

Anti-Crisis Measures, Legal Reform and Bank Lending: a Legal Perspective on Recent Changes to the Law

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I. Measures Taken to Support the Banking Sector

- Central Bank unsecured loans program
 - In late 2008, the Central Bank of the Russian Federation (“the CBR”) was empowered to grant unsecured loans to Russian credit institutions with positive ratings (ratings as determined by the CBR Board of Directors)
 - Federal Law No. 171-FZ, dated October 13, 2008
 - further clarification provided in Regulation No. 323-P, dated October 16, 2008
 - By November 2009, indebtedness of Russian banks to the CBR under this program reportedly stood at RUB 210 billion (approx USD 7.2 billion)
 - However, from February 1, 2010, the CBR will decrease by 10% the funds available for distribution and will require higher ratings (ratings as assigned by Russian rating agencies)
 - four Russian rating agencies are qualified to assign such ratings: “AK&M”, “Rusrating”, “Expert RA” and “National Rating Agency”
 - the inclusion of Russian rating agencies is a major boost to smaller banks who do not have ratings from foreign rating agencies

I. Measures Taken to Support the Banking Sector

- Central Bank secured loans program
 - The CBR's ability to grant secured loans to Russian credit institutions was also given a boost by the relaxation of certain conditions. For example:
 - promissory notes, suretyships and rights under credit agreements are now permissible forms of security for loans under this program in certain cases
 - secured bonds issued abroad by Russian banks are now permissible forms of security in certain cases (whereas previously it was only permissible to utilise securities issued in Russia). For example, the CBR accepted VTB-24 bonds listed on the Irish Stock Exchange

I. Measures Taken to Support the Banking Sector

- Central Bank compensation for losses
 - The CBR was empowered to (partially) compensate Russian commercial banks for losses on the inter-bank loan market resulting from the revocation of the counterparty's banking licence
 - As of October 2009 the CBR had reportedly entered into agreements with 18 Russian banks to compensate them for losses on this basis
 - for example: Raiffeisenbank, Sberbank, Vnesheconombank, MDM-Bank, VTB and Russian Standard Bank
 - However, this does not appear to have had a significant impact on the inter-bank loan market – probably because banks prefer to conduct business with established and proven counterparties

I. Measures Taken to Support the Banking Sector

- Compulsory decreases in charter capital of Russian banks
 - The CBR may demand that a bank decrease its charter capital to the value of its own assets (capital) without the usual right of creditors to demand early repayment of obligations in such circumstances
 - CBR Directive No. 2108-U, dated October 29, 2008
 - Federal Law No. 175-FZ 'On Additional Measures for Stabilisation of the Banking System for the Period until December 31, 2011', dated October 27, 2008
 - For example, the charter capital of each of "VEFK" Bank and "Rossiysky Capital" Bank was decreased to 1 rouble only in February 2009 and June 2009 respectively

I. Measures Taken to Support the Banking Sector

- Suspension of certain laws
 - Where a Russian bank is in financial difficulty and its shares are to be acquired by the Deposit Insurance Agency or investors in order to prevent insolvency, certain legal requirements are suspended including, *inter alia*:
 - obtaining anti-monopoly approval
 - providing mandatory offers to minority shareholders
 - disclosure of information about material facts (events) related to business activity of the bank
 - So far, efforts to dispute the suspension of these legal requirements have not been successful
 - for example, the minority shareholders of “Severnaya Kazna” Bank unsuccessfully sought to dispute the bank’s acquisition by Alfa-Bank in June 2009

I. Measures Taken to Support the Banking Sector

- New requirements and benefits for Russian banks under reorganisation
 - Detailed amendments were introduced in connection with the reorganisation of credit institutions through consolidation (*sliyaniye*), merger (*prisoedineniye*) or conversion (*preobrazovaniye*)
 - Federal Law No. 315-FZ, dated December 30, 2008
 - For example:
 - Russian banks must notify their creditors and the CBR about any reorganisation; and
 - creditors (legal entities) are only entitled to early discharge or early termination of the bank's obligations to them (and/or related compensation for losses) if it is expressly provided for in the contract in the event of the bank's reorganisation (previously this was an automatic statutory right of creditors, whether or not provided for in the contract)
 - The CBR also has announced that Russian banks under reorganisation may be granted increased access to the CBR unsecured loans program (if increased access is necessary as the result of the Russian bank's being required to perform early repayment)

I. Measures Taken to Support the Banking Sector

- CBR refinancing of foreign loans to Russian corporations
 - VEB may grant subordinated unsecured foreign currency loans to certain Russian corporates in order to refinance or repay loans from foreign lenders (for loans concluded prior to September 25, 2008). This program will end on December 31, 2009
 - Federal Law No. 173-FZ, dated October 13, 2008
 - The CBR apparently deposited USD 50 billion with VEB in order to fund the program
 - VEB has resolved to grant USD 14.3 billion in loans (with a reported USD 10.9 billion already released)
 - There have been complaints about the distribution of these loans, such as the fact that the conditions of lending (such as the credit rating for the Russian corporate borrower) have prevented small and mid-cap Russian corporations from obtaining such refinancing

I. Measures Taken to Support the Banking Sector

- Court Response to Claims from Borrowers
 - Courts have supported lenders by denying borrowers the ability to successfully challenge the application of loan terms in light of changed circumstances
 - In a number of recent cases, borrowers have sought to have unfavourable loan terms set aside, citing “material changes in circumstance” due to the global economic crisis
 - this argument is based on article 451 of the Russian Civil Code
 - examples include the recent disputes between:
 - PIK and VTB
 - Glavmosstroy and Alfa-Bank
 - Amur Shipbuilding Plant and Sberbank
 - So far, Russian courts have rejected these arguments and have ruled that commercial organisations must bear the risk of changing economic circumstances

II. Legal Reforms Related to Secured Transactions

- At the end of 2008, a number of changes to laws relating to secured transactions were introduced in Russia. These changes:
 - broadened the ability to use out-of-court foreclosure procedures
 - provided methods for the sale of assets in out-of-court foreclosures
 - instituted mandatory valuations of security in out-of-court foreclosures
 - established certain restrictions related to out-of-court foreclosures
 - clarified priorities for competing pledgee claims

II. Legal Reforms Related to Secured Transactions

- Broadening of out-of-court foreclosure procedures
 - Now:
 - prior to an event of default, a pledgor and pledgee may enter into an out-of-court foreclosure agreement (referred to as an “**Enforcement Agreement**”, which may be set out in the actual security agreement or entered into as a separate document)
 - where the pledgor fails to discharge its obligations under the Enforcement Agreement, the ‘executive signature’ of a notary may be applied for, under which a bailiff may levy execution on pledged property without a court decision
 - Previously:
 - real property: it was necessary to enter into a separate notarised agreement after an event of default
 - movable property: out-of-court foreclosure was permissible prior to an event of default, but there was no legal protection if the pledgor failed to discharge its obligations

II. Legal Reforms Related to Secured Transactions

- Methods for the sale of assets in out-of-court foreclosure
 - For movable assets, the following options are available:
 - a public sale
 - a private sale (only available to commercial entities and registered entrepreneurs)
 - a transfer of ownership to the pledgee (also only available to commercial entities and registered entrepreneurs)
 - For real property, the following options are available:
 - a public sale (through bailiffs) or auction (without involvement of bailiffs)
 - a private sale
 - a transfer of ownership to the pledgee

II. Legal Reforms Related to Secured Transactions

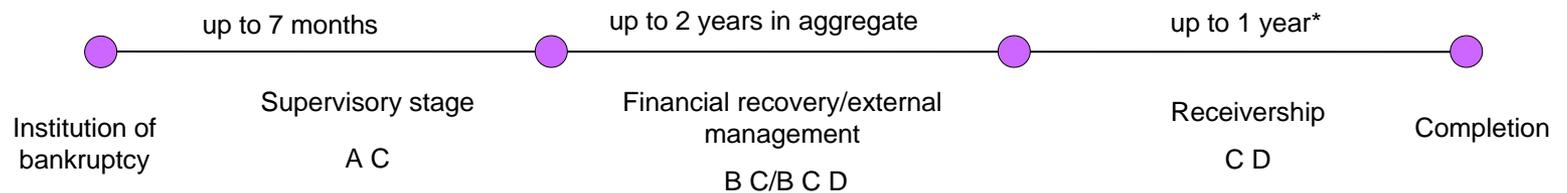
- Mandatory valuation of security for out-of-court foreclosure
 - Assets must be appraised by an independent appraiser in certain cases, for example:
 - where asset value exceeds RUB 500,000 (approx USD 15,000)
 - where assets consist of unlisted securities
 - where assets consist of real property rights in case of mortgage – i.e. rights under lease agreements or claims in relation to construction financed by future property owners (“dolevoye stroitelstvo”)
 - NB the opening offer price for the assets will be 80% of the value attributed to them by the independent appraiser (unless the Enforcement Agreement provides otherwise)

II. Legal Reforms Related to Secured Transactions

- Restrictions on Out-of-Court Foreclosures
 - Out-of-court enforcement is prohibited in certain cases, for example:
 - where there is no 'agreed feasible' foreclosure mechanism
 - mortgage of state or municipal property
 - Foreclosure over pledged assets, including out-of-court enforcement, is also prohibited upon commencement of the supervisory stage of insolvency proceedings
 - The court may refuse to foreclose if the breach of a secured obligation is 'insignificant'. The breach is deemed insignificant if:
 - the amount of unfulfilled obligations is less than **5%** of the pledged property value under the pledge agreement; and
 - the period of delay of performance of obligations is less than **3 months**
 - Unless otherwise specified in the agreement, where the principal obligation is to be discharged by periodic payments:
 - the foreclosure is only possible in cases of repeated breach, i.e. **more than 3 breaches during 12 months** (even if any single breach is, in itself, insignificant)
 - no foreclosure is allowed, if 3 breaches are in the amount of less than 5% of the value, and were made within 3 months

II. Legal Reforms Related to Secured Transactions

- Priorities of competing pledgee claims in bankruptcy
 - The unsatisfied claims of a pledgee following realisation of the secured property are discharged on a *pari passu* basis with the claims of the creditors of the third order of priority
 - Secured creditors may participate in creditors' meetings, provided that their claims are registered with the register of creditors' claims as of the date of holding the creditors' meeting
 - The timeline below shows the scope of voting rights granted to secured creditors during the bankruptcy process:



- A - able to vote
- B - able to vote if the secured creditor has waived its right to foreclose on the pledged property, or the arbitrazh court has rejected the secured creditor's application to foreclose over the pledged property
- C - has veto right on settlement agreement
- D - has veto right on replacement of the debtor's assets (i.e., the establishment of an open joint stock company on the basis of the debtor's property)

*In practice, receivership may take much longer

II. Legal Reforms Related to Secured Transactions

- Priorities of competing pledgee claims (cont'd)
 - Both matured and unmatured claims may participate in bankruptcy proceedings (if the claims arose prior to the date of the court's acceptance of the application for the debtor's bankruptcy)
 - Proceeds from the sale of pledged property which secure obligations under loan agreements are to be applied as follows:
 - 80% towards discharging secured obligations (principal and interest only, not fees, etc)
 - 20% towards a "special" bank account of which:
 - 15% towards the discharge of remaining first and second ranking creditors
 - 5% towards the payment of court expenses and bankruptcy managers
 - Proceeds from the sale of pledged property which secure obligations under agreements other than loan agreements are to be applied as follows:
 - 70% towards discharging secured obligations
 - 30% towards a "special" bank account of which:
 - 20% towards the discharge of remaining first and second ranking creditors
 - 10% towards the payment of court expenses and bankruptcy managers

II. Legal Reforms Related to Secured Transactions

- What creditors should do in light of the new laws*
 - Amend pledge agreements securing loan agreements (with amortising repayments) to allow foreclosure even if a breach has only occurred once
 - Amend pledge agreements to allow the debtor (legal entities and individual entrepreneurs) to discharge secured obligations by transferring ownership of the pledged property to the pledgee/allow the pledgee to sell the property
 - Amend pledge agreements to regulate the initial sale price (in cases of mandatory determination of the price by the independent appraiser)
 - Carefully describe the extrajudicial foreclosure procedures in the pledge agreement

* Please note that such examples are not deal-specific. Decisions on amendments to actual pledge/mortgage agreements should be taken on a case-by-case basis

III. Conclusion

- The RF Government, the CBR and other state bodies moved relatively quickly to try and support the Russian banking sector by implementing various measures, including measures intended to fund banks, to protect lenders and to increase liquidity.
- These steps have helped to stabilize the market and have ensured that massive runs on the banks did not collapse the sector. However, the changes to law have in certain cases not gone far enough to address underlying systemic problems and do not address some of the fundamental problems with realizing security in Russia through lawful means. Further amendments will be necessary to provide greater confidence to creditors that loans will be repaid and their rights enforced.