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CHOICE OF LAW FOR PLEDGE OF SHARES IN RUSSIAN JOINT-STOCK COMPANIES

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Many Russian transactions involve share pledge as one of the elements ensuring proper fulfillment of obligations by the parties. The proper choice law in this regard, as we discuss below, may be an important element in ensuring that your pledge is effective and can be enforced by Russian courts.

The choice of Russian law: key issues to consider

The traditional and most common choice of governing law for share pledge agreements in respect of the shares of Russian joint stock companies is Russian law. There exist good practical reasons making such choice advisable: such choice is more straightforward, it makes enforcement of the pledge through Russian courts simpler and recognition of priority in the course of Russian insolvency proceedings more likely.

However, the choice of Russian law has its drawbacks, too. Not only does it reduce the parties' flexibility, but there may be instances where choosing Russian law to govern the pledge agreement may cause serious legal problems, such as the need to satisfy the rigid requirements for defining the "essential (mandatory) terms" of a pledge agreement.

Pursuant to Art. 432(1) of the Russian Civil Code ("CC"), a contract is deemed concluded (entered into) if the parties have reached an agreement on all of the so-called "essential terms" (sushestvennie uslovia).

Among the statutory "essential terms" of a pledge agreement are the nature, amount, and time period for performance of the principal obligation secured by the pledge (Art. 339(1) of the CC). Russian courts have traditionally adopted a very rigorous approach towards defining them. In the event the court establishes that any of the "essential terms" are not sufficiently defined, the pledge agreement may be considered not concluded, i.e., ineffective from the outset.

A recent example of such approach is the Unicredit case (see Resolution of the 9th Arbitrazh Appeals Court dated August 16, 2011, Case No. A40-62359/10-38-239Б), in which the court considered a Russian law pledge agreement not concluded because the agreement defined the time of performance of the principal financial obligation by reference to an anniversary of an

unspecified loan drawdown date, rather than a specified calendar date or a time period running from it.

The Unicredit case exemplifies the high enforcement risks of entering into a Russian law governed share pledge agreement in instances where the nature, value and timing of the principal (secured) obligation are defined in a manner that is not straightforward and fully consistent with the Russian law approach and legal concepts. Such issues may arise, for instance, with complicated English law based corporate and financial transactions that need to be secured by pledge of shares in Russian companies. In such situation it may be worth considering foreign law to govern the pledge agreement.

The choice of foreign law: key issues to consider

Assuming there exists a "foreign element" in the relationship, e.g., one of the parties is a foreign company, Russian law allows the parties to choose foreign governing law for their agreement, including in respect of share pledge agreements. Russian law also does not prevent the technical perfection (establishment) of the pledge as an encumbrance of the shares based on a foreign law governed pledge agreement.

One should bear in mind, though, that a foreign law governed pledge agreement must not be fundamentally incompatible with Russian law.

First, under Art. 1206(1) of the CC, the origination (accrual) of the rights in rem (rights in things) is determined under the law of the country where the thing or asset is situated, e.g., under Russian law as regards shares in Russian companies. Arguably, the pledge holder's rights or at least elements thereof qualify as rights in rem, which means that it is ultimately Russian law that determines if the encumbrance of shares validly arises pursuant to the pledge agreement. Accordingly, a pledge agreement that is incompatible with Russian law, e.g., seeks to establish a form of lien that is unknown to Russian law, may be unenforceable in Russia.

Second, the pledge may have to be enforced through Russian courts, which will apply the relevant Russian procedural laws. There is certain ambiguity as to the consequences of any possible conflict between such procedural rules and the foreign law applicable to the pledge agreement. However, it is clear that should a pledge agreement provide for an enforcement procedure fundamentally incompatible with that envisaged under Russian law, there is a risk that such procedure may be unenforceable.

Based on these and other considerations, even if foreign law is chosen to govern the pledge, it is advisable to make the share pledge perfection and enforcement procedures consistent with Russian law.