third priority, since the Law provides for a guaranteed amount of proceeds received through the sale of the pledged property (being 70%, or if the creditor is a bank, 80%) that must be transferred to creditors under secured obligations.

The Law's provisions apply to bankruptcy cases initiated after the Law became effective. However, upon completion of a stage of the bankruptcy proceedings initiated before the Law became effective, further legal proceedings are governed by the provisions of the Law.

### **Acquisition of Pledged Shares and the Mandatory Buy-out Offer**

In the context of the current world financial crisis, the Law protects a pledgee's interests by granting, in certain cases, a one-year exemption from the requirements for a mandatory buy-out offer to repurchase shares of an open joint-stock company which would otherwise be applicable under the provisions of the Joint Stock Company Law.. In accordance with the Law, if the open joint-stock company shares, which were pledged under an obligation to a credit institution, were acquired as a result of the foreclosure of

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such shares, or as a result of a breakup fee by the credit institution itself, or by third parties through an auction or a direct sale (including the result of a resale of shares by the credit institution to a third party), the acquirer of shares is entitled not to submit a mandatory buy-out offer to the remaining company shareholders to purchase their shares. The exemption granted by the Law will be in effect until January 1, 2010.

#### **Conclusion**

As a result of the changes introduced by the Law, aimed at improving and facilitating the procedure for foreclosure and disposal of pledged property, the security function of the pledge and, accordingly, its application are expected to increase. The rules established by the legislation that was previously in effect served, to a greater extent, the interests of the pledgor, sometimes to the detriment of the pledgee's interests. The adopted Law increases the degree of protection of the pledgee's interests by providing the alternatives of entering into an agreement on the extrajudicial procedure for foreclosure and disposal of pledged property, transferring title to such property to the pledgee, as well as selling the pledged

property directly, thus bypassing the auction procedure. Thus, a more efficient mechanism of securing the debtors' obligations has been created.

At the same time, the Law continues to protect the pledgor's interests by establishing the presumption of insignificance of a violation of an obligation secured by pledge subject to certain conditions defined by the Law, as well as by prohibiting the sale of the debtors' pledged property in an extrajudicial procedure upon the introduction of supervision under bankruptcy proceedings.

Since the effect of the Law covers relations of parties that occur after its entry into force, we recommend analyzing agreements that were previously entered into, specifically focusing on the possible changes that could be made in light of the new legislation. In part, the sides may review separate conditions of such pledge agreements. It may be advisable for the pledgee to enter into amendment agreements to existing pledge agreements that would provide for extrajudicial foreclosure of the pledged property, and the transferability of the title to the pledged property to the pledgee or to third parties without a public auction.

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