Some aspects of Collateral Bonds in Russian Law (may 2011)

Russia can be called a stranger to defaults on the bond[1] market. The majority of defaults on the bond market that took place before 2008 did so under exceptional circumstances. These defaults were simply believed to be anomalies in the fundamental economic rules. However, everything changed after the insolvency of Lehman Brothers as the number of defaults increased sharply. Over the course of the next six months, during which economic volatility and uncertainty was at its peak – from Q4 2008 to Q1 2009 – 124 bond issuers could not fulfil their respective obligations on the aggregate amount of RUR 116,1 bn[2]. Some issuers could neither find sufficient finances for dealing with the refinancing of bond debts nor for paying coupons. However, the financial crisis was not the sole reason for this situation. The financial crisis may simply have proven to be the catalyst, as some of the issuers exploited the confused situation in order to evade obligations. Ultimately, it was the lack of adequate regulation that enabled issuers to get away with this. However, conclusions were eventually drawn and as a result, new regulatory mechanisms were put into effect and certain legislation is going to be amended. Moreover, investors no longer find themselves in the position where incentives are skewed towards excessive risk taking and leverage, and they cease to hunt for high returns, which have always been associated with venture investments and huge financial schemes involving the placement of bonds through SPVs. Alternatively you could be engaged in buying blue chips bonds which are issued by parent companies with top credit ratings and highly disclosed, in spite of the yield spread (current average blue chips' yield on bonds with one year maturity is just 6.0% per year).

The debt market in Russia is still considered as an emerging market with all the attendant consequences, such as below-investment-grade credit rating and high price volatility, which are the result of inadequate transparency and information, sophistication in monitoring and legal uncertainty. One of the factors which determine the situation on the securities marked is connected with the quality of bonds issued by Russian companies; most bonds are blank bonds which are not collateral, they do not contain any covenants and in no way guarantee investors the reliability of their investments.

Russian Statute Law determines conditions and procedure for issuing bonds as major securities that are designed for enterprise value enhancement through the implementation of capital investment projects. The main features of the bonds such as nominal value, coupon, maturity and the payment of the par value are subject to the decision of the company to issue bonds. Such decisions could be made by the board of directors, or in shareholders' meetings (if mentioned in the articles of association) and should bear all requisites required by Art.17 RF Securities Market Act[3] of 1996 No39-ФЗ (SMA hereinafter). The size of the bond debt cannot be more than companies' authorized capital or the amount of security, otherwise there is the possibility to issue bonds without any security, but not earlier than on the third year of incorporation, and with the proper approval of the annual balance sheets in two completed fiscal years[4]. Such wild restrictions led to the fact that in 2008, before the crisis, the amount of 3-tier bonds on the market was over 50%[5], everyone seemed to be happy with such numbers while the market was calm. However, the situation changed during the financial crisis and 3-tier securities started to default.

These days when money is very expensive and confidence in judiciary is very low, chances for survival remain only with blue chips and collateral bonds. Issuance of collateral bonds requires additional clauses, referred to as security conditions, to be mentioned in the decision to issue bonds and prospectus. In the case of default on bond debt (when the issuer does not make any payments of the par value for more than 30 days or coupon for more than 7 days[6]) according to section 2 article 450 Russia Federation Civil Code of 1994

---

[1] In Russian terminology there is only one word to define bonds and notes, "bonds" is more common in use even when talking about notes with short maturity

[2] Statistic from www.Cbonds.ru

[3] RF Securities Market Act[3] of 22.04.1996 No39-ФЗ

[4] Section 2 Art.102 Russia Federation Civil Code of 1994

[5] I.E. Smirnov, At the Bond market. "Investment Banking" magazine, 2009, No2.

[6] Section 6.2.10 Issue Securities and Prospectus Register Standards provided by Resolution of the Federal Financial Market Service of Russia Federation (hereinafter FSCM?? FFMS???) of 25.01.2007 No 07-4/пз-н (hereinafter Standards) – these are the only reasons for the creditor to claim for earlier payments. Such instrument as, for example, cross-default does not exist in Russia.

(hereinafter Civil Code) the investor has a right to break his relationship with the issuer through applying directly to the issuer[7] or to the court. Bondholders can raise an action only after the rejection by the issuer to settle the case, or if the latter avoids response for more than 30 days (art. 452 Civil Code). The limitation period is two months[8].

When the issuer does not want or cannot fulfil his obligations in the case of collateral bonds, losses could be covered by security. There are several ways to secure your securities debt[9]: pledge/mortgage, suretyship guarantee, bank guarantee, government and local authorities' guarantee.

In the case of bonds, pledge is a way of creating security by the establishment of encumbrance only over securities or real estate[10]. According to sec. 8 art. 27.3 SMA collection could be drawn out of a court decision under the written claim of any bondholder by the entity specified in the decision to issue bonds as the entity which will sell pledged property. Those securities which are issued in dematerialised form could be the object of transactions only through the Registrar[11] or Depositary[12] which maintains a securities register[13], which constitutes the record of entitlement, provides confidentiality, and makes official notes of any transactions. The recording of the termination of uncertified securities given as a pledge should be made on the basis of a transfer order signed by both 'pledgee' and 'pledger' or their authorized representative[14] with attachment of documents as specified in pledge instructions (for example, originals, or certified copies of a court decision (if applicable), and contracts of sale of pledged securities entered into as a result of the public tender sale, etc.). If bonds are secured by real estate mortgage there are additional requirements – the decision to issue bonds has to be notarized, and placement of mortgage-backed bonds before the state registration of mortgage is prohibited[15]. Pledge and mortgage as types of security protect the interest of creditors better that any other. Moreover, in the case of issuer indebtedness, creditors' claims will be prioritized by authority of law: article 134 of Insolvency Act 26.10.2002 N 127-ФЗ (Insolvency Act) states that claims of creditors for the obligations secured by pledge or mortgage of the debtor's property should be satisfied on account of collateral primarily to other creditors, except for obligations to creditors of first and secondary priority.

Suretyship guarantee is an undertaking answerable for the debt or default of another; it may be given either for a specific advance or as a continuing guaranty. The guarantor is jointly[16] obliged to fulfil the obligations of the issuer. This type of security was very popular as different subsidiaries or parent companies from one holding could make an offer to become a guarantor, and, in such a way, increase the attraction of issued bonds. In general, all information about the guarantor and other conditions of security as well as signature of guarantor should be contained in the Prospectus[17]. Furthermore, the guarantor has to sign the decision to issue bonds and the certificate when the papers are certificated[18]. By this action he provides not only the purity and credibility of information about security, but also accepts the existence of such security. There were precedents when guarantors tried to waive their obligation on default of the issuer on the grounds of absences of guarantor's signatures on the certificate or offer to grant a guarantee. According to court decisions these provisions of law should not be construed literally – Federal Court of Arbitrazh[19] of Moscow Region

[7] Amendments made in December 2008
[8] Section 8 Art.27.3 SMA
[9] Art. 27.2 SMA
[10] Art.27.3 SMA
[11] Art 8 SMA "Registrar" means a legal entity (only) empowered to hold register of securities; registrar could be the issuer or professional participant of securities' market empowered by the issuer.
[12] Art 7 SMA "Depositary" means a legal entity (only) entrusted with securities, professional participant of securities' market, which perform depository activity.
[13] Section 2 Art.149 Civil Code RF
[14] Section 17, 18 of Federal Commission for the Securities Market (was formed to FFMS on March 13, 2004) Oder No 11-10/пз-н of 05.04.2011 – the same rule is applicable for uncertified securities kept in depositary.
[15] Section 4 Art.27.3 SMA
[16] Article 363 Civil Code
[17] Article 22 & 22.1 SMA
[18] Section 3 Art. 27.3 SMA
[19] In Russian judicial system - a Court where you can apply after the Court of Appeal; the next and the last stage is the Supreme Commercial Court of the Russia Federation

(hereinafter FCA of Moscow Region) had pointed out in its judgement[20] that breach of this article does not revoke the consideration to establish security; it is enough to have guarantor's signature in the decision to issue bonds.

The aforementioned court opinion encourages guarantors to seek new ways of escaping performance of their obligations. Some companies tried to change their names and legal addresses moving their registered office to Siberia, hence creating problems for counterparties which had to waste additional amounts of money in order to find a guarantor. One more way not to perform its obligations was tried by some unscrupulous guarantors: article 367 Civil Code which gives general information about the contract of guarantee in section 1 incorporates that guaranty is terminated in case of change of principal obligation entailing an increase in liability, or other adverse consequences for the guarantor without his consent. Such provisions gave guarantors an opportunity to state that they could quit their obligations if, for example, coupon was changed and hence liability increased. In its judgement FCA of Moscow Region 09.10.2009 N КГ-А40/9978-09 supported this rule of law and released the defendant from the obligation to act as guarantor on the ground that the coupon rate was changed without his consent, in this case the coupon was established as a fixed amount on each bond. However, Section 6.2.23 of Issue Securities and Prospectus Register Standards (hereinafter the Standards) provided by Resolution of FFMS of 25.01.2007 No 07-4/пз-н allows the issuer to change the rate of coupon (or the procedure of determining the rate) in different coupons periods[21]. Furthermore, the Supreme Commercial Court of the Russian Federation[22] (hereinafter SCC) in its opinion judged that when the decision to issue bonds does not set up a numerical coupon rate the guarantor cannot apply article 367 of Civil Code, as setting the rate of the next coupon may not be qualified as a change in commitments which entails an increase in liability of guarantor without his consent. Hence the bondholder can come upon the guarantor as a jointly obliged entity for recovering losses. This opinion gave grounds to some creditors for reopening cases in view of newly discovered facts. Recently, in its decision Ninth Arbitrazh Appeal Court on 24.09.2010 not only supported the SCC' opinion but judged that when a guarantor is a subsidiary or parent to the debtor then the guarantor's acceptance to change coupon rates is not necessary.

Suretyship can also be established by banks, government or local authorities. These types of guarantees are similar; state law[23] requires that the term of such guarantee should be no less than six months longer than the maturity of secured bonds, it cannot be revoked, all responsibilities of the guarantor should be join and conditions of this guarantee have to contain a clause that the right in action should be transferred to the one who bear bonds. According to sections 6.2.17 and 6.2.18 of the Standards the decision to issue bonds has to contain the day when the bank or government's guarantee has been issued. Therefore, the issuing guarantee should be separated from the bond issue – this condition distinguishes these types of guaranty from other types mentioned above, and the decision to issue bond is not the document of issuing guarantee. This type of suretyship can be considered as safe but it is very expensive, so is not used frequently.

These are the most common and obvious methods of protection of investors' rights which exist today in Russia and there are problems with their application. This year some significant changes have been made by the legislature about the disclosure of information by participants of the securities market. However, quarterly issuers' reports are still full of standard statements and lots of unnecessary information about paid debts which cannot be helpful to creditors. The uncertainty in understanding how such instruments as securitization and sub-debts, covered bonds, and bondholding meetings can be used inn the Russian market is still very strong, and most projects for new legislation and amendments to existing acts are stagnating for years in the State Duma without any progress[24]. All these problems do not meet the requirements of the market. Russian companies are far more dependent on the debt market (no matter whether it is loans or syndicated loans, bonds or Eurobonds) than the average company in Europe or USA, primarily because the owners of business in our country do not really understand how to raise capital through the IPO or SPO system. Moreover, those who

[20] Judgment of FCA of Moscow region 24.12.2009 N КГ-А40/13395-09 (there are other judgments with the same decision)

[21] The only restriction is about the first coupon period during which the issuer is not authorized to amend the rate mentioned in the decision to issue bonds.

[22] http://www.arbitr.ru/eng, Judgment of the Supreme Commercial Court of the Russian Federation 10.11.2009 N 10462/09

[23] Article 27.5 SMA

[24] The Amendments to SMA about bondholders meetings and representatives of bondholders are a good example: first project reached State Duma in 2006 but was removed rapidly for development; finally, it was adopted on the first readings last autumn, however, another year passed and no other developments were made.

issue bonds from the beginning are usually ready to refinance their debt in future, making the maturity of loan longer and the price cheaper, instead of searching for new investment projects. All of this has brought us to the point where we are now. However, in the last 7-10 years Russian companies have been growing in confidence; this process requires money which could be obtained through the bond market, which means that the market will continue to fight for better conditions.